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**HELPING VIETNAM TO MAKE BETTER CHOICES:  
A DISCUSSION PAPER**

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## Introduction

Vietnam is widely viewed as an aid success story. It has reduced poverty, grown rapidly, and managed to attain macroeconomic balance while increasing its exports and social welfare at a rapid rate. What is not to like? And, surely, with increasing aid flows now equivalent to 5% of GDP, the aid community has had a role in this record.

This paper will take a contrarian position. It will argue that the record in recent years is less good than it seems. It will maintain that there are important negative trends in public investment and slow reform that are arguably aggravated by the availability of aid rather than the reverse. Finally, it will suggest that a slower disbursement of funds and a different style of donor dialog is needed to help Vietnam make the tough next steps in the reforms that it has already committed to.

## The Record

The 8-9% annual GDP growth of 1991-97 was arguably driven in part by the "Asian bubble" which was not sustainable. Since then, official growth in the 1998-2002 period is estimated at somewhat over 6%, but the IMF estimates for the same period average out to about 4.5%.<sup>1</sup> This is still not bad, but slower than China or India - both of which are richer nations, and should therefore be expected to grow more slowly. In terms of investment efficiency, India's growth of 5.7% a year, compared to its investment rate of 23%<sup>2</sup> gives a capital-output ratio of four. If Vietnam's growth really is 4.5%, its capital-output ratio is over six. This suggests a markedly less efficient use of capital than in a low-export and rather rigid economy. China has a ratio of about five, also lower. If Vietnam were as efficient as India in using capital, it could really grow at 6% and only invest 24% of GDP. That is, it could do so without any foreign aid loans, viewing them strictly as a source of capital.

Foreign Direct Investment (FDI) has, in value terms, been dominated by energy, heavy industry and real estate rather than light industry, which is often export-oriented. Indeed, light industry has accounted for only 8% of licensed FDI in 1998-2000, compared to 30% for heavy industry. The prospect of making most sugar, cement, steel, auto, or similar investments competitive soon is cloudy at best. The level of FDI commitments has fallen in half this year, and is likely to run around \$1 billion compared to over \$5 billion a year average from 1994-98, and \$2 billion for 1999-2001. Actual inflows are expected to rise from the \$700-\$900 million levels of 1998 to 2001 to double that in 2002-2004. In other words, after fifteen years of reforms, ODA is still larger than FDI.

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<sup>1</sup> There is an active debate about this, but many rules of thumb suggest actual growth is less than official.

<sup>2</sup> There are some differences between the IMF and ADB investment ratios for India. The IMF ratio is closer to 21%, while the ADB is 23%. The higher ratio is used.

As a thought experiment, I have urged the Vietnamese to compare themselves to Guangdong province in China. Vietnam and Guangdong happen to have identical populations, similar literacy rates, and life expectancies. Obviously, there is no equivalent to Hong Kong for Vietnam, though Taiwan, Singapore, and South Korea together might be considered a partial replacement. In any case, FDI inflow in Guangdong runs \$10-\$15 billion a year compared to about one-tenth as much in Vietnam. Manufactured exports in Guangdong are \$100 billion a year, compared to \$8 to \$9 billion this year for Vietnam. There is no suggestion that Vietnam should equal Guangdong, but could it not aspire to reach (say) one-third of its level of FDI?<sup>3</sup> As with any arbitrary target, the interesting question is when it might be reached. Certainly, if licensed FDI is falling sharply in Vietnam, the time of reaching any reasonable level will be far in the future. It is not credible to argue that the global economy is mainly responsible for the current decline when China's FDI is rising this year. Clearly, in spite of the BTA, other problems are holding back foreign investment in Vietnam.

### *Reasons for Low Foreign Direct Investment*

A recent MPI/JETRO study has highlighted many of the relevant problems - legal confusion and contradictions, high infrastructure costs, lack of supplier industries, unreasonable taxes and a lack of intellectual property protection. If this plausible list is correct, what role can ODA play in hastening substantive improvements? It is not enough to say that there have been programs to help with legal reform, tax reform, or infrastructure. The problems alluded to are not merely technical or solved by more infrastructure. They reflect much deeper bureaucratic and political issues that need to be resolved by the Vietnamese themselves.

A curious commonplace in economic growth analysis is that the higher the proportion of natural resource revenues, the lower the expected growth rate. This is counter-intuitive to many people. Surely, it is lucky to have oil or minerals available? Yet, those nations that have minerals have a larger state role, often with inefficient spending. They typically develop some version of the "Dutch Disease" - that means that exchange rates discourage other (non-mineral) activities. Elites come to view wealth as something to be captured rather than created. The results of having more foreign exchange, capital or tax revenues are offset by these other negatives. If aid is freely given, many of the same arguments apply, except that debt is accumulated rather than natural resources depleted. If resources are easy to come by, it is harder to be disciplined in making decisions.

