THE WORLD BANK

Internal Discussion Paper

ASIA REGIONAL SERIES

Report No. IDP 74

A Case Study of a Gradual Approach to Economic Reform: The Viet Nam Experience of 1985–88

Zdenek Drabek

September 1990

ASIA REGION DISCUSSION PAPER SERIES 1/

	Title	Author	Date	Originator
IDP2	The Labor Force Participation of Women in the Republic of Korea: Evolution and Policy Issues	C. Grootaert	May 1987	F. Iqbal
IDP15	The Role of Exchange Rate Policy in Four East Asian Countries	Sang-Woo Nam	May 1988	D. Leipziger 81388
IDP28	The Small-Scale Enterprise Credit Program (S.S.E.P.) Under the Second and Third Calcutta Urban Development Projects (CUDP II and CUDP III) - An Assessment	F. Kahnert	March 1988	F. Kahnert 81413
IDP35	Improving Tax Policy Advice: Lessons and Unresolved Issues from Asia Experience	H. Fleisig	June 1989	H. Fleisig 81413
IDP36	Direct Taxes and Fiscal Policy Issues: An Illustration for East Asia	A. Virmani	June 1989	H. Fleisig 81413
IDP37	Commodity Taxation in Selected Countries in South East and East Asia	Z. Shalizi	June 1989	H. Fleisig 81413
IDP38	Tax Analysis in Developing Country Settings	R. Musgrave	June 1989	H. Fleisig 81413
IDP39	Indonesia: External Shocks, Policy Response and Adjustment Performance	Sadiq Ahmed	June 1989	Sadiq Ahme 73723
IDP42	An Analysis of the Nature of Unemployment in Sri Lanka	W.T. Dickens and K. Lang	July 1989	R. Zagha 80433
IDP44	Assisting Poor Rural Areas Through Groundwater Irrigation	F. Kahnert	August 1989	C. Chamberlin 81409
IDP51	Educational Development in Asia: A Comparative Study Focussing on Cost and Financing Issues	Jee-Peng Tan Alain Mingat	October 1989	Jee-Peng Tan 81408
IDP52	Chinese Reforms, Inflation and the Allocation of Investment in a Socialist Economy	Oktay Yenal	October 1989	Oktay Yenal 81415/81416
IDP63	Public Policy to Promote Industrialization: The Experience of the East Asian NICs and Lessons for Thailand	D. Dollar	May 1990	David Dollar 80518
IDP65	A Study of the Poor in Sri Lanka	C. Rouse	June 1990	Y. Huang 80419
IDP68	Health Sector Financing in Asia	C. Griffin	August 1990	Jee-Peng Tan 81408
IDP74	A Case Study of a Gradual Approach to Economic Reform: The Viet Nam Experience of 1985-88	Zdenek Drabek	September 1990	Z. Drabek 80504

1/ Extra copies may be obtained from the Asia Information Service Center.

A CASE STUDY OF A GRADUAL APPROACH TO ECONOMIC REFORM: THE VIET NAM EXPERIENCE OF 1985-88

Zdenek Drabek *
AS2CO

* I am grateful to D. Leipziger, A. Singh and R. Teja for their helpful comments on an earlier draft of this paper. I have also benefitted from the comments of A. Wood on a related paper. None of these colleagues, of course, are responsible for any shortcomings which may remain.

A CASE STUDY OF A GRADUAL APPROACH TO ECONOMIC REFORM: THE VIET NAM EXPERIENCE OF 1985-88

Zdenek Drabek

Abstract

The CEM on Viet Nam recently prepared (Viet Nam: Stabilization and Structural Reforms) presents a convincing case of a largely successful 1989 reform effort in which centralized planning has made way for market socialism. In order to fully appreciate the rapid responsiveness of the economy to revised incentives, it is instructive to review the more half-hearted reform attempts pursued in the 1985-88 period.

In late-1986, the Vietnamese Government introduced economic reform measures - "Doi Moi" or "renovation" as the process became known in Viet Nam, which represented a major departure from central planning. The reform was partially a response to the serious economic crisis, which engulfed the country in the previous years and culminated in a currency reform in 1985. Doi Moi included a package of measures which called for price liberalization, ownership diversification, establishment of the independent status of enterprises, opening up of the economy to commercial relations with foreigners, particularly with countries outside the CMEA trading area, strengthening of agricultural incentives and fundamental reform of the financial system.

On most counts, the reform was a failure. It adversely affected economic growth due to drastic cuts in public investment expenditures necessitated by the reduced availability of resources. The growing real resource problem mainly reflected the deteriorating savings performance of the public sector due to poor fiscal performance and mismanagement of public enterprises as well as the impact of rising inflation on private sector savings. On the supply side, the reform failed to stimulate a dynamic supply response due to the persistence of foreign exchange shortages and serious distortions in incentives and institutional weaknesses. Poor macroeconomic policy also contributed to the proliferation of speculation in productive activities and was directly responsible for the dramatic monetary destabilization. In general, macroeconomic control received inadequate attention and monetary policy was extremely accommodating, particularly to growing demand for credit by public enterprises.

In sum, the reform failures resulted from the authorities' inability to control aggregate demand primarily due to the poor fiscal and monetary policies pursued. The failure to stimulate a supply response was largely due to an incomplete price liberalization, continued arbitrary fixing of the exchange rate, and rigid and highly distorted interest rates. Tax policies discriminated against exports, providing another disincentive to exporters already discouraged by the distorted exchange rate. Inefficient import substitution activities continued to be encouraged through a rigid system of administrative import controls. The supply response was also hindered by weak institutional support, the main shortcomings being inadequate support for the private sector, the complete absence of efficiently functioning institutions for foreign exchange and domestic financial transactions, and, finally, highly circumscribed enterprise autonomy.

A CASE STUDY OF A GRADUAL APPROACH TO ECONOMIC REFORM: THE VIET NAM EXPERIENCE OF 1985-88

Table of Contents

		Page No.
1.	Introduction	1
2.	Slowdown of Economic Growth	3
	Basic Economic Setting	3
	Agriculture-led Slowdown	4
	Investment Cutbacks	7
	Persistence of "Extensive Growth"	8
	Employment Implications	10
3.	The Savings Constraint	12
	Low Savings Propensities	12
	Impact of Policies	15
	Reduction of the Savings Imbalance	16
4.	Rising Foreign Exchange Shortages	17
	Impact of Domestic Demand Pressures	18
	Anti-export Bias	19
	Structural Weaknesses	19
	Deterioration in Terms of Trade	21
	Crucial Role of Foreign Capital	24
5.	Monetary Destabilization	25
	Causes of Inflation	25
	Credit Expansion	26
	Financial Squeeze of Public Enterprises	27
	Fiscal Indiscipline	28
	Fiscal Implications of Price Reform	30
	Dollarization and Collapse of the Exchange Rate	30
	Indexation	31
	Government Role	31
6.	Conclusions: Shortcomings of the 1985-1988 Stabilization Program	33
	Absence of Real Adjustment	33
	Distorted Incentives	35
	Institutional Weaknesses	35
	Ineffective Fiscal and Monetary Policies	35
	Lessons Learned: The 1989 Stabilization Measures	36

1. Introduction

The economic situation in Viet Nam dramatically deteriorated after 1985. This reflected a fairly significant slowdown in economic growth and rapid destabilization of the economy, which led to hyper-inflation. The country accumulated a large external debt, which it has been unable to service. The nature and magnitude of these difficulties have been such that the authorities have admitted the futility of maintaining the traditional centrally-planned ("DRV") strategy of economic growth. They have recognized that without significant changes in economic management, the traditionally high growth rates of output would not be sustainable, and there was a real danger that both the economy and social cohesion could break down under the weight of the population's collapsing confidence in the currency.

Economic reform has a long history in Viet Nam, but the year 1985 was an important benchmark for the country. The half-hearted measures of economic reform adopted throughout the first half of the 1980s had clearly been unsuccessful in containing inflation and reducing serious fiscal imbalances.1/ In response to the serious macroeconomic situation, the Government introduced in 1985 a currency reform and other measures with the objective of stabilizing the economy. Even though the measures have not been successful, they marked the beginning of fundamental change in the perception of the authorities about the future course of economic policy. This change was ultimately reflected in the resolutions of the Sixth Party Congress of December 1986, which called for decentralization of economic decisions, restoration of sectoral balances, and recognition of the importance of markets as a mechanism to allocate resources.

The reforms proposed in December 1986 focussed on six main areas: (i) establishment of the independent status of enterprises with the objective that they operate according to "socialist accounting principles," a concept calling for financial and economic independence of public enterprises; (ii) price liberalization to move away from administratively determined prices to market-determined prices; (iii) ownership diversification to encourage non-state ownership and to provide for a partnership between the state, cooperative and private sectors of the economy. In agriculture, this involved recognition of the failure of collectivization 2/ and a move towards private participation; (iv) opening up of the economy to commercial relations with foreigners, particularly with countries outside the CMEA trading area, and encouragement of foreign investments; (v) relative strengthening of agricultural incentives and institutional support for agriculture to reverse the past

---

1/ For details see S. de Vylder and A. Fforde: Viet Nam: An Economy in Transition; Stockholm: SIDA, 1988, p. 66.

2/ Discussion of the difficulties encountered in the collectivization can be found, for example, in Vu Khieu: Sozdanye Rezhima Kolleknivnogo Khoszyaistvovaniya Preodoleniye Perezhitkov Razvitiya Melkogo Proizvodstva v Protsese Sotsialisticheskogo Obobschestvlenyia, in Ekonomicheskye Problemy Perekhoda k Sotsialiszmu Stran s Nerazvitoi Ekonomikoi; Moscow: Nauka, 1986, pp. 49ff.

trend of supporting industry and (vi) fundamental reform of the financial system to separate central banking functions from those of the newly created commercial banks. Also implemented were adjustments in official exchange rates and some liberalization of foreign exchange regulations.

The purpose of this paper is to assess the country's recent macroeconomic performance (1985-88), to identify the main causes of economic growth slowdown and of acceleration of inflation during this period, and evaluate the extent to which economic policy affected the performance. It will be argued that the economic difficulties were mainly of domestic policy origin even though cuts of Western assistance as well as reduction in commercial relations with the West following Viet Nam's invasion of Kampuchea have also played a role. The reform measures introduced after the 1986 Party Congress clearly failed; the design of the reform included measures that were incomplete, poorly sequenced and implemented. The details of the specific measures are discussed in the recent Country Economic Memorandum and they are not repeated in this paper. The failure of the 1986-88 reform stimulated adoption of further measures in 1989 that dramatically deepened and accelerated the reform. It was not until these additional and radical measures were introduced that economic performance improved.

The measures of the economic reform of 1986-88 adversely affected economic growth, and the effects were felt on two levels. On the demand side, the Government drastically cut its investment expenditures, which resulted in a major demand shock. The cut in investments was necessitated by the reduction in the availability of resources, which mainly reflected the deteriorating savings performance of the public sector due to poor fiscal performance and mismanagement of public enterprises. Government policy was also responsible for the poor savings performance of the private sector (households) due to Government's loss of control over inflation. On the supply side, the reform was not successful in stimulating a dynamic supply response. This was mainly due to rising foreign exchange shortages, which largely reflected poor investment planning, persistence of serious distortions in incentives and inadequate institutional reform. Poor macroeconomic policy has also contributed to the proliferation of speculation in productive activities.

The 1986-88 reforms were also responsible for a dramatic monetary destabilization. The measures initiated were concentrated on microeconomic policies, while macroeconomic control received inadequate attention. Monetary policy was extremely expansionary to accommodate a rapid growth of demand for credit originating in poorly managed public enterprises and fiscal indiscipline. In addition, the Government made the situation worse by inappropriately sequencing price reforms, incomplete liberalization of inter-enterprise transactions, wage indexation and its failure to recognize the fragility of the tax base.

