VIETNAM: RIPE FOR ECONOMIC REFORM

Paolo Pasicolan and Larry M. Wortzel, Ph.D.

The government of Vietnam has a window of opportunity to undergo market reform, increase foreign investment, and ultimately uplift the plight of its people. Contentious negotiations with the United States finally resulted in a comprehensive bilateral trade agreement that was ratified by the U.S. Senate on October 3, 2001. Meanwhile, the International Monetary Fund (IMF) resumed lending, approving a $385 million tranche, after Vietnam agreed to implement necessary reforms. And the country's year-old stock exchange has increased four-fold. Vietnam's credit rating has even improved from "negative" to "stable."[1] More surprisingly, a survey of tourism executives ranked Vietnam the "safest in Asia."[2]. From the vantage point of the Communist Party of Vietnam's new reform-minded General Secretary, Nong Duc Manh, change is critical to develop the support for his country of 80 million people, the 12th most populous in the world. Vietnam's population may well be the youngest in the world—60 percent of the population under 30 and 85 percent under 40—a stagnant economy may be the biggest threat to domestic stability.[3]

Wary investors are watching to see if Vietnam can translate these opportunities into sustained economic growth. Facing a crossroads of sorts, the Vietnam Communist Party admits that if the country does not seize this opportunity now, they "would fall further behind neighboring countries in economic development."[4] Disillusioned investors could easily relegate Vietnam into Asia's ash heap of economic failures. A growth strategy, however, comes with conditions: the Communist Party of Vietnam (CPV) believes that if it is to survive, it needs to find the right mix of economic liberalization to spur growth without losing control of the country altogether. To do this, it will have to answer three basic questions: (1) what does it need to do to achieve sustained economic growth; (2) what impact will growth have on the Vietnamese people; and (3) how will the CPV deal with the changes that accompany economic growth?

WHY FREE TRADE AND ECONOMIC OPENNESS IS GOOD

Fifteen years ago, Vietnam began a process called *doi moi*, but the pace of this so-called "economic renovation" has been erratic, reflecting Vietnam's reluctance to commit to a particular economic strategy. Although no single formula guarantees sustainable economic growth, a robust statistical correlation exists between economic freedom and wealth. The *2001 Index of Economic Freedom* took data from 155 countries, and after analyzing 50 independent variables concluded that "countries with the most economic

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[1] Nguyen Nam Phuong, "Economic Reforms Get Boost From New Leader," Inter Press Service, April 27, 2001.
[2] Kay Johnson, "Vietnam to Exploit 'Safest in Asia' Rating to Woo Tourists," *The Straits Times*, October 26, 2001.
[3] Andrew J. Pierre, "Vietnam's Contradictions," *Foreign Affairs*, November/December 2000, p. 69.
[4] Strategy for Socio-Economic Development 2001-2002, presented by the Central Committee, 8th Tenure, to the 9th National Congress, available at http://www.cpv.org.vn/chuyende/nationalcongress9/docs/stratery.htm.

freedom also have higher rates of long term economic growth and are more prosperous than are those with less economic growth."[5] This is true because open markets are conducive to healthy competition, which requires institutionalizing transparency and the rule of law, and results in the most efficient allocation of resources. With this in mind, Vietnam has once again stepped up the pace of *doi moi*.

U.S.-Vietnam Bilateral Trade Agreement. Vietnam committed to reducing trade barriers in July 1999, when it signed a bilateral agreement with the United States, promising to lower tariffs on U.S. goods and services, relax investment regulations and improve enforcement of intellectual property rights laws. Prior to the agreement, Vietnam had been such an insignificant market for the United States that American exports to Vietnam averaged less than $300 million a year–a mere three *days* worth of exports to Japan.[6] Now that the trade agreement is ratified, however, average tariffs on most U.S. goods will be slashed by some 33 to 50 percent. Concomitantly, U.S. tariffs on Vietnamese goods will be reduced from 40 percent to 3 percent, translating to an estimated $1.3 billion a year.[7] For instance, Swedish furniture-maker Ikea currently exports $100 million worth of goods each year from Vietnam—but none to the United States because tariffs had been so prohibitive. Now that the trade agreement has reduced them drastically, Ikea expects to more than double production in the next five years. In order to do this, it plans to increase its current workforce by a third, more than 30,000 new jobs. Export processing zones all over the country are already bracing for an influx of foreign direct investment following the ratification of the trade agreement. By years end, exports through these zones are expected to increase 30 percent, roughly $300 million.