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<sup>3</sup> An interesting research proposal would be to posit a \$1 billion increase in public spending given the existing priorities and compare it to a \$1 billion increase in export-oriented FDI. The evaluation could be on output, jobs, poverty reduction, multiplier effects, etc. Given the strong link between job-intensive growth and poverty reduction, it is possible that FDI would even dominate existing ODA in terms of its anti-poverty impact.

A more systematic and comparative way to view this issue is to look at various surveys that rank Vietnam compared to other Asian nations. In the following table, three such recent surveys are shown. One, the Global Competitiveness Report is relatively well known. It purports to rate the overall relative national competitiveness of a nation's policies and infrastructure - both soft and hard. The Economist Intelligence Unit's focus is narrower, asking how good the environment is as a business location. The Global Information Technology Report looks more at IT capacity and policies. All three have come out within the last year. What do they show?

<u>Nation</u>	<i>Ranking within Asia in each Report</i>			<u>Average</u>
	<u>GCR</u>	<u>EIU</u>	<u>GITR</u>	
Singapore	1	1	1	1
Hong Kong	3	2	2	2
Taiwan	2	3	3	3
South Korea	5	4	4	4
Japan	4	5	5	5
Malaysia	6	7	6	6
Thailand	7	6	7	7
Philippines	9	8	9	8
India	10	9	8	9
China	8	10	10	10
Sri Lanka	12	11	11	11
Indonesia	13	12	12	12
Vietnam	11	13	13	12 (tie)
Pakistan	NR	14	14	14

NR = Not Ranked; The GCR has both a "growth" ranking and a "current competitiveness" ranking. The growth ranking is used above. The ranking of Vietnam in the current competitiveness ranking was lower - #13, not #11. If the current competitiveness ranking were used, Vietnam would slip to #13, below Indonesia.

For those of us who are boosters for Vietnam, the picture is not pretty. Vietnam is just above a country wracked by terrorist violence and threats of nuclear war. We could simply deny the relevance of these surveys. China, after all, is not very high and below India, yet it gets a lot of FDI. However, it has a huge domestic market and has become a low cost center of manufacturing for many products. Vietnam has a tiny domestic market and no such reputation or accomplishments. It is likely to need a good ranking to get more of the right kind of investment.

### Interest Groups and Public Investment

It is here that the role of ODA can be either positive or negative. Any government has many pressures on it from various interest groups. If money is plentiful, hard choices are

not easily made. Specifically, even if aid is always used wisely for necessary projects, that could free up other funds for projects driven by political pressures - many of which respond to rather narrow groups. Looking at the public investment program in Vietnam today with two oil refineries, two urea fertilizer plants, a billion dollar highway connecting mountain villages, and billions of dollars more planned in high-cost steel, hydro, and other activities, can anyone say that this is rational? Can anyone doubt that there would be less of these debt-inducing industrial pyramids if there were a more serious donor dialogue?

For those who doubt the economic illogic of the *approved* projects. consider the urea plants. If a 10% return is to be earned (close to the cost of sovereign dollar debt), and if gas is to be sold at the thermal equivalent of \$17 a barrel of oil, then the cost of production will exceed \$150 a ton. Imports are \$110-\$120 CIF and bagged, and are likely to remain in that range. Building the urea plants will either create a very low return to public funds, price gas well below its true value, or impose an effective tax on farmers through higher urea prices. According to official figures real per capita rural incomes rose from 173 to 184 thousand dong per capita per month from 1995 to 1999, while urban incomes rose from 453 to 682 thousand in the same period. That is, rural incomes rose 1.5% a year while urban incomes rose 11% a year. Can anyone justify on equity or economic grounds the construction of these plants - forgetting even any commitments under various trade agreements that might make the plants loss making by the time they open? Would the National Assembly approve a tax of \$30 a ton on urea? The problem is not technical advice. For example, JICA advised in January not to build the just-approved second oil refinery, as it will cost at least \$100 million **each year** in extra refining costs.<sup>4</sup> Is it the best course to allow billions of dollars of these projects to proceed while billions in aid is pumped into the economy?

