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SUCCESS AND FAILURE:
CHOOSING THE RIGHT PATH TO EXPORT-LED GROWTH

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Introduction

Vietnam is widely viewed as one of the most successful aid recipients and an exemplar of how economic growth can be both fast and equitable. The World Bank, the International Monetary Fund, and Professor Joseph Stiglitz have all heaped praise on the economic strategy of Vietnam, suggesting it is on the right track and will produce continued success. If this is correct, it would suggest more of the same is in order. If it is not, the praise and soft loans create a sense of complacency that will undermine further reform.

This paper will argue that Vietnam, in spite of a number of successful reforms, is closer to failure than success with its strategy for rapid, export-led growth. This failure will not show up in the next year, but will become apparent in the next three or four years. The likely failure is due to an inability to create the conditions that cause private foreign and larger private domestic investors to flourish[1]. In spite of rhetoric to the contrary, the government is set up more to protect and expand state enterprises - often operating in an uncompetitive way - than to encourage low-cost industries and firms capable of growing on their own. The result is slow growth, limited job creation, and growing social tensions. This outcome would be especially disheartening because Vietnam's labor is of good quality; its financial resources are adequate; and it has access to all major markets. The failure would be due to an inability to create conditions where all of these positive elements come together and create a self-sustaining period of rapid growth.

There are those that argue that Vietnam has done remarkably well since the Asian crisis, and is slated to grow at 7% or more this year. If the official growth data are taken seriously, this would be true. It is telling that *every* external group trying to estimate real GDP growth has come in with lower figures. The IMF figures for 1998-2001 estimate 4.5% growth rather than better than 6%, as the official figures do. Recent World Bank estimates for 2002 GDP are 2% lower than official projections. The growth of fuel

[1] The rapid growth of private investment since the Enterprise Law of January 2000 still leaves the share of formal private industry to total industry in 2002 below that in 1995, and under 3%. Licensed FDI is falling in spite of the new law of Foreign Investment and the BTA. The problem is not so much one of intellectual perception as of interests creating a *de facto* policy that satisfy short-term concerns while undermining long-run growth.

imports, normally twice the real GDP growth rate, has been 10% a year since 1998.[2] This implies a growth rate of 4% to 5% a year, scarcely enough to absorb the growing numbers of workers or create widespread and rapid progress.

In addition, much of the high industrial growth comes from gains in high-priced products such as cement, sugar, steel, and motorbikes. These products are priced well above those in neighboring nations, and will have a much lower weight in output when tariffs drop in a few years.[3] Thus, much of the industrial growth is an artifact of temporary protection, not an indicator of real output gains at current world or future Vietnamese prices. To be clear, Vietnam is industrializing on a foundation of sand. Unless there is a clear and rapid pathway for these industries to lower costs, they will face losses, shutdown, or need subsidies. This will result in considerably slower growth in the near future, as has been true for dozens of other nations that followed the same growth strategy. Vietnam is not special. It is simply making common mistakes, enjoying a temporary and partly illusory burst of growth, and sowing the seeds for future problems.

Is Export Growth Sustainable?

The other objection to the "closer to failure" argument is that Vietnam has made remarkable gains in exports. Here, we need to ask two things: where did the gains come from in recent years, and are they sustainable into the future. For example, coffee was one of the major growth factors in the early 1990's, but has been stable or down since 1995. Rice peaked in 1998-99, and seafood may also be following a similar path now. Unless there are constantly new sources of growth, it will be hard to maintain any momentum. The most consistent source of sustainable export growth for most nations is manufactured exports. Here, Vietnam is noteworthy in that it has relatively few types of manufactured exports that are significant and their total has been growing slowly. While the BTA has resulted in some new factories being built, and this will make the next year or so register better results, there are structural problems restraining further progress.

[2] Other crude checks show import growth rates about half of the 1994-98 period and real revenue growth of under 3% a year from 1997-2001 if GDP deflators are used. All signs point to 4 to 5% real GDP growth.
[3] The argument is made that investing in these SOE projects is necessary for social and economic stability. Not only are few jobs created directly or even indirectly compared to private sector promotion, but by creating high-cost "facts on the ground," compliance with trade pacts will be more expensive and difficult.