At the end of 1988 and in the beginning of 1989, the Government economic policy made a dramatic turnaround. The Government adopted measures which demonstrated its determination to stop inflation by adopting radical measures of both macroeconomic and microeconomic nature. It has learned from the recent experience and from the lessons of the gradual approach to economic reform that nothing short of strict macroeconomic management combined with measures to encourage supply response will succeed in bringing inflation under control. The measures are briefly discussed at the end of this paper, and more detailed discussion can be also found in the recent Country Economic Memorandum.

Unfortunately, available statistical information on the Vietnamese economy does not allow rigorous analysis of the country's economic ills. Data are often scanty, and even when available, they are not necessarily of the best quality. As a result, it was impossible to undertake detailed analysis of the income and expenditure sides of national income due to the absence of reliable national income accounts. Interpretation of some officially-provided data was difficult. Moreover, national income accounts are based on the so-called MPS concept, which does not make them directly comparable with the Western (SNA) definition of national income. Even though national income figures used in this paper were re-estimated and converted to the SNA basis, they remain only estimates. All these problems are particularly relevant for this paper, which relies heavily on analysis of national income accounts. The findings should, therefore, be treated with caution.

The paper is divided into five further sections. Section 2, which analyzes the recent growth of GDP and its components, shows that economic growth has decelerated and that the main causes of this slowdown were highly disappointing growth in productivity and the impact of various policy measures aimed at reducing the savings-investment imbalance. The reduction in the savings-investment imbalance was achieved by a reduction in investments while the availability of domestic and foreign resources most likely declined during the 1985-88 period. These issues are discussed in Sections 3 and 4, respectively. Section 5 reviews the monetary and fiscal policies pursued at the time and identifies the causes of inflation. The stabilization measures adopted in the course of 1985-88 are assessed in the concluding section, which argues that the stabilization policy and the gradual approach to economic reform were highly unsuccessful and further weakened the already highly destabilized economy.

2. Slowdown of Economic Growth

Basic Economic Setting. Viet Nam's economy is typical of a highly underdeveloped country. While the country's national income figures are affected by serious statistical distortions, there is general agreement that Viet Nam belongs to the group of poorest countries in the world with a per capita income close to that of Bangladesh. The nutritional status of the population is very low even by international standards, and malnutrition is widespread, especially among children. The economy is heavily oriented towards agriculture, with 68 percent of the labor force in agriculture in 1988. According to the authorities, the share of agriculture in national income (MPS concept) was 46.2 percent in the same year, while the industrial share was 32.3 percent.

The country has a tremendous potential for development that has been so far untapped. The natural resource endowment is very promising, and remains underutilized. Similarly, human resources constitute a major national asset, reflecting the high level of educational attainment, impressive healthcare achievements and long entrepreneurial tradition. With its population of 65 million, Viet Nam potentially represents a very large market, which similarly has not been well utilized so far. This is mainly due to a serious lack of infrastructure in rural areas and the difficulties of integrating the northern and southern parts of the country. At the same time, the economy has been poorly integrated with the world economy, reflecting in part the economic sanctions imposed on Viet Nam by the West following Viet Nam's military involvement in Kampuchea and in part the Government's deliberate choice to pursue closer ties with the Soviet Union and other CMEA countries. The production performance of industry and agriculture has also been well below the country's potential. Crop yields have been very low, and grain production has absorbed excessive manpower. Industrial efficiency has also been extremely low.

Agriculture-led Slowdown. The period of 1985-1988 witnessed a dramatic slowdown in domestic economic growth. After the fairly respectable growth during the Third Five-Year Plan period (1981-85), when the average annual rate of growth of national income reached 6.4%, growth steadily decelerated (Table 1). This was primarily due to the near-disastrous performance of agriculture, which was seriously affected by a series of natural calamities (typhoons and floods, spread of insects and pests) but which also suffered from a long period of neglect and forced collectivization. The result was a stagnation of agricultural production throughout 1985-88 and a decline of output in 1987.

Alhough official data show continued growth of industrial output, industrial performance also deteriorated. The growth of industrial value-added slowed to 4.5 percent in 1986, a low rate by historical standards. Even though the rate of industrial growth picked up in 1987 and 1988, there are reasons to believe that data on the value of industrial output during this period may be overstated.3/ The main cause of decelerating industrial growth was the increasing difficulty of industrial enterprises to secure intermediate inputs, particularly inputs obtained from abroad, which in turn reflected extremely serious foreign exchange shortages. The slowdown was also due to slower growth in domestic demand for industrial goods, partly reflecting the serious agricultural situation and stagnation of agricultural incomes.

While the role of other sectors in the economy is much smaller than that of industry and agriculture, which together account for more than 75 percent of GDP, their contribution to growth has not been insignificant. It is widely accepted that the contribution of other sectors has been greatly

---

3/ Comparisons between national income accounts and physical indicators of industrial output performance raise doubts about the accuracy of the industry components of national income accounts.

underestimated, particularly during the last two to three years, and the emergence of various private sector activities which were allowed to proliferate on an increasing scale after the Party Congress in 1986.4/ Their contribution to output and employment is underestimated primarily because they often constitute informal sector activities and, therefore, "escape" the grasp of statisticians and tax authorities. Retail trade activities especially mushroomed after the authorities facilitated contacts between Vietnamese nationals and their family members and others living abroad.

4/ The impetus was provided by the Decree of February 22, 1987, which legalized private sector activities in Hanoi. Other cities and provinces followed suit in the next few months. See G. Will: Vietnam nach dem 6. Parteitag der KPV: Zwei Schritte Forwards, Ein Schritt Zuruck; Koln: Berichte des Bundesinstituts fur Ostwissenschaftliche und Internazionale Studien, 20-1988.

Table 1: VIET NAM: SELECTED INDICATORS OF PRODUCTION, INPUT USE AND CHANGES IN AGGREGATE DEMAND /a

	[1984=100]				
	1984	1985	1986	1987	1988
1. Production					
GDP	100	105.6	109.2	111.9	118.5
Industrial Output	100	112.4	117.5	130.8	144.4
Gross Output: Heavy Industry	100	111.3	116.2	127.5	133.7
Light Industry	100	112.4	120.3	131.5	146.0
Agriculture	100	104.5	106.0	102.4	106.0
Foodgrain production per capita	100	99.7	98.7	92.1	97.4
2. Input Use					
Total Employment	100	103.6	109.2	111.6	114.3
Industrial Employment	100	107.7	111.5	119.2	123.1
Industrial Productivity (Industrial Net Output/Man)	100	104.4	105.3	109.7	117.3
Agricultural Employment	100	104.5	110.0	112.5	115.8
Agricultural Productivity (Net Output/Man)	100	100.0	96.4	91.2	92.3
Cultivated Area	100	100.2	99.9	98.4	101.8
3. Aggregate Demand					
Total Fixed Investments	100	106.9	88.5	69.0	58.3
Fixed Investments: Construction	100	115.9	97.1	77.7	63.6
Fixed Investments: Machinery	100	72.0	61.2	50.2	44.0
Fixed Investments: Heavy Industry	100	101.8	94.0	90.2	93.5
Fixed Investments: Light Industry	100	90.4	92.2	85.3	60.3
Fixed Investments: Transport	100	92.9	67.2	37.5	33.4
Fixed Investments: Non-productive Sectors	100	139.8	98.4	82.4	41.8
Fixed Investments: Agriculture	100	105.4	98.3	62.7	63.8
Exports: Convertible Currency	100	121.7	111.2	155.8	168.5
Non-convertible Currency	100	111.4	129.3	117.1	169.0

/a Data expressed in constant (1982) prices, except foodgrain production, which was calculated in physical terms, and exports, which were calculated in U.S. dollars ("convertible currency") and transferable rubles ("non-transferable currency").

Source: Based on tables provided by the authorities.

Investment Cutbacks. The slowdown of economic growth was the product of emerging constraints both on the demand and supply sides. On the demand side, constraints emerged from the adverse impact of poor agricultural performance on domestic incomes, and from the impact of various policy measures adopted by the Government in 1986 and in subsequent years. As part of its stabilization program to reduce inflationary pressures, the Government took radical steps to reduce the fiscal deficit, which by 1985 is estimated to have reached almost 17 percent of GNP.5/ The program involved a major adjustment in public investment expenditures, which were reduced dramatically between 1985 and 1988. As shown in Table 1, total fixed investments were cut by as much as 42 percent in real terms in only three years, between 1985 and 1988. Even though the reduction in investments fell primarily on expenditures for purchases of imported machinery in view of the high import content of domestic machinery investments, the reduction also adversely affected domestic production. This direct impact on domestic output brought about the simultaneous reduction of Government expenditures on construction, which amounted to as much as 37 percent of total investments during the same period.

The impact of the massive reduction in public investments on the economy cannot be fully assessed due to serious data problems. According to official investment statistics and IMF estimates of GDP, however, the share of total fixed investments in GDP was slightly below 13 percent in the mid-1980s (Table 1). The great bulk of all fixed investments originated in the public sector and was largely financed through the central budget. By international standards, therefore, especially by standards of centrally planned economies, the investment share in GDP appears to have been very low. However, there are reasons to believe that the absolute level of the investment share is underestimated, and the degree of underestimation is probably very large. This is due to a significant undervaluation of capital goods, reflecting four major sources of distortions: the biased method of domestic price formation, a highly overvalued exchange rate, "undervalued" capital goods in terms of convertible currencies in the CMEA market, and exclusion from national income accounts of investments originating in cooperatives, the private sector and locally-managed enterprises.

The methodology of domestic price formation biases the relative prices of capital goods mainly due to the failure to account correctly for the scarcity value of capital. Until the recent major correction, the "overvaluation" of the exchange rate stemmed from the authorities' practice of determining the price of foreign exchange administratively, without giving due consideration to the true economic value of foreign exchange.6/ The "undervaluation" of capital goods in the CMEA market arises due to the perverse

---

5/ The stabilization program including the fiscal measures are discussed in greater detail in Section 2 below. In view of the likely underestimation of GNP, the share of fiscal deficit in GNP has been recently revised to 12 percent. There is no doubt, however, that the deficit was large by most standards.

6/ The "correction" was made by devaluing the currency to the approximate level of the unofficial (i.e., black-market) rate. For further details see discussion in Section 5 below.

mechanism of price negotiations among CMEA member-countries, which does not allow an automatic transmission of changes in world prices into the corresponding CMEA prices.

With these caveats in mind, the implications of the investment cuts are likely to have been extremely serious. In addition to the direct impact on the construction industry noted above, the original level of total investments was probably sufficiently large to bring about a correspondingly large shock to other domestic suppliers of capital goods, and through enterprise linkages to the rest of the economy. According to Bank estimates, for example, the 1985 investment share in GNP would increase to 25 percent after a conservative adjustment is made for "overvalued" exchange rate.7/

Persistence of "Extensive Growth" Approach. On the supply side, the principal cause of economic slowdown, in addition to the factors affecting agricultural performance noted above, was the low and declining efficiency of production. In the past, the Vietnamese economy developed along the path known from other centrally planned economies as "extensive growth".8/ The concept of "extensive growth" identifies as the main sources of economic growth expansion of factor inputs rather than their better utilization and higher efficiency. The symptoms of such growth are high investment rates originating in the "investment hunger" of public enterprises, expansion of production capacities rather than better utilization of existing capacities, growing labor employment as well as growth of the land area under cultivation. Even the use of natural resource-based intermediate inputs tends to grow faster than in bona fide market-economies as a result of planners' promotion and the protection of natural-resource-using industries and due to large x-inefficiencies. Slow or even negative growth of total factor productivity is, therefore, typical of such economies. Production subsidies become pervasive as enterprises are unable to generate sufficient financial resources.