Furthermore, stronger implementation of intellectual property rights, such as counterfeiting protection, will encourage firms to invest more in Vietnam. For instance, Nike estimates that fake Nike products outsell real products 10 times. If Vietnam can crackdown on counterfeiters, brand-name companies, like Nike can meet the demand vacuum, increase production and fuel more investment into the country.

Vietnam has also negotiated trade agreements with other countries; it recently announced that it will lift a majority of its non-tariff barriers in order to meet the targets set by the Association of Southeast Asian Nation's Free Trade Area. If Vietnam keeps its commitments, increased openness to trade will improve the standards of goods and services both available in and produced by Vietnam.

Easing the Burden of State Enterprises. Unfortunately, the biggest impediment to healthy competition in Vietnam remains the heavily protected state sector. Profligate state-owned enterprises continue to crowd out domestic and foreign private corporations. Of the roughly 5,500 state firms, 75-80 percent are operating in the red, effectively using up over half of Vietnam's available bank credit and giving Vietnam the highest level of

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[5] Gerald P. O'Driscoll, Jr., Kim R. Holmes, and Melanie Kirkpatrick, *2001 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones Company, Inc. 2000) p. 1.
[6] Mark E. Manyin, "The Vietnam-U.S. Bilateral Trade Agreement," Congressional Research Service Report to Congress, June 20, 2001, p. 8.
[7] Dana R. Dillon, "Another Vietnam Quagmire," *The International Economy*, January/February 2001, p. 45.

non-performing loans in Asia.[8] Yet despite this massive allocation of government resources, the percentage of industrial output by state firms has dwindled to 42 percent from 62 percent eleven years ago. Furthermore, state enterprises employ only about five percent of the workforce, down to 1.6 million from 2.5 million in 1990.[9] In short, state-owned enterprises are using up more resources to produce less output and sustain fewer jobs. Under the conditions of the IMF/World Bank reform package, Vietnam has begun a process of "equitization," selling off shares of some 2,300 firms and transforming them into limited liability companies.[10] More importantly, government ministries and provincial People's Committees would not be able to maintain their ownership activities. Unfortunately, most of the state business targeted for privatization are of marginal economic consequence. If Vietnam is to become truly competitive in the global marketplace, this sector will need a significant overhaul because increasing the pace of privatization will encourage more private investment, both domestic and foreign, and will free up unproductive capital. The government took a significant step forward when it ordered a moratorium on the creation of new state firms after July 2001. In the past, any effort to reduce the number of state firms in some sectors would be accompanied by the emergence of new state business in other areas, undermining the privatization process completely. Furthermore, it is the office of the prime minister that is spearheading the initiative, giving much needed credence to the process which has been met with stiff resistance from interest groups.

Once real privatization begins, investment restrictions that exist to protect state firms can be lifted. The initial steps in this direction have already produced tangible results. The enterprise law, which eases entry requirements on domestic investment, generated $2 billion worth of new local private investment and created nearly 15,000 new private firms after it came into effect in the beginning of 2000. After the foreign investment law streamlined regulatory procedures, foreign direct investment commitments spiked to nearly $882 million in the first five months of this year. Furthermore, 5,000 new enterprises emerged worth $400 million have been officially registered since the beginning of the year.

The Fledgling Stockmarket. Another promising development for Vietnam is the growth of the stockmarket. The index is among the world's best performers with shares having risen four fold since its inception in July 2000. This is somewhat deceiving, however, since there are only six companies listed, five state-owned firms and a bond issued by a state bank. Furthermore, the government started off significantly undervaluing shares then instituted a restrictive safety valve that limits price movements to 2 percent in either direction. Plus, the stockmarket is open for an hour a day, three days a week, so many orders often go unprocessed. As a result, very few investors sell shares to earn profit, but buyers are coming in droves.