The global phasing out of garment quotas by 2005 should also deal a blow to a system that has been supporting low-margin and inefficient exporters. In summary, most of the recent gains have been coming from raw materials and future gains from either primary products or manufactured goods will be harder to come by without further reform.

The argument about slow manufactured export growth may appear surprising because there were such rapid gains prior to 1998. However, consider the figures for the major manufactured export commodities since then, shown on the next page. Even if their pace picks up, as is likely later this year, it will still be true that 2002 levels will only show 5% per year growth over 1999 levels. That would scarcely be rapid enough to count as an export-led growth strategy. Indeed, the growth of heavily protected industrial output at 10% or so *each year* (14% in 2002) has far outdistanced the manufactured export growth.

Major Manufactured Exports of Vietnam (in Million$)

	1999	2000	2001	2002*	1999-2002 Growth
Garments	1746	1892	1975	1806	1.1%
Footwear	1392	1464	1560	1740	7.7%
Electronics & parts	585	782	700	454	-8.1%
Handicrafts	168	237	237	330	25.2%
Total	3891	4375	4472	4330	3.6%

*Estimated at 12/5 of the January to May export level; Growth rates are annual.

Vietnam is becoming a nation dominated by high-cost import substitution. The two refineries, two fertilizer plants, steel plants, petrochemical factories, and other similar projects will lock in Vietnam as a high-cost supplier unable to compete in world markets. Unable to export, it will soon be the rate of domestic market growth that limits output, and this can be expected to slow radically as export growth turns sluggish and the burden of debt repayments grows. For those who argue that it is the world economy that is at fault, it is worth asking why China's export and FDI growth this year is over 10%, while Vietnam has negative rates for both in spite of the approval of the BTA.

The rate of total export growth since 1999 has been somewhat better, and will pick up later this year as some raw material prices improve and manufactured exports respond with a lag to the BTA. Exports of $11.5 billion in 1999 will grow to nearly $17 billion this year, a growth of 14% a year. The key question is if manufactured export growth will be able to create the new sources of growth, since raw materials are unlikely to play so large a role as in the last five to ten years. There will be no similar expansion of seafood, rice or coffee, though important gains can be made if higher value-added goods are made the focus of agricultural exports.

Reasons for Vietnam's Sluggish Manufactured Export Growth

Why is Vietnam apparently failing in recent years to follow an export led growth strategy? There are some external and some internal reasons.

1. The global economy has been slow and other nations have suffered declines in exports in both electronics and selected raw materials.
2. The BTA was not passed until the end of 2001 and the gains will be seen only later in 2002 and early in 2003.
3. China has joined the WTO and is becoming ever more competitive.
4. Slow reform in crucial areas has diminished the desirability of Vietnam as a location for FDI.
5. Quota allocation remains anti-competitive. It frustrates the natural growth of clusters which enhance competitiveness and create a dynamic advantage.
6. The financial system remains state-oriented and incapable of providing services to rising small and medium firms that lack collateral.

Mainly External Factors

The global economy did slow down in recent years. Due to the decline in the prices of both raw materials and technology products, the growth in the value of developing country exports has slipped from 12.9% in 2000 to only 1% in 2001 and 2-3% this year. Future projections are for 7-8% value growth, similar to the average of the last decade. [*Global Development Finance 2002*, p. 20] Note that the average export growth since 1998 has been 5-6%, similar to the growth in Vietnam's manufactured exports. Vietnam has done no better than average, and perhaps worse considering its small exposure to electronics. There is little that Vietnam can do about global conditions, except hope that the projections are correct. However, the general picture is one of an environment which, while well short a boom, will allow an export led growth strategy.

The signing of the BTA was delayed until late in 2001, and as a result the full benefits will be felt only in later 2002 and 2003. There are dozens of factories that will open, especially in and around HCMC. These provinces accounted for 70% of provincial exports in the first quarter of 2002. (Hanoi, Haiphong and Quang Ninh accounted for nearly 15%, leaving only 15% for the rest of the nation.) The forthcoming gains are welcome but are not necessarily an indicator of medium-term gains. If FDI in Vietnam were similar to that of China, it would be more positive. But approvals so far this year are running at an annual rate below $1 billion, compared to well over $50 billion for China. This is not a good sign for future gains. Why should there be such a difference?