As seen in Table 1, the features of "extensive growth" have been present in Viet Nam, and they have persisted despite the Government's attempts to increase production efficiency. Investment spending has been traditionally oriented towards industry rather than agriculture, and within industry towards heavy rather than light industry. The investment cuts introduced in 1986 did

---

7/ The "overvaluation" was assumed to amount to 1,000 percent. While this constitutes a massive distortion, the assumption is still most likely conservative. In comparison to the unofficial rate in the same year, for example, the official dollar exchange rate was "overvalued" 64 times. Clearly, the unofficial black market rate is not necessarily the most economically meaningful rate, but it implies that the working assumption is not unreasonable.

8/ This is discussed at greater length in de Vylder and Fforde, op. cit., and A. Fforde and S. Paine: The Limits of National Liberation; New York: Crook Helm, 1987. See also Vu Huu Tu: Problemy Sotsialisticheskoi Industrializatsii vo Vietname; Ekomicheskye Problemy Perekhoda, p. 189.

very little to reverse this pattern. In fact, the traditional bias towards heavy industry has been maintained as the authorities made a determined attempt to concentrate investible resources on completion of ongoing projects in this sector.

As a result of the investment cuts and the continued priority given to heavy industry, the public investment program could not be effectively used to relieve or at least mitigate the most serious constraints that adversely affect domestic growth. Arguably the most severe supply constraint has been the lack of infrastructure, which has affected virtually all productive sectors of the economy. Agriculture has suffered from the absence of an efficient irrigation network, poor transport and storage facilities and lack of effective extension services. Growth of industrial output has also been severely constrained by poor transport, a highly inadequate communications network, and a primitive trade and distribution network. The investment choices made the overall situation even worse as investments for infrastructural sectors declined even more dramatically than investment as a whole. The transport and communications sectors were most affected, receiving in 1988 only a third of the investible resources provided in 1984. At that rate, the transport sector could hardly finance the existing capital stock needing replacement.

The use of other inputs expanded. Labor employment continued to rise steadily, reflecting the rise in both industrial and agricultural employment. The growth of industrial employment was particularly fast (an average rate of 5.3 percent per annum). In agriculture, the size of the cultivated area remained more or less unchanged mainly because no further expansion was possible in most parts of the country. As a result of the slowdown in the rate of growth of output and the growth of employment, labor productivity performance continued to be disappointing. The growth of output per man in industry was modest and in agriculture output per man declined dramatically between 1984 and 1987. In 1988, agricultural output per man was only marginally higher than five years earlier.

The continuation of industrial growth in spite of investment cuts points to the presence of underutilized capacity in the mid-1980s. Unfortunately, the information on capacity utilization in industry is very scarce but fragmentary evidence provided by some secondary sources 9/ confirms this hypothesis (Table 2). The presence of spare capacity combined with continued demand for industrial products assured that industrial growth did not stop despite insignificant additions to existing capacity during this period. With further cuts in investment spending and growing financial difficulties in 1989, the problem of serious capacity underutilization re-emerged. According to a study of the Ministry of Labor, 18-20 percent of industrial workers and 10-12 percent of administrative personnel were temporarily unemployed in 1989.

9/ According to Andreff, the average capacity utilization in industry in 1987 was 30-50 percent. See W. Andreff: "Les Reformes en Coree du Nord et au Viet Nam": Economie et Humanisme; September-October 1988, No. 303, p. 61. Similar estimates are quoted in A Review of the Economics of Vietnam, Laos and Kampuchea; Australian National University, National Center for Development Studies, April 1989, p. 12.

Table 2: VIET NAM: CAPACITY UTILIZATION IN INDUSTRY

	1976-80	1981-85
Output gains and increases in installed capacity in selected branches of industry:		
Electricity		
1. Capacity gain, m kW	0.116	0.446
2. Output gain, m kWhr	563.1	1389.9
3. line 1: line 2 x 10,000	2.1	3.3
Fertilizer		
1. Capacity gain, 1,000 t/year	69.2	275.7
2. Output gain, 1,000 t	-74.5	171.2
3. line 1: line 2	-	1.6
Cement		
1. Capacity gain, 1,000 t/yr	573.0	2410.4
2. Output gain, 1,000 t	-110.7	948.9
3. line 1: line 2	-	2.5
Fibers		
1. Capacity gain, 1,000 t/yr	16.3	33.1
2. Output gain, 1,000 t	-	20.3
3. line 1: line 2	-	1.6

Source: S. de Vylder and A. Fforde, An Economy in Transition, Stockholm, SIDA, p. 101.

Employment Implications. The slowdown in production growth had serious implications for the growth of employment opportunities, and consequently, for the general employment situation. Given rapid rates of population and labor force growth, the slowdown in domestic economic activities increased pressures in the labor market, leading to serious open unemployment, particularly in urban areas, and to large underemployment in rural areas.10/ Even though total employment grew steadily throughout the period, the increase came mainly from rapid absorption of labor in agriculture. During 1984-88, agriculture employed 2.8 million more people, which corresponded to 78 percent of the total number of new jobs created during that period. In view of the stagnation in agricultural output, the growth of agricultural employment did not originate in the expansion of effective demand for labor. Instead, it represented the failure of sectors other than agriculture to absorb the rapidly growing labor force and the need for greater family employment.

10/ According to Nhan Dan, there were 2.6 million people unemployed in March 1987. See W. Andreff, Op. Cit., p. 61.

As noted above, industrial employment was also growing rapidly, but the relative size of the sector was too small to absorb all new entrants into the labor market. Together with agriculture, industry generated almost all new jobs in the formal sector during 1985-88 (95 percent). Starting approximately in 1988, an increasing number of people began to set up various informal sector activities such as street cafes, repair shops, restaurants, vending, etc. How many people have been actually absorbed in the informal sector is not known, but the numbers are probably significant. The poor employment record of other formal sector activities has also reflected the government policy of restraining the growth of public employment in view of serious budgetary difficulties, particularly in 1987 and 1988. According to official sources, 31 central government agencies have retired or fired 40 percent of their workers. About 10,000 provincial and district employees were laid off. In total, 10 percent of all central government employees and 20 percent of provincial government employees have been put out of work.11/

In the beginning of 1989, the employment situation further deteriorated as the financial difficulties spilled over to industry. Following the recently adopted measures to stabilize the economy, many industrial enterprises found themselves in a serious financial situation due to a credit squeeze and the high cost of borrowing. The precise impact of these measure is not known but both redundancies and failure of enterprises to pay wages to their employees have been widely reported in the local press.12/

In view of the rapid growth of the labor force and the slowdown of economic growth, unemployment increased. Tensions in the labor market were further aggravated by the recent demobilization of soldiers, which is likely to accelerate after the withdrawal of the Vietnamese army from Kampuchea.13/ According to official sources, the total number of unemployed or irregularly employed people was six million in mid-1988, or about 20 percent of the total labor force. If the underemployed are also included, total underemployment is 40 percent of the total labor force according to official estimates.

The Government has used various measures to alleviate the difficult employment situation. Throughout the period, the authorities resisted pressures to permit large-scale redundancies by providing assistance to financially-strapped enterprises. This practice was abruptly stopped with the stabilization measures of 1989. Another initiative was a resettlement scheme to relocate workers and their families from high density areas to new economic zones, mainly located in the central highlands. According to the authorities, the total number of people resettled under the scheme in 1988 was 80,000,

---

11/ As reported in the Bangkok Post, May 30, 1989.

12/ Failure to pay wages was reported in the coal and rubber sectors, 17 enterprises were dissolved in Tay Ninh, and the Quangh Ninh Coal Mine was expected to lay off 1,600 workers.

13/ According to recent reports of the Ministry of Defense, more than 25,000 demobilized soldiers have already been sent to the Soviet Union, GDR, Czechoslovakia and Bulgaria for overseas employment. See FBIS-EAS July 10, 1989, p. 88.

which brought the total number of people relocated in the 1981-88 period to 2 million, including 900,000 workers. However, due to financial difficulties, poor preparation of the sites earmarked for the new economic zones and other organizational problems, the scheme has run into serious implementation problems. The recent contribution of the scheme has, therefore, been rather limited. In addition, the Government signed several agreements with other socialist countries, which provide employment opportunities overseas.14/

3. The Savings Constraint

It was argued in the previous section that sharp cuts in public investments represented one of the most dramatic changes in the domestic growth strategy during 1985-89. The cutbacks were necessary due to the limited domestic and foreign resources which could be mobilized to finance investments and the need to stabilize the domestic economy, which was subject to severe inflationary pressures. The purpose of this and the succeeding section is to evaluate the extent to which the resource constraint has become tighter, and to trace the origins of the changes. This will be done by analyzing investment-savings balances. The stabilization policy will be discussed in Section 5 further below.

In order to evaluate the overall resource constraint it is necessary to rely heavily on various estimates of segments of national income accounts. In addition to the problem of definition of national income noted above (para. 7), national income accounts in Viet Nam are constructed by consolidating production accounts because the expenditure and income components of national accounts, the statistical information required for the present exercise, are not available. Furthermore, precise statistical accounting of incomes and expenditures in Viet Nam has recently become very difficult due to the emergence of hyperinflation and overvaluation of the exchange rate. The data presented in the following analysis should be, therefore, treated with caution and as only indicative of broad trends.

Low Savings Propensities. The data shortcomings notwithstanding, there is no doubt that the Vietnamese economy is starved of capital and the savings to finance investment. In the mid-1980s, aggregate domestic savings are estimated to have reached about 9 percent of GDP, falling far short of the overall requirements for fixed investments (Table 3). The resulting savings-investment imbalance had to be financed by foreign savings, which in 1985 accounted for almost 6 percent of GDP. The imbalance was partly due to the high level of investments, the true level of which is most likely considerably above the officially quoted share, as noted above.

14/ According to Western sources, some 60,000 Vietnamese workers were in socialist countries in 1984, including 20,000 in the Soviet Union and 30,000 in Czechoslovakia. Most likely, this considerably expanded in recent years. Recent Western reports have suggested, for example, that 17,000 Vietnamese workers are in Bulgaria and 29,000 remained in Czechoslovakia. Vietnamese workers are also in the GDR, Poland, Iraq and Algeria. See Bulgaria's Ethnic Policy Backfires, Washington Post, p. 12, July 1989; M. A. Crossnier and E. Lhomel, "Vietnam: Les Mecomptes d'un Socialism Asiatique," Le Courrier des Pays de l'Est, July-August 1987, No. 320, p. 17, and Mladá Fronta, November 1, 1989.

Table 3: VIET NAM: AGGREGATE RESOURCE BALANCE, 1984-88 /a
(As percent of GDP)

	1984	1985	1986	1987	1988
1. GDP at Market Prices	100.0	100.0	100.0	100.0	100.0
2. Resource Gap (M-X) = 3-4	5.5	4.7	5.8	3.9	3.2
3. Imports G + NFS					
4. Exports G + NFS					
5. Total Domestic Absorption = 1+2 = 6+10	105.5	104.7	105.9	103.9	103.2
6. Consumption = I+8+9 = 5-10	91.2	90.0	93.6	94.1	95.0
7. - N G					
8. - L G U					
9. - Private					
10. Domestic Investment = 11+12 = 13-2	14.4	14.7	12.3	9.8	8.2
11. - Fixed I	12.6	12.8	10.3	7.8	6.2
12. - Changes in Stock	2.0	2.0	2.0	2.0	2.0
13. Domestic Savings = 1-6 = 2+10	8.9	10.0	6.4	5.9	5.0
14. - Net Factor Income					
15. - Current Transfers	-0.4	-0.7	-0.5	-0.4	-0.3
16. National Savings = 13-14-15	8.4	9.3	5.9	5.5	4.7

/a The sums may not add up due to rounding.