### *Progress in Reform is Mixed at Best*

If we move on to other areas, such as state-enterprise reform, the pace of change is well documented. The first equitization rules were promulgated in 1995. By mid-2002, fully 3% of SOE capital had been equitized. Even if a core group of key activities is to be kept by the state, how many years should be taken for the remaining firms? Has anyone noticed that the compensation to laid-off personnel is largely directed to HCMC and Hanoi, where jobs are easiest to find? How many of the "laid-off" workers who get compensation then join a similar company owned by state enterprises? There have been failed or very

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<sup>4</sup> To be clear, the \$100 million figure is the author's estimate, based on published data and general costs of similar refineries. A 10% cost of capital is assumed. Processing costs will be \$4-5 per barrel. The difference between crude oil export and oil product import prices to July in 2002 was \$2.50 per bbl.

Refining charges of \$1 per barrel are charged in Singapore's larger and scale-efficient refineries. There are currently 700,000 barrels a day of excess refining capacity in the region. Transport costs differences are considered in the estimate, but refinements based on harder numbers are needed.

expensive attempts in other nations to reduce SOE size and employment. How carefully have the lessons of experience been applied in Vietnam?

The pace of financial reform has been described as glacial (in private) even by many Vietnamese. Except for the BTA, which allows for a gradual phasing in of foreign banks, there has been only modest structural movement towards a well-functioning financial system. The international audits for fiscal year 2000 will be completed by 2003. Loan classifications are being improved and some joint-stock banks are closing. Restructuring plans are being adopted. There has been a phased relaxation of interest rate controls. On the other hand, state commercial banks remain dominant and foreign banks severely limited in their operations. This will not change quickly. The stock market is largely limited to equitized firms, and in any case is small and slowly developing. The bond market is effectively limited to government entities. The Development Assistance Fund is a parallel source of finance almost wholly bureaucratically directed, with access to pension funds - even though it lends at subsidized rates. Leasing firms, in spite of a new law, remain hobbled by legal problems requiring changes of procedures at the local level. Taking the financial system in its totality, it is such a gradual reform process that one might reasonably wonder when market-based allocation will account for as much as half of the mobilized funds. What would the current rate of change imply as a date?

The rapid reduction in many tariffs and quotas has been justly praised and noted. Even the amount of garment quota to be auctioned will be raised to 25% this year. Of course, if Vietnam joins the WTO, all garment quotas will cease in 2005, just three years from now. In order to compete effectively, supplier industries should develop in "clusters" around the few areas that specialize in these exports. The quota, of course, is spread much more widely. Does it make sense for Vietnam to allocate three-quarters of its quota in a way that discourages supplier industries when these will be needed to compete very soon? How far ahead is the international community looking? It is not easy to switch to a market mechanism, but without nudging or alternative investments, movement will be altogether too slow. This also applies to many high-cost products still being promoted for import-substitution. In many ways, the trade and industrial policies of Vietnam are on a collision course. Has anyone identified a glide path during which the costs of these products can reasonably be reduced? If not, what happens when protection is lowered?

The problem in so many of these areas is not that the wrong things are being said. The direction of movement is generally in the right direction. The *speed* of movement is typically much less than needed to remain competitive in the market for FDI, with China, or even with some other ASEAN economies. In surveys of Asia in commercial publications, how often is Vietnam even mentioned? The ODA community has to become a more dynamic part of a solution to difficult problems of governance, which extend to the provincial level. Many legal or administrative reforms rise or fall at the local level. Could donors propose linking more public funding at the provincial level to their success in

attracting private funds? Many provinces now perceive public funding as a substitute for private investment. Effort is spent lobbying for questionable projects rather than trying very hard to become more attractive for private investors. Using ODA to change incentives might change behavior.

To repeat, the opposite point of view is easy to argue. Look at Vietnam's export growth, for example. Exports have risen from \$9.2 billion in 1997 to perhaps \$16 billion this year, an 11-12% annual rate of increase even when many raw material prices were falling. Manufactured products are growing and may now equal half of the total. Indicators of health and education are strong for a poor country. But the best way to continue poverty reduction is fast, labor-intensive growth. (Only a quarter of aid goes to human or rural development directly, and anyway supply-side programs work better if there is more demand.) In addition, for every positive is a daunting negative. Industrial output is growing more than exports, and even faster than major manufactured exports, in recent years - suggesting a high cost import substitution strategy that will soon slow. Quality of schooling is such an issue that there is a rush for private and even foreign schooling. Financial and enterprise reforms are lauded, but the land and real estate bubbles in major cities suggest many funds seek other havens, and state banks choose not to lend dollar deposits. Telecom charges are dropping - but other nations are cutting too, so the gap with other countries remains large enough to merit repeated criticism. It is not hard to sound optimistic, but a balanced view has to ask why it is so difficult to make more rapid progress.