One reason is that Vietnam, in spite of its perceived stability and freedom from terrorism, is still rated near the bottom of several competitiveness tables, at least among Asian nations. Three important rankings are from the *Global Competitiveness Report*, the *Economist Intelligence Unit* ratings of business locations in Asia, and the *Global Information Technology Report*. All three have come out in the fourth quarter of 2001 or the first quarter of 2002. All three rate many countries, including the major ones in Asia, on a variety of dimensions. The GCR rates an overall national ability to create a good environment. The EIU focuses more on conditions for multinational business. The GITR looks at the ability of the nation to engage in IT (information technology) activity. Most of these come out every year, so it should be possible to get current indications of how Vietnam is perceived as a desirable destination for investment. The ratings of these three tables, listing only South, Southeast, and East Asian nations, are shown on the next page.

One reasonable objection to these sorts of rankings is that China is none too high, and indeed below India. However, it gets a lot of FDI, more than ten times the amount that India does. So do these tables really matter? The answer is probably yes, they do matter. China is a huge market, with hundreds of billions of dollars a year in exports that is growing fast. It is a low-cost export platform as well. Many companies believe they cannot be left out of China, and so come in even though conditions are not ideal. India is not in this position, and so cannot attract so much investment. So, even though other considerations matter, it helps to be higher rather than lower in these tables. Vietnam has a small market, only about one-quarter of Thailand's, and so has to make itself attractive rather than rely on its market size to draw in investors. The recent downturn is FDI, showing an annual rate of below $1 billion a year, suggests that more must be done to make Vietnam a more attractive destination.

Ranking within Asia in each Report

Nation	GCR	EIU	GITR	Average
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.

China has joined the WTO and will have more open access to every market. It has done a good job of investing in education and modernizing its universities. It has cut its telephone and Internet charges, and Internet use is 2% instead of 0.3% in Vietnam. (This is the most recent estimate of users in Vietnam.) China charges just $6.60 for 20 hours of Internet use each month, while Vietnam is twice as much with half of the per capita income. China will get over $50 billion of FDI this year, and export over $300 billion, mostly manufactured goods that are well diversified. It is important to realize that China does not "need" money from FDI - it has a very high savings rate, enough to fund a rate of investment equal to 35% to 40% of GDP. Rather, FDI has been shown to increase the growth of productivity. FDI accounts for 25% to 30% of non-state investment and about half of all exports. In many ways, FDI was allowed to dominate as private firms were held back until about five years ago. That is, during the 1990's, the state and town-and-village sector output fell in industry while FDI and, more recently, the domestic private sector began to grow. As investment flows into banking, distribution and telephone sectors, it is likely that costs of production will drop further and even more FDI will be attracted. *China is a fierce competitor that is accelerating and getting even better.* Vietnam will need to accept this as a fact of life and decide how to respond. It is true that a growing China will demand raw materials, but this is only of limited help.

Mainly Internal Factors

We have discussed the rest of the world, about which Vietnam can do little. What can Vietnam's government control? It can influence the rate of reform in key sectors, direct investment to efficient industries, and generally make Vietnam an attractive destination for both foreign and domestic investors. How well is that being done? One answer is the actual inflow, as opposed to the reported licensing, of FDI. There are various estimates of this inflow. Actual reporting is spotty, so one has to make a choice among estimates. I use the FDI data from the IMF balance of payments accounts found in their 2002 report on Vietnam. This only includes investments made by the foreign partner by bringing capital (loan or equity) into Vietnam. Gross FDI inflows fell from $2 billion in 1997 to $700 to $800 million in 1998-2000. More recent estimates put inflows at $1-$1.4 billion in 2001 and 2002. The recent increase reflects the success of a few large mining and infrastructure projects in gas and electricity. Thus, actual inflows have been running from 2% to 4% of GDP in recent years, close to the ASEAN average. However, since per capita GDP in Vietnam is lower, per capita FDI is lower than in other ASEAN economies. Using a different series from the IMF *International Financial Statistics*, in the year 2000, these are the realized FDI per capita data:

China: $30 Philippines: $26 Thailand: $55 Vietnam: $17

This suggests that by a per capita measure Vietnam is not doing as well as its neighbors.

