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An Overview of the Vietnamese Economy after The Asian Crisis

The Vietnamese government faced extremely difficult choices in the middle and later 1980's when hyperinflation and food shortages put the economy and people under tremendous strain. Their decision in 1987-88 to embark on a home grown series of economic reforms, called *Doi Moi*, was a watershed. They decided to turn farming back to the farmers, giving them long-term use rights to the land and freedom to grow what they wanted. Prices were largely deregulated, and the exchange rate was allowed to reflect the supply and demand for dollars. As government deficits were reduced and money supply growth slowed, inflation dropped. When the Soviet Union collapsed, it meant their main trading partner and source of aid almost disappeared economically. But the growing supply of oil, the strength of agriculture, and the ability of parts of industry to shift to hard currency markets allowed a smooth transition. By the early to middle 1990's, they were close to political normalization with the US, able to start receiving western aid, and also to be touched by the great waves of private capital that were then flooding much of Asia.

The period from 1992 to 1997 was marked by high rates of economic growth, averaging nearly 9% a year. This growth was supported by several factors. First, the high rate of foreign direct private capital inflows – as much as \$2 billion a year – created a high level of investment and industrial growth. This inflow alone was 5-10% of GDP each year. Aid grew to reach \$1 billion of disbursements in 1997. Oil output and exports also grew to \$1.4 billion by 1997, nearly double the \$750 million of 1992. Agriculture continued to leap ahead by 4-5% a year, and Vietnam became a major rice and coffee exporter. Exports in dollars rose from \$2 billion in 1991 to over \$9 billion in 1997. During this period, several social indicators also improved. Mortality dropped, while educational enrolments rose, improving upon the best levels of the 1980's, which were already good for a poor country. Poverty probably fell in half from 1987 to 1997. Taken together, this period was one of continuing rapid progress. GDP reached \$350 per capita.

However, there were still structural problems that were perhaps harder to deal with because of the economy's success. The state enterprises were not broadly competitive, yet they were influential and able to either impose high prices (telephone calls at several dollars a minute) or low quality (electricity blackouts) in ways that raised costs. They also weakened the banking system. It provided loans to them, even if the loans were unlikely to be repaid. Industries such as sugar, cement, steel, and motorcycles, often built with foreign capital, grew behind high tariff walls. The government quickly found that they either faced losses or needed high prices and/or subsidies, depending on how much above world levels their prices were kept. Yet, so long as everything looked bright, there seemed little reason to change. Perhaps the recorded inflow of *licensed* FDI of \$8.6 billion in 1996 was the high water mark. In spite of being rated unfavorably by various groups such as Transparency International [an international organization that surveys executives about corruption in most countries], the interest of investors did not seem to lessen. This, however, was about to change.

The Asian economic crisis had many impacts, but the largest and most immediate was that the flood of bank credit that had entered developing Asia up to mid-1997 began to flow out. Many of the

largest investors in Vietnam had been Asian, and they suddenly lacked cash. New investors came in to Asia, but they were interested in profits in the near future. Few investors had done well in Vietnam. Having faced periods of limited hard currency availability, the government had limited the convertibility of dong into dollars. The bureaucracy also had a reputation for changing rules and creating delays. So, while Thailand and South Korea saw foreign direct investment double or triple from 1995-96 to 1999, Vietnam saw licensed investment fall from \$8.6 billion to \$1.6 billion, a decline of over 80%. Actual disbursements, according to IMF estimates, fell from over \$2 billion in 1995-96 to \$700 million in 1999. This is an astonishingly low level, considering that at the end of 1999, there had been nearly \$36 billion of licensed FDI and \$26 billion was still undisbursed. Clearly, even investors who had gone to the trouble of getting a license were either unable or unwilling to implement their plans. This slowdown had an impact on the growth rate.

The years of 1998 and 1999 were marked by slower growth, which the IMF estimates at about 4% a year, though government estimates are higher. Other estimates for 2000 and 2001 run about 5-7% a year.¹ Investment dropped from 27% of GDP in 1997 to 21% in 1999, and income per capita in US\$ scarcely grew at all. Exports, however, after growing rather little in 1998, jumped by 22% in 1999, and will show similar growth this year, with some help from high oil prices. Overall, there is a prospect of moderate growth in the near future. The goal for the decade is to double output, meaning 7% annual growth.