Although Vietnam's iron hand approach to the stockmarket has resulted in significant appreciation in share values, excessive intervention may hurt it in the long run. For instance, in June the Securities Trading Center, which runs the stock exchange, restricted

[8] Margot Cohen and Adrian Edwards, "Have Your State and Eat it Too," *Far Eastern Economic Review*, March 22, 2001, p. 22.
[9] Ibid.
[10] "Country Report: Vietnam," *The Economist Intelligence Unit*, April 2001, p. 8.

the number of shares investors could purchase in each session. The market responded badly, as prices fell by half within weeks of the move. The government of Vietnam has since promised not to interfere. This is not enough. Even without periodic intervention, the existing rules of the stockmarket strongly discourage investor participation as well as the entry of more firms. Roughly 50 firms are eligible to offer shares publicly, but many of them are unwilling to disclose the necessary information to meet government regulations. As a result, a thriving gray market for shares exists with more than 90 companies are selling stock. It is reportedly 10 times larger than the official stockmarket in terms of investor participation and capital flow.

By restricting the stockmarket in the way that it does, Vietnam is forgoing a tremendous opportunity cost. Vietnam could lure a lot more investors if it expanded its current index and assimilated the gray market. In order to do this, the government must relax its strict rules and allow market forces to determine the price of goods and services—beyond the two percent limit. Furthermore, stockmarket freedom, an economic variable monitored by the Index of Economic Freedom, is important because, "Equity markets measure, on a continuous basis, the expected profits and losses in publicly held companies. This measurement is essential in allocating capital resources to their highest valued uses…" A more efficient allocation of capital investment, foreign or otherwise, will only help Vietnamese companies compete on a global scale.

GROWTH IS GOOD FOR THE PEOPLE OF VIETNAM

Contrary to popular sentiment, free trade and open markets will not hurt the working class because policies that encourage transparency and protect private property rights create an environment of fairness where everyone has the opportunity to increase their income. Empirical studies have shown that even low-income households benefit equally from economic growth. A recent World Bank working paper that surveyed 125 countries concludes that "as overall income increases, on average incomes of the poor increase exactly the same amount."[11] Hence, if a country experiences economic growth that results in a 5 percent rise in overall income, the income of the poor is likely to increase by 5 percent as well. The study goes on to say that standard pro-growth macroeconomic policies do not adversely affect income distribution; that is, economic growth does not worsen inequality.

Banking Reforms to Help Vietnam's Farmers. The government's push to privatize state-owned firms along with significant banking reforms will also help the poor directly. Three out every four Vietnamese live in rural areas where the incidence of poverty is the highest. Low-income households, particularly farming communities, are more vulnerable to income fluctuations because seasonal harvests are dependent on such forces as inclement weather and volatile market prices. As such, households require consumption-smoothing devices like savings and borrowings that allow them to maintain relatively stable living standards. However, poor households typically lack access to either savings or credit because more than half of Vietnam's available credit supply is fueled into unproductive state firms. Comprehensive banking industry reform will give local private banks more freedom to operate and allow the entry of foreign banks, increasing the

[11] David Dollar and Aart Kraay, "Growth Is Good For the Poor," The World Bank Development Research Group, March 2000, p.2.

amount of available capital in the short run to help ease the existing credit crunch. In the long run, increased competition in the banking industry should improve both the accessibility and quality of banking services as well as lower interest rates. Furthermore, an increase in the number of legitimate lending institutions with standardized interest rates will help crowd out informal loan services that have erratic and often exorbitant interest rates.