Source: Bank estimates. GDP figures are from the IMF.

In addition to large (historical) investment requirements, however, the savings-investment imbalance also reflects a low average propensity to save. As seen in Table 4, the domestic savings-GDP ratios in neighboring countries were much higher than in Viet Nam, which enabled the former countries to self-finance a much larger proportion of their domestic investment programs and at the same time to sustain high investment rates. Thailand, Korea and Taiwan are included in the comparison to dramatize the investment rates to which Viet Nam should aspire. They are also appropriate comparators in view of their relative geographical proximity and many cultural similarities to Viet Nam, which tend to be important determinants of savings rates. Even if the savings rate of Viet Nam shown in Table 4 is underestimated 15/ the difference in the comparison with other countries is so dramatic that the lower savings propensities of Viet Nam can hardly be doubted.

15/ See discussion further below in this section.

Table 4: VIET NAM: COMPARISON OF SAVINGS RATES AND INCOME LEVELS /a

	1971-75	1981-85
Thailand		
Per Capita GDP ($)	468	718
Gross Savings Rate (%)	23.6	19.5
Korea		
Per Capita GDP ($)	848	1,812
Gross Savings Rate (%)	17.5	24.6
Taiwan		
Per Capita GDP ($)	1,719	3,140
Gross Savings Rate (%)	30.8	32.3
China /b		
Per Capita GDP ($)	256	290
Gross Savings Rate (%)	32.1	35.1
Viet Nam		
Per Capita GDP ($)	-	170
Gross Savings Rate (%)	-	7.2

/a Savings rates are defined as gross domestic savings as percentage of GDP (GNP).

/b The per capita figures refer to 1979 and 1987 respectively. Gross savings rates refer to the averages of 1978-1982 and 1983-1988 respectively.

Sources: World Bank: Thailand: Building on the Recent Success - A Policy Framework (Country Economic Memorandum); Washington, D.C., The World Bank, 1989; World Bank: China: Socialistic Development; Washington, D.C., The World Bank, 1983, Vol. 1 and Growth and Industrialization under Decentralized Socialism (Country Economic Memorandum), Washington, D.C., The World Bank, 1989; Viet Nam: Author's estimates, which differ from GDP figures used in Table 3 to account for exchange rate overvaluation and for the underestimation of services and private sector. The numbers are therefore, inconsistent with the saving rate shown in this table, which was based on the original figures. The GDP estimates are tentative.

The emerging serious shortages of domestic resources for investments could have been offset by a corresponding growth of foreign savings, but the inflow of foreign savings has been severely constrained by Viet Nam's increasing difficulties in mobilizing foreign resources by borrowing and its extremely limited access to foreign capital. Thus, the rising domestic savings constraint has been accompanied by a tightening foreign exchange situation. On both accounts, the situation became worse during 1984-88, as shown in Table 5.

It is plausible that the lower savings rates originated in the country's lower income level. As indicated in Table 4, the income levels of the comparator countries were considerably higher than those in Viet Nam. However, lower income levels provide only a partial explanation. Even if an appropriate adjustment were made for income levels, consistent differences in savings rates are still maintained. This can be seen from the comparison with Thailand in the beginning of the 1970s and with China, where income levels per capita are not too dissimilar.

Impact of Policies. Although low income levels are important, perhaps an even more important determinant of the low savings rate is what may be termed an "excessive proclivity to spend." As seen in Table 5, the low savings rate reflects poor savings performance of both the public and private sectors, even though the reasons are different for each. In the public sector, the agent responsible for poor saving performance appears to be the Government, which has been a net dissaver. On closer inspection of fiscal accounts, however, it is evident that the Government's dissavings are closely, though not exclusively, related to the performance of public enterprises and to their low operational efficiencies. The inefficiencies result in poor financial performance, inadequate internal cash generation and, consequently, a need for subsidies.16/ To some extent, therefore, the Government's dissavings represented the unwillingness of central and provincial governments to discontinue support of unprofitable enterprises. The budgetary support was temporarily lifted in 1986 only to be reintroduced in the following years, but the authorities proposed to eliminate the bulk of production subsidies in 1989. In sum, the Government has faced some difficult choices with regard to public enterprises, which it was not willing to make.

Although interpretation of data on the savings performance of the private sector is not straightforward, it is clear that the average saving propensity of the private sector has also been low. The shares of the private sector have been calculated in the table as the residual between aggregate savings and government savings, and they include, therefore, not only households and private firms but also the public enterprise sector. Even though many public enterprises are not profitable, it is unlikely that the public enterprise sector as a whole is a net dissaver. The private sector savings in Table 5 are, therefore, overstated.

16/ See discussion of fiscal accounts in Section 5 below.

Table 5: VIET NAM: SAVINGS AND INVESTMENTS IN PUBLIC AND PRIVATE SECTORS, 1984-88
(as percent of GDP)

	1984	1985	1986	1987	1988
Public Savings /a	1.2	-5.9	-0.5	-0.8	-3.9
of which:					
Central Government	1.2	-5.9	-0.5	-0.8	-3.9
Private Savings /b	7.7	15.9	5.9	5.1	1.1
Foreign Savings /c	5.5	4.7	5.8	3.9	3.2
Public Investments	14.4	14.7	12.3	9.8	8.2
of which:					
Central Government /d	5.9	11.7	6.0	5.1	5.1
Public Enterprises /e }					
Local Governments /e }	8.5	3.0	6.3	4.7	3.1
Private Investments	-	-	-	-	-

/a Calculated as government revenues less government recurrent expenditures (net of interest).
/b Private savings defined as the difference between total domestic savings and public savings.
/c Foreign savings are defined as the difference between imports and exports of goods and non-factor services.
/d Central Government investments refer to capital expenditures.
/e Calculated as the residual between total investments and government capital expenditures.

Source: Author's estimates.

Saving by the private sector has been discouraged by a variety of factors. Until their recent significant increase, interest rates have been extremely low and, after allowing for inflation, real rates of interest have been negative. The opportunity costs of holding money were, therefore, also high. The financial tools to mobilize resources and the monetary instruments for Government to finance fiscal deficits have been extremely primitive. This has restricted the scope for both resource mobilization and non-inflationary deficit financing. At the same time, the confidence of the general public in the financial system was low due to the absence of an independent and financially sound banking system. As a result, a considerable amount of private sector resources was not intermediated through the financial system but remained outside official channels, where it was typically exchanged for gold or other highly liquid assets, such as convertible currencies.

Reduction of the Savings Imbalance. The serious resource constraint has been to some extent mitigated in recent years. The large savings imbalance of the early 1980s was reduced during the last four years, providing some relief for the authorities. However, the improvement has not been achieved through increased mobilization of domestic and foreign savings, but it has come about from the considerable restraint in investment spending noted earlier. This pattern of adjustment was highly undesirable. It has also been contrary to the intentions of the authorities, who took wide-ranging measures in 1986 to reduce fiscal deficits and increase Government savings. Although they initially succeeded in achieving their fiscal targets, the success was short-lived. After a considerable improvement in 1986, reflected in a significant reduction in the rate of Government dissaving, the Government dissavings increased in 1987 and even further in 1988.

At the same time, the potential for increased use of foreign savings had all but disappeared, as discussed in the following section. The current account deficit as a percentage of GDP was reduced, but this reduction combined with the decline in aggregate savings rates and virtually no foreign reserves necessitated reduction in investment rates. For 1989, the authorities proposed a further reduction of investments. According to the annual aggregate, fixed investments were expected to drop to D 11.7 billion (in 1982 prices), a 14 percent decline compared to 1988. By the end of 1989, the share of aggregate fixed investments in GDP was projected to reach only 5.1 percent. Some of the cuts would come from lower investment spending by the Central Government, but most were expected to originate in lower investment spending by local governments and public enterprises. The Government policy has been to reduce if not eliminate new investments, which implies that the resources available for investments in 1989 were primarily for ongoing projects.

It is also evident that by 1989 the investment picture and consequently future growth prospects had become near-disastrous. The rate of aggregate investments amounting to some 5-6 percent of GDP would imply that producers would have resources hardly sufficient to replace run-down capital stock, let alone finance expansion of production capacities. Since investment spending by the Central Government was already reduced to a dangerously low level and the existing resources were devoted mainly to ongoing projects, the Government's ability to provide counterpart funds for foreign-assisted projects was nonexistent.

4. Rising Foreign Exchange Shortages

The supply problems noted above also had their origins in poor policies. While domestic demand was restrained as a result of investment cutbacks and poor agricultural incomes, growth of domestic production could have been sustained only if the emerging domestic demand constraints could be neutralized. This would have required faster growth of exports and/or cheaper and better quality products for domestic consumers. Both would have required better access to foreign exchange. Instead, Viet Nam faced increasing difficulties in generating foreign exchange from exports, in mobilizing foreign resources by borrowing and in attracting foreign investment. However, foreign exchange shortages continued to rise, partly due to government policies, as is indicated by the following analysis of the current and capital accounts of the balance of payments.

As in the case of national income analysis, the analysis of balance of payments accounts is complicated by serious statistical problems. Even though the balance of payments statistics are relatively comprehensive, they are severely distorted by the official exchange rates which prevailed in Viet Nam until the recent reform of the exchange rates system, which will be discussed further below. The main problem with the former exchange rate system was the administrative determination of the rate, which was entirely arbitrary and paid no regard to the scarcity values of foreign exchange. The distortions pertained not only to the determination of the dollar rate but also to the transferable ruble rate as well as to the determination of the (implicit) cross exchange rate between the U.S. dollar and transferable ruble. As a result, the conversion of trade flows into domestic currency values at official exchange rates became virtually meaningless in view of the dramatic distortions that accompanied the rates. In addition, consolidation of the convertible and non-convertible currency components of the balance of payments accounts is very difficult due to arbitrary changes in the (implicit) cross exchange rate between the U.S. dollar and transferable ruble. Unless otherwise indicated, therefore, the two components of the balance of payments are analyzed separately.

Impact of Domestic Demand Pressures. The slowdown of economic growth noted earlier had the undesirable consequence of increasing the tensions in domestic markets. While a slowdown of economic growth in market economies reduces the extent to which the economy is overheated and, consequently, the inflationary pressures, the economic slowdown in Viet Nam contributed to the persistence of chronic shortages of goods and services.17/ To the extent permitted by the availability of foreign exchange, these shortages were mitigated by growing imports rather than by price adjustments and resource reallocations. The latter has been due to continued price controls, which distorted producers' incentives and encouraged demand. As a result, imports escalated between 1984 and 1988, growing at an average rate of 6.5 percent per annum from the convertible currency area in current dollar terms, considerably faster than the growth of real GDP (1.4 percent per annum). Even more rapid was the growth of imports from the nonconvertible currency area, which amounted to 15.5 percent per annum in current transferable rubles.

As impressive as the growth of imports from the non-convertible currency area was, the demand for such imports was clearly excessive, and could not be satisfied by traditional suppliers of these imports. Under the CMEA trading arrangement, which corresponds to the non-convertible currency area and includes Viet Nam, trade has to be balanced on bilateral trading accounts, and any excess of imports over exports constitutes an automatic financing provided by the import-supplying nation. The growth of Vietnamese imports from these countries was, therefore, constrained by the amount of credit which the CMEA countries were willing to provide. As a result, the demand for imports for such basic commodities as steel or fertilizer, which were traditionally imported from CMEA countries, spilled over into the convertible currency area. Foreign exchange shortages, therefore,

---

17/ This issue is extensively discussed by R. Portes, "The Theory and Measurement of Macroeconomic Disequilibrium in Centrally Planned Economies," London: Center for Economic Policy Research, Discussion Paper No. 91, 1986.

increasingly took a different shape--exports had to be directed to the convertible currency area, which is typically much more competitive than the CMEA market and, consequently, much more difficult to develop.