### *Some Scenarios of Vietnam's Growth*

In recent papers<sup>5</sup>, the author has made some schematic estimates of what growth in Vietnam would look like under various scenarios. A simple example is a two by two matrix, in which domestic policy is either "good" or "bad" and the global economic environment is similarly either supportive or constraining. If all things were to go well, growth similar to 1991-97 might be expected. There would be greatly increased and export-oriented FDI. Billions of dollars would flow back from overseas bank accounts into private investment. A real capital market would develop. Economic activity would broaden beyond the greater HCMC and Hanoi areas. This would be the best case for Vietnam.

An interesting comparison might be drawn with a world economy that is sluggish, even while Vietnam presses its reforms. What pace and quality of growth might be expected? Export growth would be slower, and FDI inflows lower. However, the value added of most manufactured exports is now relatively low, and many raw materials would go to parts of

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<sup>5</sup> For example, *Economic Policy for Vietnam in a Period of Economic Turbulence*, November 2001. The paper was used in an executive education class for government officials in Danang in January 2002. The MPDF supported a portion of the Vietnamese costs of the class.

Asia that would probably continue fairly rapid growth, such as India or China. In the next few years, growth might only be 1-2% a year less, or 6-7% a year. This is less, but still a respectable rate of growth.

The alternatives involving poor domestic economic policy would be slower. More low-efficiency public investment and continued slow development in the financial sector would ensure restricted growth of the more dynamic foreign and private sectors. Even in a good global environment, there might be only about 5% annual growth. In a poor global economy, it would presumably sink even lower.

The impact of domestic policy will be huge over the next decade, more important than the likely variability in the global economy. Again, money is available to fund productive investments. Good policy is needed to create the opportunities. How can the donor community help create those policies?

#### *What is the Value Added of ODA in Vietnam?*

The conventional view of aid is that it is important because it provides capital and/ or foreign exchange, plugging the two "gaps" that still appear as "funding requirements" in both World Bank and IMF documents. Vietnam could arguably attract double the productive FDI per capita it does now.<sup>6</sup> It gets \$1-\$2 billion a year in remittances, much of that likely to be capital rather than consumption transfers. It has over \$3 billion a year in oil exports, much of which ends up as foreign exchange under government control. It has billions of dollars mobilized in bank accounts in Vietnam sitting in offshore banks earning 1-2% a year. The "requirements" assume investment ratios needed to reach a target growth rate. Yet, with fewer uneconomic projects, these requirements would drop. Is it realistic to think of Vietnam as having unmet funding requirements under these circumstances? Or is it more correct to argue that the presence of plentiful low cost funding leads to the very choices the recent donor dialogue has contested?

A newer view is that ODA brings intellectual insight to developing nations. After all, if the frontier is output of \$30,000 per capita, how hard should it be to transform a literate workforce to increase from \$1% to 5% of the frontier? If this view is even partly right, how should the donor community proceed? Should it link at least certain types of aid to a more reasonable public investment program, or to success in manufactured export growth, even if that means lower disbursements? Should it put more emphasis on transforming high cost into competitive industries, or on avoiding the multiplication of yet more cases like sugar

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<sup>6</sup> In recent years, Vietnam has gotten \$10 per capita of FDI, compared to \$26 in the Philippines, \$30-\$40 in China, and \$55 in Thailand. Projections are for Vietnam's FDI per capita to rise to \$18 in 2002, with most of the rise due to energy related investments.

refining?<sup>7</sup> Should it be more careful in SOE personnel reductions or should it push for speed, even if some inevitable mistakes are made? Questions are easy and answers are hard. But Vietnam needs answers, even if it does not give them. Perhaps the donors should try harder to make sure there are not even more questions in a few years.

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"Our economy grows mainly thanks to soft loans, and to state subsidies including subsidies for interest rates on bank loans, not to mention the price of land use rights. If we do not accelerate economic restructuring and raise competitiveness, we are in imminent danger of having zero economic growth." (Letter to Vietnam Economic Times, August 2002. The writer is the Prime Minister.)

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<sup>7</sup> In Annex 5.1 of the 2002 World Bank Report on Vietnam is a discussion of the "One Million Ton Sugar Program" It describes the spending of \$750 million on sugar mills (\$470 million external) and perhaps \$350 million in associated infrastructure. Production has soared from 10 million to almost 18 million tons of sugar cane and sugar production has almost tripled. Both tariffs and quotas protect the industry, which is largely SOE's. At import prices, reached in 2000 as capacity rose to equal or exceed consumption, no mills cover all of their capital costs, and small mills do not cover cash costs. Subsidy costs are huge and many smaller mills will have to shut down without continued subsidies.