Can this record be improved? It seems likely. Vietnamese labor is universally praised as being industrious, quick-to-learn, and low-cost. Infrastructure is certainly adequate to accept more investment. Many provinces have access to good ports. If other aspects of policy are improved, then it is very probable that larger FDI flows would be realized.

Several positive steps have already been taken. Inflation is low and both the government budget and balance of payments are in good shape. The exchange rate is fairly stable. The credit rating of Vietnam has improved, and that is a good signal even if borrowing is not yet a good idea. There are billions of dollars of bank deposits offshore earning 2% a year and insurance companies cannot find good places to invest their long-term assets. There are also billions in unused ODA and FDI. Why should Vietnam borrow at 8 - 9% in dollars? (The problem is creating good institutions to put existing money to work productively rather than into real estate bubbles in Hanoi and HCMC! More is not needed now except to fund pet projects of low efficiency - and these do not pay 10% in dollars except with high protection.) The Enterprise Law, though aimed mainly at domestic business, sends a positive message to foreign investors as well. Changes in the foreign investment law have also helped. All of these steps, along with the BTA, are very good.

Is all of this enough? It is a bit like the story of two men that suddenly see a bear running after them. One starts running. The other does too, but yells, "We can't outrun the bear." The other man says, "I am only trying to outrun you!" In attracting FDI, you have to outrun the other nation, not just run. And Vietnam started behind others because of a later start. What needs to be done?

The general answer is to *benchmark* Vietnam against its competitors. This could be done for tax rates, telephone charges, customs service, general regulatory delays, ease of visa entry, freight charges, etc. By comparing itself to its competitors, and by asking investors what seems to be important, a priority list can be developed and acted upon. In some areas, such as personal income taxes and telephone charges, Vietnam is clearly the worst of its major competitors. This immediately acts as a deterrent.

There are also particular issues. One reason that China has gotten so good as so many exports is that it has <u>allowed</u> (NOT planned) the emergence of "clusters" of activity centered around particular products. These clusters arise because design, marketing, production, spare parts, inputs, repair services, skilled labor, etc. tend to be easier to find if there are lots of producers in one area. Knowledge about the particular product is "in the air" and shared among people. The whole region gets better at profitably producing the product. In Vietnam, garment quota is distributed across the country, and mainly to state enterprises. Only about one-quarter is auctioned and the rest is allocated. In other countries, virtually all quota is auctioned to those that can use it most profitably. Auctioning allows clusters to form. Wide distribution tends to prevent it, in part because the secondary market is not especially efficient. If quota were auctioned, the proceeds could be given to the state enterprises to compensate or retrain workers, buy new machinery, or hire better designers and quality control people. This would not be entirely fair, but it would be better than what is now done.

The financial system in Vietnam remains dominated by a bias towards financing of state enterprises and activities. Many small and medium firms wish to appear to remain small. Many do not use banking services at all. Bank loan officers are afraid of criminal prosecution if they make a bad loan to a private firm. The Development Assistance Fund all but rules out privately financed activity in fact, if not in theory. The result is that the growth of small and medium firms is constrained and dependent on internal funds or finance from family and friends. More importantly, savings are bottled up in unproductive activities. Some go into dollar bank accounts[4], ultimately sitting in Singapore banks earning 2% a year; others into the growing real estate bubble. Some end up in government bonds, financing low-return and high cost projects that produce little employment. *Until ways are found to break this bottleneck, there will be a fundamental failure in Vietnam's growth strategy. Savings are not being connected to good investments.* One way to start might be to allow foreign banks a larger role in the banking system. Another would be to allow bond issuance by larger private firms with good accounts and disclosure.

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[4] Individual savings accounts in foreign currency were only legalized in 1999, and they now account for about half of all bank accounts. At prevailing interest rates, most people believe that the threat of larger devaluation of the dong outweighs its slightly higher deposit rate. This dollarization means that banks are safe only if a large amount of their assets are also in dollars. This *could* be solved by lending to exporters that earn dollars, but now most dollar loans go to import-substituting state enterprises, like the oil refinery.