Anti-export Bias. At the same time, excess demand in domestic commodity markets put pressure on domestic producers of exportables to divert their products to the domestic market. This diversion of exportables to domestic markets was stimulated by strong anti-export biases in the incentives system. The exchange rate was extremely overvalued until recently, when the dong was devalued against the U.S. dollar 20 times compared to the 1988 level. The bias against commodity exports was further strengthened by the system of multiple exchange rates, which were only recently unified. Moreover, since competition in Vietnamese markets was practically eliminated by a foreign trade monopoly, domestic producers had captive markets and they were under no immediate pressure to increase the competitiveness of their products. Exporters themselves had no particular desire to penetrate highly competitive Western markets partly because of the ready markets at home and in COMECON, and partly because benefits incurred to the enterprises were limited by high taxation, highly circumscribed profit incentives and shortages of foreign exchange while the risks of failure were also considerably higher in the competitive markets.

In addition to poor trade incentives, exports were seriously impeded by highly restricted access to world markets. Following the military intervention in Kampuchea, Viet Nam's access to markets was limited by the imposition of sanctions by Western countries, arguably one of the most effective sanctions ever imposed by the West.18/ The result was a virtually complete elimination of many markets, especially those outside Asia. In 1988, Japan and Singapore together absorbed almost 65 percent of Vietnamese exports to convertible currency markets.

Structural Weaknesses. Despite the widespread shortages of goods, imports alleviated demand pressures to only a very limited extent. One reason for this was the extremely high concentration of imports, which reflected acute shortages of fertilizer, steel and petroleum (Table 6). These three commodities alone accounted for almost 70 percent of total non-convertible currency imports in the mid-1980s. Even though the share declined to 50 percent by the end of 1988, the amount of foreign exchange for other imports was extremely limited. Another reason for the limited role of trade has been the decision of the authorities to allocate foreign exchange preferentially for imports of capital goods even though imports of intermediate inputs would probably have had much higher and more immediate benefits due to the widespread underutilization of productive capacities, which could have been significantly reduced and production increased with increased imports of intermediate inputs.

18/ For an assessment of the sanctions see K. R. Nossal: "Les Sanctions Economiques et les Petits Etats; Le Cas de la 'Punition' du Vietnam par le Canada"; Etudes Internationales, Vol. 17 (Sept. 1987), No. 3, pp. 523-544.

Table 6: VIET NAM: CHANGES IN IMPORT AND EXPORT CONCENTRATION, 1984-88
(Percentages)

	1984	1988
1. Imports From Convertible Currency Area	100.0	100.0
2. Rice	13.2	7.8
3. Fertilizer	13.2	11.9
4. Steel	15.4	44.9
5. Concentration Proxy (2+3+4)	41.8	66.6
6. Imports From Non-Convertible Currency Area	100.0	100.0
7. Petroleum	41.8	28.6
8. Fertilizer	21.1	16.9
9. Steel	5.7	4.5
10. Concentration Proxy (=7+8+9)	68.6	50.0
11. Exports to Convertible Currency Area	100.0	100.0
12. Agriculture and Forestry	32.2	42.4
13. Handicrafts and Light Industry	29.3	3.8
14. Marine Products	26.8	26.7
15. Concentration Proxy (=12+13+14)	88.3	72.9
16. Exports to Non-Convertible Currency Area	100.0	100.0
17. Agriculture and Forestry	29.6	33.0
18. Handicrafts and Light Industry	54.5	55.5
19. Concentration Proxy (17+18)	84.1	88.5

Source: Based on data provided by the authorities.

In order to generate sufficient amounts of foreign exchange, the authorities took measures to ensure the adequate growth of exports. Due to the serious distortions in the structure of trade incentives and in access to external markets, the authorities were forced to ration critical inputs and set compulsory targets for exports. These measures together with further encouragement of exports to the non-convertible currency area enabled exports to expand at an average annual rate of 12.5 percent between 1984 and 1988, and at 14 percent p.a. to the convertible currency area.

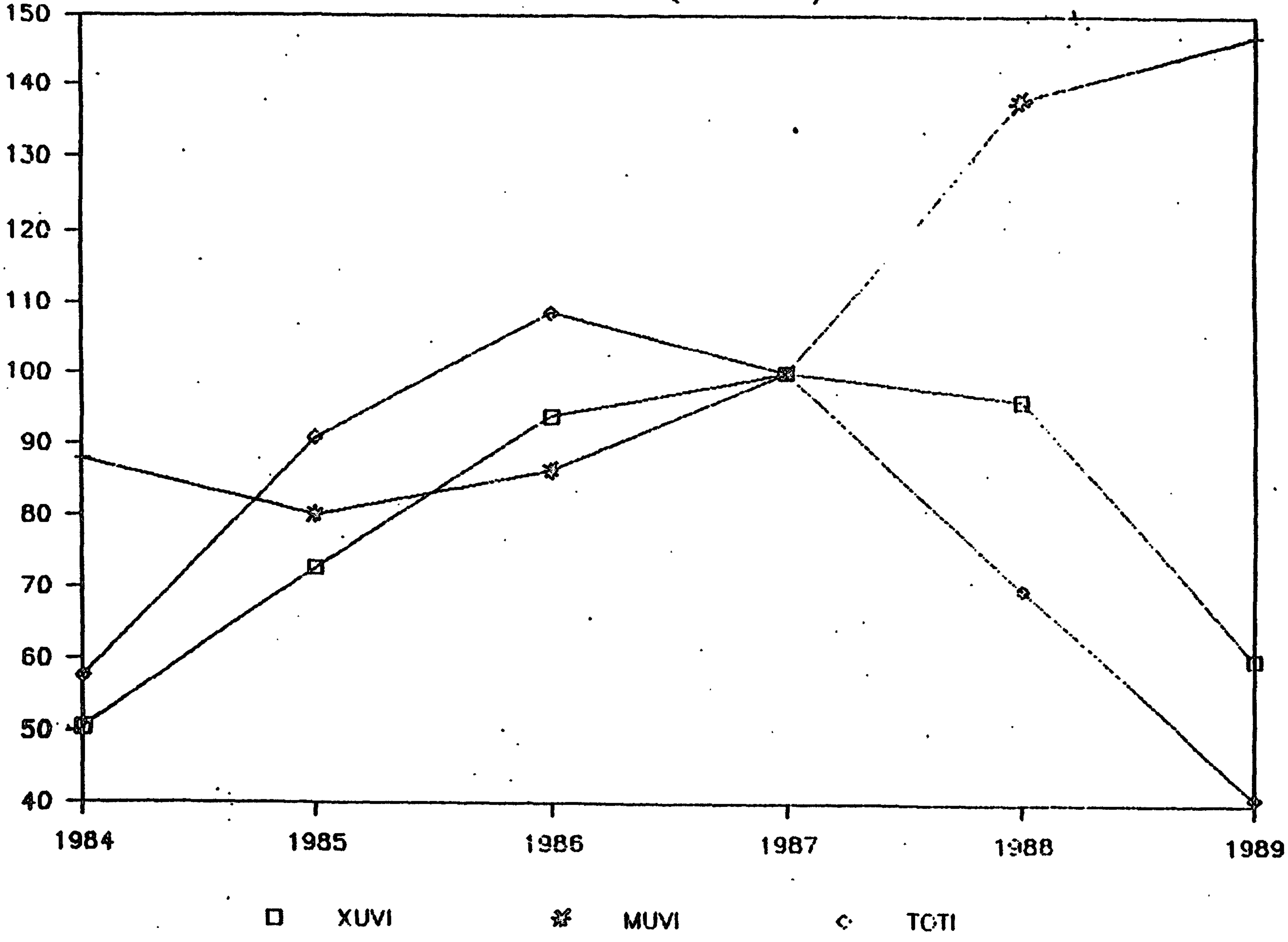
Despite the rapid growth of exports, however, deep structural weaknesses in the export sector were apparent. Due to past neglect, the export sector continued to be extremely poorly developed. For example, in 1985 exports to the non-convertible currency area represented a mere 36 percent of total imports from the same region. The excess of imports over exports had to be financed by borrowing. By 1988, the corresponding share declined even further--to 32 percent. This extremely low export orientation reflected a very low degree of export diversification and low trade intensities (Table 6). Agriculture and forestry products together with handicrafts and light industry accounted in 1988 for almost 89 percent of total exports to the non-convertible currency area while the commodity concentration of exports to the convertible currency area was only marginally lower.

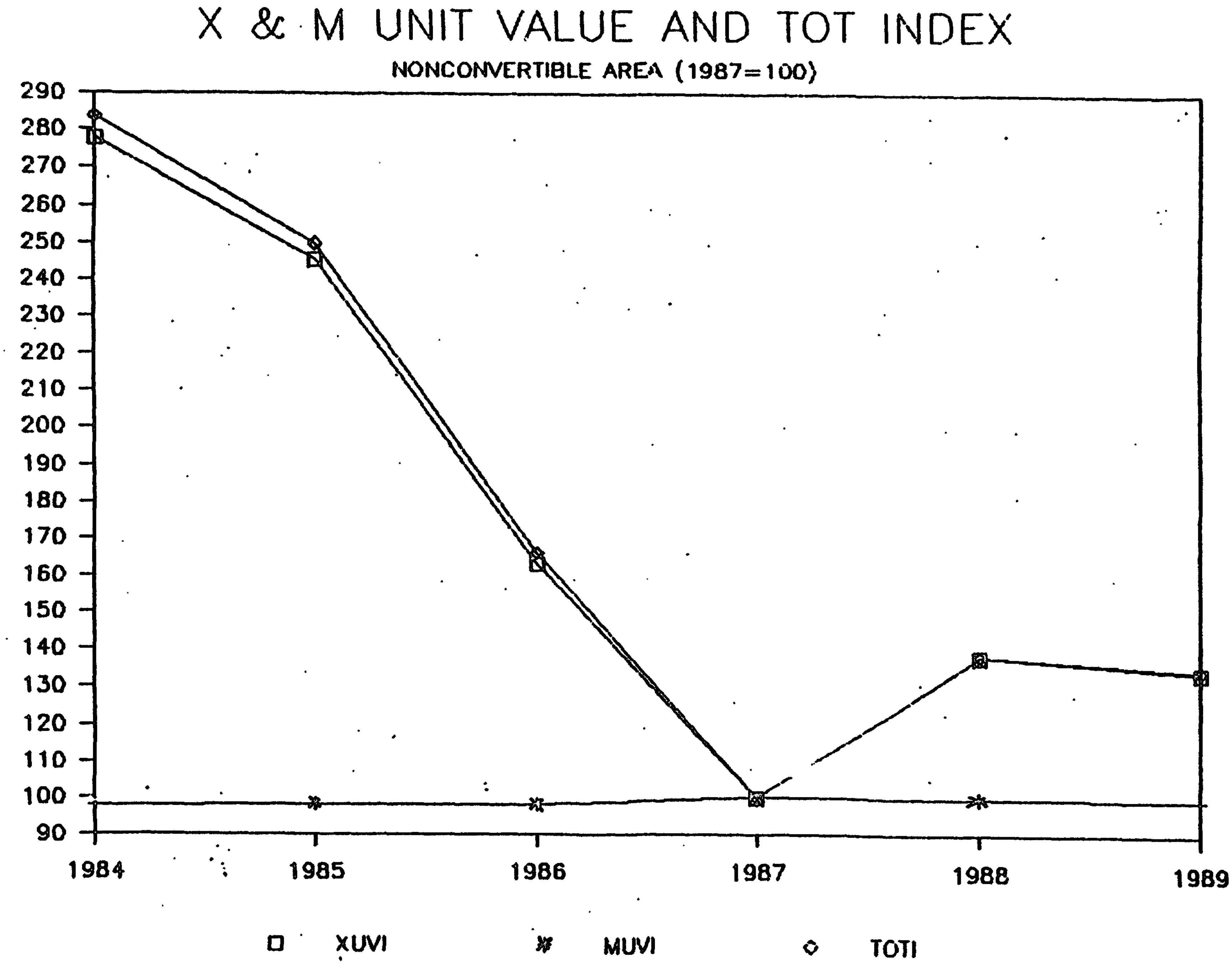
Deterioration in Terms of Trade. In addition to the factors of domestic origin, the growing foreign exchange shortages also reflected unfavorable external factors, although even the latter were related to mistakes in Government policy. While incomplete, available evidence suggests that terms of trade have probably worsened during this period. Even though there was some improvement with the convertible currency area, net income terms of trade with the non-convertible currency area (Chart 1), the dominant trade partner, deteriorated due a decline in export prices (Chart 2). Such diverging movements in terms of trade are quite common for CMEA member-countries such as Viet Nam in view of the different price formation rules prevailing in CMEA and the policy of the Soviet Union, the most important trade partner of Viet Nam, to apply the same rules to Viet Nam as to other CMEA countries.19/ More recently (1988), however, the pattern has been reversed as export prices to the non-convertible currency area improved relatively faster than those with the convertible currency area. Moreover, some gains from trade with the non-convertible currency area have been derived due to the considerable stability of import prices.