Raising Labor Standards Through Trade. Aside from farmers, industrial workers should also expect a rise in wages and an improvement in living conditions with increased economic liberalization. Despite the myths anti-globalization forces are peddling, free market competition does not create a “race to the bottom” for wages. This notion is based on the false assumption that lower wages and poor working conditions attract foreign investors because it lowers overhead costs. This is simply not supported by empirical data. Wage rates reflect the productivity of labor—and it is labor productivity that attracts foreign investment. Competition forces firms to pay productive workers higher wages. This relationship was empirically supported in the recent United Nations Conference on Trade and Development report. Although least developed countries make up approximately 25 percent of all countries, they receive only 0.5 percent of global foreign direct investment, while developed countries receive more than 80 percent. This shows that foreign investment tends to migrate toward countries that have well a paid, hence highly productive labor force.

Furthermore, in a recent Heritage Foundation *Executive Memorandum*, Aaron Schavey argues that “labor standards are significantly affected by a country’s level of economic development.” For instance, with economic development generates wealth and higher income households have less incentive to make their children work, sending them to school instead. The International Labor Organization, the World Bank and the United Nation Children’s Fund collaborated on a study of nine developing countries and found that in poorest 20 percent of the population, 20 percent of children work full time; by contrast, in the wealthiest 20 percent of the population, only 4.5 percent of children work full time. School participation also follows this trend, in the poorest 20 percent of the population, only 52 percent of children attend school; however, in the wealthiest 20 percent of the population, 83 percent of children attend school. This reflects the reality that although parents may recognize the value of education, economic necessity prevents them from taking advantage of the opportunity.

The relationship between income level and child labor is remains strong in cross-country examinations. A study on developing countries revealed that there is a lower incidence of child labor in countries with higher per-capita income. A Brookings Institution study shows that in countries with a yearly per-capita income of less than $500, between 30 to 60 percent of children work, whereas in countries where yearly per-capita income within $500 to $1,000, only 10 to 30 percent of children work.

Social Programs in Concert with Economic Policy. Aggressive economic liberalization policies and poverty-reducing programs need not be mutually exclusive. In fact, the government’s social policies should compliment effective economic policies. For instance, a study on poverty in Vietnam concludes that a “fundamental cause of poverty is too little land and capital, or too little non-farm employment, for the number of ablebodied workers."[12] There are simply too many people exploiting too little land, as evidenced by the 0.82 percent level of unemployment in the agricultural sector in contrast with the 7.4 percent overall unemployment.[13] This misallocation of labor is a system-wide problem and comes at a tremendous opportunity cost. This is certainly a problem, but it is not the "fundamental" problem. The fundamental problem is that because economic policy has restricted the growth of private investment and the entry of foreign investment, Vietnam's manufacturing and service sectors have yet to develop. In other words, labor is concentrated in the agricultural sector because there is not alternative. With greater economic liberalization, Vietnam could diversify its economy.

Every year, Vietnam is faced with the problem of generating jobs for 1.4 million people entering the workforce. Of greater concern is the fact that 46,768 university graduates remain unemployed this year, up 56 percent from five years ago.[14] Unemployment exists because there are simply not enough jobs or entrants into the labor force are not trained to perform the jobs that are available. Privatization and an investment regime that encourages foreigners to set up businesses in Vietnam will create more jobs. The second problem must be dealt with on a system wide level because "while in some sectors vast lines of applicants await jobs, other sectors are crying out for trained staff."[15] For instance, state enterprises had a 43 percent shortage of skilled and technically trained laborers. One reason is that students are not being given the necessary vocational guidance to select courses where the labor demand is high. Policymakers should coordinate educational policy with economic policy to ensure that the labor supply matches demand. If Vietnamese students can be encouraged to learn more technical skills like engineering and computer programming, Vietnam can attract more foreign investment to generate more jobs.

Banking sector reform and anti-poverty banking initiatives need not hinder each other either. The newest innovation in anti-poverty programs is microcredit, where a microbank bank lends out small, low-interest loans to individual families. Poor families can use these loans, some as little as $60, to set up a neighborhood supply store or purchase new farming equipment. Although it may seem insignificant, these microloans have can help lift millions of families above the universal poverty line of $1 a day. The 1997 global Microcredit Summit in Washington helped bring the movement to global attention, and its efficacy has been its main selling point. At the time there was 7 million borrowers and 600 microfinance programs.[16] This year, the borrowers are expected to reach 20 million and programs are expected to increase reach more than 1,000. Vietnam itself has nearly doubled the number of borrowers to 57,000 in the past four years.