The likely actual economic performance in the next several years is uncertain. Vietnam could grow as fast or faster than it did during the better part of the 1990's. It has just signed a trade pact with the US, and this should open export markets. It has a chance to get a foothold in electronic and software exports, if it makes some changes in its pricing and quality of communications and lowers its high income tax rates on Vietnamese citizens. They now face a 78% marginal tax rate on incomes over 15 million dong a month ((\$1000)). If the government manages to re-establish some momentum towards reform, it could improve its banking system and capital markets, shrink the size of the inefficient state sector, and introduce competition to some of its high priced industries. This competition is any way inevitable. Either Vietnam will implement the cuts in tariffs promised (at least) to its ASEAN partners as part of the ASEAN Free Trade Area (AFTA) and likely under the WTO, or smuggled goods will anyway undercut many overpriced local goods. (Each year, unrecorded imports probably amount to \$2 billion or more.) These changes are difficult to make, and probably unlikely in the short term.

If growth is slower, a major problem will show up in a lack of adequate jobs. Agriculture had absorbed many new labor force entrants in the 1990's, but this is likely to slow down for several reasons. Not least is that agricultural incomes are only a third of urban incomes, and the educated young people will probably not settle for isolated and low-paying jobs. Nearly three-fifths of young rural people, and nearly all urban children, now get at least some secondary schooling. The physical output in agriculture is also likely to slow, reducing the growth in demand. State enterprises will absorb few if any additional workers and even foreign investors will do well to take a tenth of those needing jobs. The domestic private sector is weak and has had a shrinking share of output. However, with legal and regulatory changes, it could become a source of both jobs and output growth. If it is allowed to "take off" then overall growth will approach double digits. The recent changes in the Enterprise Law encouraged 7000 firms to enroll officially, though probably most of these were not really new. Still, it is an indication of what is possible if capital is allowed to flow to efficient firms and private firms are encouraged rather than repressed. Most job growth will have to come from

¹ The flooding in the Mekong Delta and elsewhere may depress economic performance this year to some degree. The predicted growth rates of about 5% this year do not take the floods into account.

these domestic private firms, or else many young workers will end up in dead-end jobs in the informal urban sector.

However, it will not be easy for local authorities to allow private firms to compete with the thousands of state enterprises, many of which are useful to their localities. Even now, high inventories of sugar and steel are leading to attempts to close down more efficient private firms. It is more likely that there will be residual preferences for the favored state firms, and this will slow the emergence of competitive services and products. The result will be that many of those moving to urban areas will have to settle for poorly paid self-employed jobs or may even turn to crime. This would create the kind of social evils that all want to avoid. Even 7% growth may not be sufficient to absorb all those who want urban jobs. It is certain that GDP growth of 4% to 6% would not be nearly enough. With social evils, and a weak ability to develop local suppliers, it is likely that foreign investment would continue to lag. This would be doubly tragic because few doubt that the Vietnamese labor force is of high quality, learns quickly, and works hard. Slower growth would also waste the opportunity that is being created by the US-Vietnam trade pact and the likely future WTO membership.

The short-term outlook is fair. High oil prices will help this year, and there will be some upturn in foreign investment with ratification of the US trade pact. Funds from overseas Vietnamese run from \$1 to \$2 billion a year. It will be seductively easy to compromise on tough reforms and hope that the good old days of 1992-97 will return. However, the world has changed decisively since then, and not in ways that necessarily help Vietnam. Investment is more discerning, and high rates of return can now be sought in many places, including the technology sector in developed countries. The Internet is becoming a major factor, and Vietnam's high costs and slow speeds (due largely to aggressive use of firewalls to control and check content) precludes its use as a business tool. The per capita use of the Internet in Vietnam is less than a tenth of that in China. Even telephone rates, while dropping, are among the highest in the region. Meanwhile, high marginal tax rates for local people drive many of the most qualified to work abroad. This makes local staffing harder (it is often cheaper to higher foreigners at higher after-tax pay levels because of the tax differential) and raises the cost of doing business. In short, without much more change, it will be hard to attract the kind of quality FDI that Vietnam needs. In this respect China is well ahead. Its \$700 motor bikes compete very well against local Hondas selling at \$2100 in Vietnam!

It is likely that eventually more of the leadership will understand not just the need but also the urgency of reform. This may take more failure, or it may come as a result of better information about the pace and extent of changes in the world. Either way, the decision to move ahead more quickly will come none too soon.