19/ For further discussion and evidence see Crossnier and Lhommel, op. cit., p. 34.

X & M UNIT VALUE AND TOT INDEX

CONVERTIBLE AREA (1987=100)




X & M UNIT VALUE AND TOT INDEX
NONCONVERTIBLE AREA (1987=100)
290
280
270
260
250
240
230
220
210
200
190
180
170
160
150
140
130
120
110
100
90
1984
1985
1986
1987
1988
1989
XUVI
MUVI
TOTI

Crucial Role of Foreign Capital. The unfavorable developments in the foreign trade sector discussed above have further emphasized the crucial role of foreign capital in sustaining economic growth. In addition to providing much needed resources to finance investments (Section 3), foreign resources have become increasingly important in financing Viet Nam's import needs. Due to the extreme pressures of demand for imports and the very weak export base, Viet Nam's current account with the non-convertible currency area has been in deficit, which has been recently very large but stable. The size of the deficit was almost entirely dependent on the willingness of the Soviet Union and other CMEA countries to provide additional loans, which were repordedly on highly subsidized terms.20/ Government borrowing requirements have been enormous, and quite in excess of the amounts which the CMEA countries have been prepared to provide. Even though lending to Viet Nam increased considerably between 1985 and 1988--the current account deficit increased from TR 721 million in 1985 to TR 1.3 billion in 1988, or from 176 percent of total exports to the non-convertible currency area to 215 percent--the increase took place basically in one single year--1986. Between 1986 and 1988 the amount of lending by these countries to Viet Nam remained more or less unchanged, forcing Viet Nam to turn increasingly to alternative trade partners.

However, the shortages of convertible currencies have been even more serious. Transactions with the convertible currency area have been almost entirely financed by foreign exchange earnings from exports since official capital flows from Western countries all but ceased following the military conflict in Kampuchea. At the same time, private capital inflows were phased out due to Viet Nam's default on its commercial loans. Foreign reserves have been virtually depleted, and are now estimated to represent only one week of imports from the convertible currency area. Since import demands had to be increasingly met from supplies from the convertible currency area, the expansion was restricted to the growth of exports.

The shortages of foreign exchange have been so acute that Viet Nam has been unable to service its debt to all creditors (Table 9 below). The pressures intensified between 1986 and 1988, when Viet Nam was unable to service even its non-convertible currency debt. Even though the size of the external debt has not been large by international standards, it has exceeded the country's debt servicing capability, and the debt has also been rising dramatically. The outstanding debt is estimated by the IMF to have reached US$13 billion by the end of 1989, an approximately 100 percent increase since 1984. The increase was due to the accumulation of loans from the non-convertible currency area, short-term credits in convertible currencies and rising interest on arrears.

20/ According to French sources, the loans have taken the form of commercial credit to finance the trade deficit. These credits have been automatically converted into long-term loans and carried an interest rate of 0.5 percent to 2.0 percent per annum. See M-A. Crosnier and E. Lhomel, op. cit.

5. Monetary Destabilization

The extreme shortage of real resources discussed in the previous sections represented only one element of the deteriorating economic situation. The other and arguably equally important feature of the difficulties was the dramatic monetary destabilization of the economy as the authorities turned to inflationary financing of real expenditures. The destabilization resulted in an accelerating pace of inflation that had no parallel among any other centrally-planned economies. According to official data, the price level approximately doubled in 1985 and inflation turned into hyperinflation in the following years. Unofficial estimates put the inflation rates in 1987-88 even higher than those officially quoted--in the range of 800 to 1,000 percent per annum.

The strong inflationary pressures and the resulting rapid inflation have been only two of several symptoms of the serious monetary destabilization. Due to the authorities' difficulties in satisfying demand through the official distribution network, and because of the massive inflation leading to rapid erosion in the value of money, both producers and consumers had to increasingly rely on parallel markets to obtain scarce inputs and consumer goods.21/ This enforced the segmentation of official and parallel markets, and made it increasingly difficult to maintain the official system of administered prices. In addition, widespread smuggling of goods from Thailand and more recently from China has been reported. As part of their hedging against inflation, both households and firms moved increasingly out of dong-denominated assets. As a result, inter-enterprise transactions were increasingly conducted through barter trade arrangements. Demand for gold skyrocketed as households sought to protect the value of their assets. The domestic currency--dong--all but ceased to be used as a means of exchange in retail transactions, which were increasingly conducted in U.S. dollars. This "dollarization" of the economy spread even to the enterprise sector, for which access to dollars represented, *inter alia*, the possibility of obtaining extremely scarce inputs.

Causes of Inflation. The acceleration of inflation during the 1984-88 period mainly resulted from serious macroeconomic mismanagement and loss of macroeconomic control as well as factors inherent in structural imbalances in the economy. It complicated the process of economic reform outlined in the policy strategy of the Sixth Party Congress in December 1986. The Congress placed considerable emphasis on measures of a microeconomic nature--greater autonomy for public enterprises, improvement in the incentive

---

21/ Many of these activities bordered on illegality. In 1987, however, the Government adopted a directive which authorized state employees to have second jobs in commerce, handicrafts and services, implicitly recognizing the inadequacy of money wages for this group of employees. In addition, the Government permitted Vietnamese to receive merchandise from their family members living abroad and to resell it in the free domestic markets. According to official estimates, such subsidies constitute US$100 million a year. The serious social impact of the stabilization program is discussed in greater detail in, for example, Crosnier and Lhommel, op. cit., p. 27.

structure through comprehensive albeit incomplete price liberalization, reorientation in investment, and greater scope for private sector activities. The underlying feature of the reform was to stimulate a supply response through better utilization of resources in production--a strategy designed to move from an "extensive" to an "intensive" pattern of growth. The fact that the reform did not succeed can be partially explained by poor coordination of the reform measures with macroeconomic policies, and by the half-hearted nature of the reform.

The inflationary process in Viet Nam has been highly complex, and can be attributed to five fundamental factors. The first and most immediate reason was an extremely accommodating monetary policy, which allowed virtually unrestrained growth of credit, primarily to public enterprises. The second factor was the size of the Government budget deficit and the methods of its financing. The third factor was strong inflationary expectations due to a long history of inflation and poor record of inflation control. This together with the increased dollarization of the economy was also the main reason for acceleration in the rate of inflation during the period. The fourth reason was a poor supply response, which continued to be adversely affected by weak incentives and inadequate institutional support. Finally, inflationary pressures were accentuated by the impact of the incomes policy, which had a built-in inflationary bias. All these monetary phenomena have accompanied deep weaknesses on the real side of the economy--an excessive level of domestic spending, lack of real savings and a poor supply response. While the previous sections addressed the real side of the economy, the monetary issues are discussed in the remaining part of this paper.

Credit Expansion. As can be seen from Table 7, monetary policy was extremely expansionary during the period. In 1987 alone, money supply (M2) increased by 324 percent, and the growth even accelerated in 1988 (406 percent). Until mid-1988, the banking system, represented by the State Bank of Viet Nam, did not separate central banking from commercial banking functions, and the scope for endogenous growth of the money supply through secondary expansion fueled by "second-tier banks" (i.e., branches of the State Bank of Viet Nam) was very limited. All deposits with the State Bank were by definition a part of reserve money and changes in the money stock, therefore, represented exogenous changes in the money supply. By implication, monetary policy by and large accomodated the growth of demand for credit, which was expanding extremely rapidly.

Table 7: VIET NAM: GROWTH OF CREDIT AND LIQUIDITY, 1985-88
(percentage change, end of period)

	1986	1987	1988
Foreign Assets		-813	-35
Domestic Credit		249	391
-Government (Net)		321	736
-Nonfinancial Public Enterprises		221	354
-Cooperatives		238	289
-Private Sector		700	75
Total Liquidity (M2)		324	406
-Currency Outside Banks		273	400
-Deposits (Dong)		340	370
-Deposits (Foreign Currency)		2,800	734
Memorandum Items			
Net Government Credit (As % of Domestic Credit)	12.5	15.1	25.7
Credit to Nonfinancial Public Enterprises (As % of Domestic Credit)	77.0	70.8	65.6
Currency/GDP Ratio /a	6.1	5.9	6.4
Liquidity/GDP Ratio /b	12.8	12.7	14.5

/a Currency in circulation.
/b Liquidity defined as M2.

Source: Based on data provided by the authorities.

Financial Squeeze of Public Enterprises. The main reason for the rapid expansion of domestic credit demand was insatiable demand for credit by (nonfinancial) public enterprises. In order to finance their investment needs and, increasingly, their current operations, public enterprises relied heavily on domestic borrowing and budgetary subsidies. As noted above, the budgetary support was temporarily cut (1986), after the decision of the authorities to eliminate subsidies, but this only increased the enterprises' demand for credit. As a result of the price reform, input prices were increased without allowing corresponding flexibility in the formation of prices of final output. This led to the escalation of production costs and to deterioration in the internal cash generation of public enterprises. In addition, growing shortages of materials and food due to poor agricultural harvests in 1987 as well as rising shortages of foreign exchange increased upward pressures on prices in parallel markets and further squeezed profit margins of public enterprises. Within a year the authorities had to reverse the policy of eliminating subsidies and some budgetary supports were reintroduced in 1987 and 1988.

Fiscal Indiscipline. The second most important reason for the rapid expansion of credit has been the lack of fiscal discipline. Although the fiscal implications of changes in the financial performance of public enterprises clearly very serious, budgetary operations have also been adversely affected by the lack of strict fiscal discipline. Fiscal operations of the Government have been traditionally in serious imbalance, a stark difference to practices of highly centralized, planned economies (Table 8). This primarily reflected relatively large spending on national defense and subsidies and, by standards of other centrally planned economies, weak revenue collection, which was in the range of 15-20 percent of GDP during the period. By 1985, the overall primary deficit of the Government budget reached almost 17 percent of GDP, and the Government became acutely aware of the serious implications of the deficit on monetary expansion. Even though a large part of the deficit was financed by grants and soft loans from external sources for deliveries of capital goods, the recourse to domestic financing was extremely high--about 60 percent of the overall deficit in the same year, which corresponded to about 10 percent of GDP. The authorities succeeded in reducing the fiscal deficit in 1986 following the reduction in subsidies and capital expenditures, but sharp revenue shortfalls and growth in wages and subsidies resulted in further growth of fiscal deficit, which by 1988 reached 8.3 percent of GDP, and according to Government projections, the deficit was large even in 1989--7 percent of GDP.22/

The growing fiscal deficits resulted to a large extent from the inability of the Government to control the growth of budget expenditures. At the same time as the Government was reducing real spending on capital projects, recurrent expenditures continued to rise rapidly due to the growth of wages and subsidies. The growth of wages originated in the Government policy to protect real incomes of Government employees. The growth of subsidies originated partly from consumer subsidies to supplement wages by payments in kind for Government employees, and partly from the growing need to subsidize public enterprises.