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[12] Litvack and Rondinelli (Eds.), Economic Transition and Social Change: Institution Building in Vietnam, (Quorum Books: Westport, CT., 1998).
[13] Vietnam: Statistical Appendix and Background Notes, *IMF Staff Country Reports* No. 00/116 (International Monetary Fund: Washington, DC, 2000), p 13.
[14] Tran Dinh Tranh Lam, "Graduate Employment Doubles in Five Years," *Inter Press Service*, July 19, 2001.
[15] Tran Dinh Tranh Lam, "Graduate Employment Doubles in Five Years," *Inter Press Service*, July 19, 2001.
[16] Alkman Granitsas and Deidre Sheehan, "Grassroots Capitalism," *Far Eastern Economic Review*, July 12, 2001, p. 38.

Philippine President Gloria Macapagal-Arroyo is so impressed with the effectiveness of the program that she wants to make microcredit the cornerstone against her fight against poverty. Both the Philippine government and non-governmental organizations have already cooperated to set up programs that serve 120,000 borrowers across the country. Microfinance is highly suitable to the Asian communal psyche as its repayment schedule is based on peer pressure. Lending officers will travel to small rural communities and assemble a group of five women who are interested in joining the program. Most microloans are only made to women because they have been shown to be more responsible as well as financially prudent. The first loan is made to one woman, but the entire group is accountable for repaying the loan. The second woman will only be able to get a loan if half of the first loan is paid off, and so forth. Each week, the various groups discuss the status of all loans, which requires its members to disclose each families financial situation. Because of peer pressure and fear of "loss of face" microfinance programs have a 98 percent repayment rate.

WILL THE COMMUNIST PARTY OF VIETNAM SURVIVE?

The Communist Party of Vietnam is in no immediate danger of losing control as membership remains stout. But the election of a young moderate, Nong Duc Mahn, to the office of General Secretary reflects the CPV belief that resisting change is the best way ensure its obsolescence. Thus, the question today is no longer if the CPV will loosen its grip, but how much they willing to let go. A possible metronome for the pace of reform lies in the fact that Vietnam has to grow a lot faster than its current 5 percent per annum in order to keep pace with demographic changes.[17] As the examples of China, Singapore and Malaysia have demonstrated, it is easier for a dominant party to remain in control if the economy is chugging away and people remain fed. Former President Suharto of Indonesia can attest to the corollary assertion. Vietnam's population demographics makes if particularly prone to civil unrest: 80 million people, 60 percent of which under age 30 and 85 percent under 40. If Vietnam is unable to find productive work for them, they are more prone to engage in more active forms of civil disobedience. Thus, the CPV faces the unenviable task of changing to remain the same. So far, incremental economic liberalization has neatly coincided with tangible growth in the real economy. Even so, this does not guarantee that the CPV will survive.

Rooting Out Corruption. As foreign corporations enter Vietnam, market competition will demand institutional transparency and the rule of law. A recent internal survey revealed that 43 percent of party members reviewed had been found guilty of corruption in the past five years.[18] A typical business can expect an average of 2.6 "state inspections" annually (some unfortunate firms have more than ten).[19] There is no effort to hide the fact that these inspections are merely a context for government officials to extract bribes. The need to streamline regulatory practices to remain competitive in the global marketplace will force the CPV to rid itself of corruption. This means that conflicting interests within the party will face off more often. For instance, in an effort to

[17] Paolo Pasicolan, *U.S. and Asia Statistical Handbook 2000-2001* (Washington, D.C.: The Heritage Foundation, 2000) p. 127.
[18] Margot Cohen and Adrian Edwards, "Have Your State and Eat it Too," *Far Eastern Economic Review*, March 22, 2001, p. 22.
[19] "Vietnam at a Glance: 2002-03" Economist Intelligence Unit *Country Report*, October 2001, p. 16.

scale down the massive state-owned sector, the office of the prime minister has had to butt heads with the managers of state firms as well as the government ministries that supervise them.