There are, of course, other examples of problems. The Customs Service too often acts with impunity to obstruct the orderly flow of goods. Inspections can be arbitrary and designed to extract from businesses rather than to reveal needed improvements in health or environmental issues. Tax negotiations often end up reducing revenues for the government. For this sort of problem, a better mode of complaint resolution is needed. If an investor shows there has been arbitrary or corrupt treatment, the result should be more serious for the offender than the victim. There should not be one or two ceremonial firings, or a court judgment with no damages. The government should hold itself accountable to uphold the law, or at least to prevent flagrant abuses. This could involve better application of existing laws, special prosecution if local governments are not responsive, or other methods. The point is to create enough security that investors feel safe running a legitimate business under the law. This is not yet the case. The laws are so restrictive and the regulations so burdensome, that unless most private firms cheat in some way they are unable to carry on business at all.

It is sometimes observed that there are a (very) few provinces where investment has flourished, far outrunning the pace in other provinces. Binh Duong is one of these few provinces, and has been much studied. Most of the studies miss the point. It is not any precise administrative procedure that is the secret. It is the attitude of the leadership in the province, that was widely shared among the government apparatus. They figured out that both they and the province would prosper if they made it easy to do business there. So they got up every day and asked themselves, "What can we reasonably do to make it easier to do business?" They asked the firms and owners. They improved access to land, to credit, and to labor. They worked on housing and infrastructure. They avoided taking an extractive stance. As other provinces come to the same basic idea, they will find ways to act in a similar way. The details are of some interest but not crucial. The attitude is crucial. This is where another issue arises.

Many provinces cannot imagine a future in which most of the industrial and service activity comes from competitive private firms. So, rather than try to develop such firms, they put a great deal of effort into attracting public investments of one sort or another.

They use public money as a substitute for private money. (Public money can include highly protected enterprises, even if privately funded. Without the protection, they would not exist.) The government, partly out of concerns about regional poverty and partly due to simple politics, has encouraged this attitude. In order to hasten reform, a new paradigm is needed. *Public money should be used as a complement to private investments.* That is, even if we set the few hyper-successful provinces aside, public investments should be directed at those provinces that prove successful in attracting private investment. Of course, the really poor and isolated provinces would continue to get funded. Roads and electricity would still be extended to all communes. But public money - including investments in protected heavy industry - should not be the major way of evening out regional inequities. Instead, these regions should be rewarded when they find ways to attract efficient private investment, foreign or domestic. If this were done, the interests of provincial officials might be aligned more nearly with the national interest. This is not yet the case, and the result is a great deal of very poor public spending and investment.

One further element, although somewhat longer-range, needs to be mentioned. One reason that China is doing so well is that it has invested heavily in overseas education. They have sent tens of thousands of students each year who then return to improve the nation's universities, businesses, and government departments at all levels. They have people - and more importantly *organizations* - that understand the global economy and how to work with knowledge. This allows them to tap into technology in a productive way, getting into new markets. Unless Vietnam makes a serious effort to do the same, it will be at a terrible disadvantage. If the objection is made that there is no money, this is simply wrong. Now there are choices being made, such as building a premature highway for a billion dollars parallel to Highway 1 rather than investing heavily in education. This investment is not just money but in reformed procedures. Many universities (and other parts of the system) do not work well and should not get a lot more money unless there are better operating rules. Unless Vietnam also begins to take this aspect of reform seriously, it will soon find it has trouble competing. A high literacy rate is a great advantage, but knowledge of how to plug into global information networks is now becoming as important. This is not a skill that is now being taught, and it needs to be. Successful globalization requires this kind of knowledge.

In summary, there are major obstacles ahead. Vietnam's industrialization policies are now heavily weighted towards high-cost import substitution. They are on a collision course with its trade policies. The collision will slow growth as many existing firms have to cut output and learn to compete after getting used to high prices. Or, perhaps, the firms will continue to get protection and subsidies, leading to retaliation against Vietnam's really profitable exports. Policies from telephone monopolies to education to taxes to regulation need to be improved. The financial system needs to be greatly restructured so that the substantial savings of Vietnamese are directed away from unproductive uses.

If things remain as they are, or move only slowly in the right direction, it is likely that Vietnam's growth rate will remain well below its target and potential, while its job creation lags well behind the amount needed to reduce social tensions and evils. The trick is to create conditions so that more officials identify their own interests with the national interests. There is now a serious disconnect which no amount of lecturing or anti-corruption drives will overcome. Institutional changes have to be made so that more people decide to do the right thing so that it helps them, as well as the nation.