Revenue shortfalls can also be attributed to weaknesses in Government performance. They reflected partly the design of the Government tax structure and policies and partly serious inefficiencies in tax administration. In addition, the authorities encountered growing resistance by taxpayers, which contributed to revenue shortfalls. According to reports of the industrial and trade tax agencies for the first six months of 1989, for example, tax collection was only 29 percent of the annual revenue target.23/ Revenue shortfalls originating in the tax design were due to the authorities' heavy reliance on revenues from the turnover tax. These revenues have been increasingly more difficult to collect in recent months due to the growing financial difficulties of industrial enterprises, which in turn reflected tighter credit markets and higher input prices.

22/ Until September 1985, remuneration of state employees was paid partly as wages and partly as subsidies in kind. Payment in kind included rations for nine essential products sold to the employees at highly subsidized prices--rice, meat, fish, sugar, brine, soap, glutamante, fabrics and fuel. After September 1985, most of the subsidies were eliminated except for the most important items like rice and fuel.

23/ See FBIS, July 11, 1989.

Table 8: CENTRAL GOVERNMENT REVENUES AND EXPENDITURES IN VIET NAM AND SELECTED CPEs, AVERAGE 1985-88
(Percent of GDP)

	Hungary	Poland /a	Viet Nam
Revenue	60.7	39.2	17.2
of which: Tax Revenue	52.2	35.0	3.5
Non-Tax Revenue	8.5	3.6	12.5
Current Expenditures	54.6	34.4	19.6
of which: Subsidies	34.1	16.3	5.7
Capital Expenditures	7.9	5.6	7.0
Overall Deficit	2.1	1.4 /b	9.5

/a Average of 1984-87.
/b State budget balance, excluding extra-budgetary funds balance.

Sources: IMF Recent Economic Development - Hungary (1989), Poland (1989) and data provided by the authorities.

Table 9: VIET NAM: DEBT SERVICE INDICATORS
(As percent of respective exports)

	1984	1985	1986 /a	1987	1988
Current Account Deficit					
NC Area	-181	-176	-257	-296	-214
CC Area (Commitments)	-81	-51	-64	-20	-42
CC Area (Cash)	-57	-27	-40	-3	-25
Accumulation of Arrears /b					
CC Area	78	10	103	57	77
NC Area	-	-	7	21	17
Scheduled Debt Service					
CC Area	54	58	77	39	61
NC Area	31	21	15	37	81

/a The large increase in recorded imports from the non-convertible currency area reflects the adoption of a more comprehensive coverage to include imports financed by long-term credit from that area.
/b Change in arrears.

Source: Based on data provided by the authorities.

<u>Fiscal Implications of Price Reform.</u> In addition to fiscal measures, the budget was also affected by a price reform and the manner in which it was implemented. The difficult financial situation of public enterprises noted above spilled immediately over into the Government budget since the accounts of public enterprises and Government budgets are closely intertwined.24/ In 1988, the Government collected about 75 percent of its total revenues from transfers from public enterprises. As a result of the profit squeeze in 1988, the corresponding share declined to less than 64 percent.25/ At the same time, production and export subsidies alone accounted for about 10 percent of total recurrent expenditures, and if subsidies for food procurement are included, the share was almost 32 percent. Since a large part of capital spending was also directed towards investment projects of public enterprises, changes in the financial position of public enterprises had a direct and significant impact on the budget and severely constrained the conduct of fiscal policy.

The second channel through which the fiscal deficit was adversely affected by the price reform was the impact of the latter on inflation and, consequently, on government revenues. Under conditions of excess demand for goods and services, the price liberalization of 1986-88 contributed to the acceleration of inflation and considerably slower growth of tax revenue. Tax revenues as a share in GDP declined from 4.5 percent in 1984 to 3.0 percent in 1987. Inflation also adversely affected transfers from public enterprises, which declined from 15.1 percent of GDP in 1984 to 10.5 in 1988 and the Government forecasted a further decline in 1989 to 7.3 percent of GDP.

<u>Dollarization and Collapse of the Exchange Rate.</u> The third source of inflation was the dollarization of the economy noted above and the collapse of the exchange rate in the parallel markets. In view of the rising shortages of imports and further loosening of control over public enterprises, secondary markets for domestic as well as foreign inputs developed during this period. Thus, while the official exchange rate continued to be fixed by the authorities and remained highly overvalued throughout this period, the increased access to imports became possible only at a price which largely reflected the parallel market exchange rate.

24/ The interdependence has been well known among Vietnamese observers but evidently not well understood by the policy makers. See Max Spoor: "Reforming State Finance in Post-1975 Viet Nam," <u>Journal of Development Studies</u>, Vol. 24 (1988), p. 108.

25/ Strictly speaking it is incorrect to speak of taxation of public enterprises since their profitability and their transfers to the budget depend, <u>inter alia</u>, on the price policy of the government. The governments in centrally planned economies can, therefore, choose how they collect budgetary revenues--either by taxation or through price-fixing procedures.

The effect of increased dollarization of the economy as well as the significant emergence of an endogenous component of the fiscal deficit on the demand for credit, and on the accommodating growth of money supply was very large. The continuous dollarization of the economy also meant that the real scarcity of foreign exchange was more or less properly "discounted" in the (unofficial) market for imports before the actual devaluation of the official exchange rate in 1989, which facilitated the control of inflation by the authorities when the rate was actually devalued.

Indexation. The fourth source of inflation originated in Government incomes policies. In order to protect their incomes, the Government provided income in kind to state employees. As noted above, these payments traditionally included a variety of commodities and were financed directly through the budget. The remuneration package was fundamentally changed only in January 1989, when the Government left only kerosene and rice under ration. Kerosene rationing was eliminated in June 1989. As a compensation, state employees received cash remuneration to offset the loss of the subsidies.

Government Role. The inflationary expansion of credit was also due to the failure of the Government to recognize the artificial nature of the public enterprise sector as a solid tax base. As noted above, the price liberalization fully revealed the financial difficulties of public enterprises, which have found it increasingly difficult not only to finance their current operations but also to meet their tax liabilities. These liabilities have been set at a standard rate of 10 percent of total turnover (paid out of profits), and an additional 50 percent tax on remaining profits. Enterprises in difficulties have been traditionally able to renegotiate their liabilities on an individual basis. In spite of these practices, many enterprises continued to face difficulties in meeting their tax liabilities, and they turned to the banking sector for credit.

Even though the underlying difficulties of the public enterprise sector were engrained deeply in the sector itself, the inability and/or unwillingness of the authorities to recognize the difficulties of enterprises to pay the required taxes led to a credit expansion that accommodated the enterprises' tax liabilities. As indicated in Table 10, the correlation between budgetary transfers of public enterprises and credit to public enterprises has been remarkable over the last four years. Moreover, both the amounts and the growth of credit relative to transfers suggest that tax liabilities had to be financed increasingly from bank credit.

Table 10: VIET NAM: ORIGINS OF CHANGES IN MONEY SUPPLY AND SEIGNIORAGE, 1985-1989
(Billion dong, changes at end of period)

	1985	1986	1987	1988	1989 June
1. Money Supply (M2)	34	62	360	1,914	302
2. Credit to Public Enterprises	21	45	259	1,333	474
3. Endogenous Fiscal Deficit /a	2	34	102	571	..
4. Seigniorage (as % of real GDP) /b	8	9	8	12	..
Memorandum Items:					
Transfers from Public Enterprises	15	60	285	971	452
Inflation Tax (as % of total seigniorage)	100	37	89	72	..

/a The endogenous budget deficit is defined here as the resources required to finance the budget deficit, which arises from maintaining the real value of Government revenues at the 1985 level, treating only 80 percent of public enterprise transfers as the "hard core" tax base of public enterprises. In addition, the deficit was estimated by keeping total expenditures (excluding interest) at the 1989 level, which is assumed to contain only non-discretionary expenditures.

/b Seigniorage refers to resources obtained through the printing of money. The inflation tax is the transfer of resources from the holders of depreciating money balances during periods of inflation to the money issuing authority. GDP figures are in constant 1982 dong.

Sources: Recent Economic Developments, 1987 and 1989 issues, Washington, D.C., IMF, and staff estimates.

One possible interpretation of this accommodating expansion of credit and money supply was the expediency and convenience with which the authorities have dealt with some loss of control over resources due to fiscal and enterprise reform. In this respect, the case of Viet Nam is very similar to the case of other socialist countries which have experimented with decentralization.26/ The loss of control was accompanied by increased reliance on monetary mechanisms by mobilizing resources through the printing of money--by seigniorage.27/ As can be seen in Table 10 above, seigniorage was very important during the period under consideration, and increased in significance. Moreover, the growth of seigniorage was only to a small extent generated by real growth of money. Much more important was the size of the inflation tax, which accounted for as much as 100 percent of seigniorage.

Conclusions: Shortcomings of the 1985-88 Stabilization Program

Absence of Real Adjustment. The serious monetary destabilization combined with the slowdown of economic growth and the worsening balance of payments situation were the three main symptoms of the failed stabilization efforts during 1985-88. The reasons for the failure were several, ranging from the design of the stabilization program to its timing as well as to the synchronization with other measures. The salient features of the stabilization program are summarized in Table 11 and discussed in the remaining part of the paper.

As the table indicates, the main emphasis of the stabilization effort was placed on mobilizing as much external financing as possible. While this policy minimized the cost of adjustment, it also implied that the necessary adjustment was postponed. Moreover, the attempt to seek external financing from Viet Nam's traditional partners was severely constrained by the amount of resources which these countries were prepared to transfer to Viet Nam. This has restricted the amount of imports which could be obtained from this area, and called for the need to increase imports from the convertible currency area. However, convertible currency imports had to be financed by increased exports, which diverted supplies from the domestic market and further increased the inflationary pressures.

26/ The Bank's most recent economic report on China found a similar phenomenon following the decentralization of the early-1980s. The report suggested that the central government found that the monetary mechanism is a convenient device for regaining some of the resources surrendered through fiscal and enterprise reform. See World Bank: China: Macroeconomic Stability and Industrial Growth under Decentralized Socialism (Country Economic Memorandum), Washington, D.C. The World Bank, 1989, p. 49.

27/ The inflationary monetary policy was undoubtedly also a function of political expediency. The controversy about the reform has been considerable in Viet Nam, and economic decisions have often reflected a political compromise. The anti-inflation program of May 1989 was an exception to the rule, when the dire economic situation dominated the process. For an account of the controversy, see Tan Ten Lang: "Economic Debates in Viet Nam"; Canberra: Australian National University, Institute of Southeast Asian Studies, Research and Discussion Paper No. 55, 1985.

Table 11: VIET NAM: ADJUSTMENT VS. FINANCING OF INTERNAL AND EXTERNAL IMBALANCES /a
(1984=100)

	1985	1986	1987	1988
I. Adjustment				
Imports: Convertible Currency	98	97	99	129
Imports: Non-Convertible Currency	104	156 /b	158	178
Exports: Convertible Currency	122	111	156	169
Exports: Non-Convertible Currency	111	129	117	169
Total Fixed Investment	107	89	69	64
Aggregate Consumption	98	103	103	104
II. Financing				
Public Savings	17	71	60	24
Aggregate Domestic Savings	112	72	66	56
Net External Financing:				
Convertible Currency	76	89	38	88
Non-Convertible Currency	103	174 /b	182	190

/a Net external financing defined as the current account imbalance. Export and import figures are in current U.S. dollar (transferable ruble) terms, consumption and investment in constant (1982) price terms. Public savings is defined as the difference between Government revenues and current expenditures.