Although there have been no open confrontations, high ranking government officials have contradicted each other on the issue of accepting the gospel of globalization. In his first public comments after taking over as party chief, Nong Duc Mahn called for "foreign investors to continue their investment in Vietnam, especially in infrastructure, production and business." Prime Minister Phan Van Khai, on the other hand, warned that Vietnam risked instability if it became dependent on foreign money.

Furthermore, free markets give entrepreneurs more control over the economy and inevitably more influence in politics. It took some time to occur but Mexico's entry into the North American Free Trade Area (NAFTA) resulted in a change in ownership of the political economy. As Marcia O'Grady observes, "As NAFTA proved in Mexico, foreign competition and contact with the outside world weaken the very pillars of statism."[20] The same can be said of People's Republic of China, a model that the CPV has surely examined with great care. The Chinese Communist Party itself faces the very same catch-22. Without economic reform, they face the growing number of unemployed or "floating workers," making the potential for civil unrest.

Economic Freedom and Civil Rights. As a result, social policy will have to change. Although there is no proven causal relationship between economic liberalization and civil liberties, the same principles underlie both freedoms. It becomes increasingly difficult for a government to justify the availability of one without the other. Furthermore, the arrival of foreign employees and managers accustomed to a certain degree of liberty forces the government to either maintain a tenuous double standard between foreigners and local residents or to moderate restrictions on civil liberties altogether. For instance, "as American companies move into Vietnam…they bring in will invariably form communities of worship and this creates a positive influence on the religious climate in Vietnam."[21] The Vietnamese will occasionally make a clear statement to demonstrate its control over religion, such as the ludicrously harsh 15-year prison sentence issued to Father Thadeus Nguyen Van Ly, a Catholic priest guilty of "undermining national unity."[22] However, such repression will merely highlight the stark contrast of social and economic freedoms, forcing many Vietnamese to wonder why they can have one but not the other.

Cracks are also beginning to show as ethnic tensions that continue to seethe under the media radar. In February 2000, government troops were dispatched to the central highlands to disperse what has been described as either riots or peaceful demonstrations. The exact details of the incident are unknown since the government tried to seal off the area. What is clear is two men from the Montagnard Foundation, an advocacy group for Vietnam's highland ethnic minorities, were arrested, and likely tortured. The government

[20] Gerald P. O'Driscoll, Jr., Kim R. Holmes, and Melanie Kirkpatrick, *2001 Index of Economic Freedom*, p. 26.

[21] Testimony of Larry M. Wortzel, Ph.D. before the United States Commission on International Religious Freedom, Senate Dirksen Office Building, Room 124, February 13, 2001.

[22] "Priest's 15-year jail term a blow to reform efforts," *South China Morning Post*, October 22, 2001, p. 12.

insists they were “local provocateurs,”[23] inciting violence over long-standing grievances over land rights. Although many details remain unclear, clashes between demonstrators and police were violent enough to result in a large number of injuries and some fatalities. Unlike in China, rural unrest in Vietnam is rare and often limited in scale. The last major local uprising occurred in 1997 when local villagers protested excessive taxation and prevalent corruption.

CONCLUSION

Vietnam has taken the necessary steps in the right direction. It now faces the most difficult task of all: translating a plan into action. However, the impetus for economic and social reform abound from both internal and external sources. To remain in control, the Communist Party of Vietnam needs to reform the economy in order to generate enough growth to meet the growing needs of a young and vibrant population. Its promises to the United States and to the International Monetary Fund are clear and abandonment of its commitments will come at a high cost. Fortunately, it is the people of Vietnam who have the most to gain both economically and politically.

--Paolo Pasicolan is a Research Assistant and Larry M. Wortzel is Director of the Asian Studies Center at The Heritage Foundation.

[23] Tini Tran, “Vietnam Protests Blamed on Arrest,” *Associated Press Online*, February 9, 2001.