/b The large increase in recorded imports from the non-convertible currency area in 1986 reflects the adoption of a more comprehensive coverage to include imports financed by long-term loans from that area.

Sources: Based on Tables 1, 3 and 5 in the text, and other data provided by the authorities.

In view of the serious external constraints on the amount of resources which could be mobilized from abroad, there was a growing need to finance investments from domestic sources. In this respect, the stabilization program contributed very poorly to the domestic savings effort. The most serious failure was the inability to mobilize savings in the public sector. Both in the case of the Government and public enterprises, the main problem was the inability to control the growth of expenditures, even though the Government also had difficulties in mobilizing resources through a more effective tax revenue effort. This together with the desire of the authorities to protect consumers from the impact of the adjustment has resulted in a large accumulation of cash balances by enterprises and households, which have fueled already existing inflationary pressures.

The only effective real adjustment undertaken by the authorities was the deep cuts in public investments--the one policy variable which was perhaps easiest to adjust but which also had the potentially most serious consequences for future growth. The other Government attempt to respond to domestic demand pressures by cutting the budget deficit was short-lived and ineffective. At the same time, the desire of the authorities to protect domestic consumption only further increased the need to restrain aggregate demand through cuts in public investments. Since public investments represent more than 90 percent of total fixed investments, the consequences of investment cuts for both the growth of productive capacity as well as for growth of demand were extremely serious. By giving priority to the completion of ongoing projects, Government investment spending continued to be heavily import-dependent while projects with higher domestic content were curtailed, adversely affecting domestic producers.

Distorted Incentives. In addition to the failure to control aggregate money demand, the program failed to stimulate a dynamic supply response, a sine qua non of a successful stabilization program. This was partly due to exogenous factors, such as weather conditions and their impact on agricultural supplies. However, there have been serious flaws in the overall incentive structure which stifled production.28/ As noted above, the price liberalization was incomplete, which left a wide range of commodity prices subject to administrative controls. Exchange rates continued to be fixed by the authorities and remained highly overvalued throughout the period. Interest rates were similarly fixed and were negative in real terms. No serious attempt was made to introduce proper pricing of capital and land. Wages were fixed by central authorities. In addition to a highly overvalued exchange rate, export incentives were distorted by export duties levied on a large number of commodities. Import substitution was encouraged by a highly rigid system of quantitative import controls and import duties.

Institutional Weaknesses. Institutional support remained weak. The expansion of private initiative both in agriculture and in other sectors was hindered by slow introduction of regulations that would clearly define the scope for operations of the private sector and legislate rights and obligations. Nevertheless, the emergence of a stronger private sector together with good agricultural performance in 1988 were perhaps the only bright spots on the supply side during this period. Foreign exchange transactions remained extremely regulated and centralized as were export and import flows due to export and import quotas and licences. The banking sector failed to separate central banking from commercial banking functions (the so-called "monobank"), and it was not until July 1988 that a two-tier banking system was established. Autonomy of financial and nonfinancial enterprises was highly restricted. While increased, enterprise autonomy was limited in many areas such as investment planning, employment and wage practices and disposal of profits.

Ineffective Fiscal and Monetary Policies. The range of policy instruments to stabilize the economy was very narrow until the adoption of

---

28/ Many observers have regarded the post-1986 reform "as two steps forward and one step back," until the most recent measures. See, for example, G. Will, op. cit.

more radical reforms in 1989. The effectiveness of monetary policy was highly circumscribed due to an extremely rigid interest rate policy. While there was a move towards decentralization in the case of nonfinancial public enterprises, no corresponding autonomy was given to banks. The Central Bank (i.e., the State Bank of Viet Nam) had virtually no instrument to mop up excess liquidity--even assuming that authorities were prepared to do so. The control of the banking system was also extremely loose. It has been based on the so-called credit and cash plans, which had an inflationary character and distorted credit allocations. For example, cash and liquidity requirements were not regulated until the introduction of the two-tier banking system and until February 1989, respectively.

Both monetary and fiscal policies have been highly inflationary. Once the subsidies to public enterprises were cut and many enterprises found themselves in a financial squeeze, monetary policy was too accommodating to satisfy demand for credit in the sector. Financially-squeezed and loss-making enterprises were kept in operation by a generous provision of credit. Those enterprises which could increase prices following the price liberalization did so to offset the loss of subsidies from the budget, while demand was fueled by rising money incomes brought about by monetary expansion. As a result of the price liberalization supported by expansionary monetary policy, therefore, prices in the official market quadrupled in one year--1986. In sum, monetary policy continued to be expansionary mainly because monetary authorities were convinced that they needed to augment bank resources to finance credit to public enterprises, which would otherwise be unable to continue their normal operations.

The inflationary impact of fiscal policy resulted from a combination of factors. The authorities were not able to control the budget deficit except in 1986, and this became one of the main sources of the rapidly expanding demand for credit. The rising budget deficit was due to the inability to control the growth of expenditures, which in turn was closely linked to the misguided policy of indexation and to large defense expenditures. It also reflected a poor tax collection effort. Since the provision of external credit was highly limited, the authorities had to finance the deficit from domestic sources. However, in view of the virtual absence of financial and money markets, the growing demand for credit could be satisfied only by central bank financing and through money creation.

<u>Lessons Learned: The 1989 Stabilization Measures</u>. By the end of 1988 it became evident that the current macroeconomic policy was no longer sustainable. Inflation was completely out of hand, and it threatened not only the course of economic reform and production for the market but also the country's social fabric. The Government became very aware that more radical reforms would be needed to stop hyperinflation, encourage domestic production and savings, and in general to provide an economic environment that would be more conducive to economic reform at the level of enterprises and households. The Government reform proposals in 1989 were formulated as part of a new package, which became the subject of ongoing discussions with the IMF.

The package of measures adopted in the spring of 1989 was impressive. Together with measures adopted at the end of 1988, the package represented perhaps the most comprehensive and radical set of reform measures adopted by any socialist country at that time. The authorities dramatically reversed the practices of their past monetary policy, and imposed tight credit ceilings through control on the growth of reserve money, introduction of cash reserve requirements and liquidity ratios, and increased interest rates to highly positive levels in real terms.29/ Access to state bank credit by commercial banks was restricted. This was to be supported by strict control of the budget deficit and Government borrowing from the State Bank. Reduction of the budget deficit was to be achieved by both expenditure restraint and revenue mobilization supported by improved tax administration and new tax measures. The Government unified the exchange rate close to the level of the parallel market, and devalued the ruble rate to the more realistic level of the dollar/ruble cross-exchange rate. The authorities now propose to introduce a foreign market by establishing trading floors. Traditional foreign trade monopolies were all but dismantled by allowing other public enterprises and private traders to engage in foreign trade transactions. The number of quotas, previously covering more than 100 commodities, were reduced to 7 export and 12 import quotas. In support of the above policies, the Government also strengthened structural policies. Price reform was extended even further by liberalizing virtually all commodity prices. This left only a handful of prices which continue to be subject to administrative controls. Agricultural contracts have been modified to link output and input prices closely to market developments. The remuneration package of public employees was restructured, removing most subsidies in kind. Enterprise autonomy was strengthened by reducing the number of compulsory plan targets. The exceptions are only enterprises in petroleum, electricity, postal services, and rail and international waterways transportation. A better system of monitoring the performance of public enterprises has also been introduced.

The full impact of these policy measures cannot be assessed at this stage in view of the short period of time since their introduction. There is no doubt, however, that their impact on inflation has been impressive. Inflation, which was running at an annual average rate of about 1,000 percent in the fourth quarter of 1988, was reduced virtually overnight to 3-4 percent in April 1989 and this was followed by a decline in the price index by 5 percent between April and July 1989. Agricultural output also picked up dramatically, resulting in a significant improvement in food supplies in the

---

29/ The authorities have recognized serious shortcomings in the management of monetary policy. The policy has been traditionally conducted in the framework of cash and credit plans, which have been constructed as the respective sums of cash and credit needs of individual agents in the economy (the so-called "bottom-to-top approach"). Such an approach will not typically lead to optimal expansion of the money supply since it would require rapid access to perfect information and its efficient processing. Moreover, it is evident that the expansion of money supply tended to be considerably faster than even that foreseen by the authorities in their plans, leading to what may be termed "endogenous growth of money supply."

domestic market. Moreover, the Government has been able to export rice for the first time in years. Total exports amounted to about one million tons in 1989, making Viet Nam a major exporter of rice in that year, and significantly contributing to the balance of payments. However, as impressive as this achievement has been, the issue faced by the authorities at present is how to build on this success, and to ensure that there will be no back-sliding on the policies. This is a crucial time for the Government, when it will have to address further policy and institutional issues which are still outstanding.

Bibliography

W. Andreff: "Les Reformes en Coree du Nord et au Viet Nam": Economie et Humanisme, September-October 1988, No. 303.

ANU: A review of the Economics of Vietnam, Laos and Kampuchea; Australian National University, National Center for Development Studies, April 1989.

Crosnier and E. Lhomel, "Vietnam: Les Mecomptes d'un Socialism Asiatique," Le Courrier des Pays de l'Etat, July-August 1987, No. 320.

IMF: Recent Economic Developments, (Poland) and (Hungary); Washington, D.C.: International Monetary Fund, 1989.

A. Fforde and S. Paine: The Limits of National Liberation; New York: Crook Helm, 1987.

K. R. Nossal: "Les Sanctions Economiques et les Petits Etats; Le Cas de la 'Punition' du Vietnam par le Canada", Etudes Internationales, Vol. 17 (Sept. 1987), No. 3.

R. Portes, "The Theory and Measurement of Macroeconomic Disequilibrium in Centrally Planned Economies," London: Center for Economic Policy Research, Discussion Paper No. 91, 1986.

Max Spoor: "Reforming State Finance in Post-1975 Viet Nam," Journal of Development Studies, Vol. 24 (1988).

Tan Ten Lang: "Economic Debates in Viet Nam"; Canberra: Australian National University, Institute of Southeast Asian Studies, Research and Discussion Paper No. 55, 1985.

Vu Huu Tu: Problemy Sotsialisticheskoi Industrializatsii vo Vietname; Ekomicheskye Problemy Perekhoda k Sotsialiszmu Stran s Nerazvitoi Ekonomikoi; Moscow: Nauka, 1986.

Vu Khieu: Sozdanye Rezhima Kolleknivnogo Khoszyaistvovaniya Preodoleniye Perezhitkov Razvitiya Melkogo Proizvodstva v Protsese Sotsialisticheskogo Obobschestvlenyia, in Ekonomicheskye Problemy Perekhoda k Sotsializsmu Stran s Nerazvitoi Ekonomikoi; Moscow: Nauka, 1986.

S. de Vylder and A. Fforde: Viet Nam: An Economy in Transition; Stockholm: SIDA, 1988.

G. Will: Vietnam nach dem 6. Parteitag der KPV: Zwei Schritte Forwards, Ein Schritt Zuruck; Koln: Berichte des Bundesinstituts fur Ostwissenschaftliche und Internazionale Studien, 20-1988.

World Bank: China: Socialistic Development; Washington, D.C., The World Bank, 1983, Vol. 1.

World Bank: Thailand: Building on the Recent Success - A Policy Framework, (Country Economic Memorandum); Washington, D.C., The World Bank, 1989.

World Bank: China: Macroeconomic Stability and Industrial Growth under Decentralized Socialism (Country Economic Memorandum), Washington, D.C. The World Bank, 1989.