Unsolicited Advice to Foreign Investors

Vietnam is not a major destination of US foreign direct investment. At the end of last year, total licensed US investment in Vietnam was \$1.3 billion, or about 4% of its total licensed foreign investment. Actual US disbursements of FDI were estimated by the IMF at \$11 million in 1998 and \$41 million in 1999. The total GDP is roughly \$30 billion, or one-third the size of Singapore. It is true that with population approaching 80 million, there is a future market there, but it will take many years before it is a major consumer of products that most US firms make. It might seem easier to use existing plants in Southeast Asia to supply Vietnam, whose markets will soon be more open due to its signing the ASEAN Free Trade Area agreement. WTO membership should also lower trade barriers in a few years. Viewed as a customer by itself, it will not be very big very soon. It could well be twenty years before it is as big as Singapore is now.

The fact of the matter is that if you are hoping to produce high-cost consumer goods behind high tariff walls, you are coming late to the party. Many others (over ten auto companies for 10,000 units sold in a year) have come in already. There are requirements that foreign exchange use be “balanced” for most consumer goods, meaning you have to export enough to fund your foreign exchange use. If Vietnam doesn’t make sense as a regional production center; it is probably not sensible as a place to invest.

There is one other aspect that is of more interest. Vietnam could become a major supplier of labor intensive goods, and perhaps others. Literacy is over 90% and most kids get at least some secondary schooling. Virtually everyone reports workers learn fast and work hard. Pay starts at about \$50 a month. High-end workers are also promising, though more training is needed. (Vietnamese often do well in the Math Olympics.) Exports are growing over 20% a year, even if from a low base. But Vietnam has a reputation as a tough place to do business. It ranks low on corruption and transparency, and these offset some of the labor advantages. Infrastructure, though improving, is still poor and sometimes expensive. But, above all, there is still a prejudice against domestic private businesses. These will reduce the likelihood that supplier networks will be built up quickly and reduce costs as much as in China or other places. This bias is more in the North than the South, but not absent altogether anywhere.

So, should Vietnam attract any serious attention? For some, such as Nike, it already does. So long as trade relations are normalized, it will be possible to use Vietnam as an export base for making athletic shoes and clothing. Perhaps, over time, suppliers will emerge to lower costs further. But what of other kinds of investment? There is a checklist of questions that should be answered if a software developer or electronics assembler wants to invest mainly for exports:

1. Is there a firm legal basis for a 100% owned foreign and/or domestic company?
 2. Will corporate and personal income taxes be broadly comparable to other nations?
 3. Will the Internet and telecoms be allowed to function as well as in nearby nations?
 4. Will the banking system become responsive enough to provide modern services?
 5. Will decisions regarding import, export, expansion, etc. be made in a timely way?
1. The answer to question #1 is yes, on the books. The problem comes in moving from the broad law to actual practice, which is often much different. In 1998, there were only 168 private domestic manufacturing firms with more than 300 workers. A recent change in the enterprise law for domestic firms may lead to better actual practice over time. If you mainly export, there is not a problem getting approval for a 100% foreign firm. But watch and see if domestic private firms really start to grow. If they do, it is a good sign of a shift in thinking and practice, not just rhetoric.
 2. There is not much of a problem with corporate tax rates, but personal income taxes on well-paid Vietnamese rise to a marginal rate of 78% at about \$1000 a month. However, software is supposed to get a special concession, so that Vietnamese software writers get to pay the same income taxes as foreigners. The changes are in the right direction, but it still may be cheaper to hire an Indian engineer than a Vietnamese in a disk drive factory. That is, the Indian has lower taxes even if a higher after-tax income. Tax laws in general are still opaque, harshly enforced, and difficult.
 3. The Internet right now is almost unusable. The gateway for the entire country is about eight megabits per second, and heavy use of filters and firewalls slows messages to a crawl. Data lines are very expensive, and telephone calls are \$2 to \$3 a minute. Unless the capacity of the routers

and switchers is drastically increased, and the firewalls become less intrusive, any industry needing to use the Internet will have real trouble. This is partly a security decision and partly a reluctance to give up a quarter billion dollar revenue stream that the telephone company receives from direct and settlement payments. A lot of outward looking investment will wait for changes in these areas.

4. State banks dominate the banking system. They lend mainly to state enterprises, and are inefficient. (Peasants can also get short-term working capital loans.) As a result, most transactions involve cash. Checks and loans to private firms are rare. Banking services are rudimentary. This slows down the development of the private sector, and reduces the ability of suppliers to lower input costs for exporters. If the government becomes more serious about changing, look for more competition and innovation in banking. The stock market and bond markets are at a very early stage too, really barely functioning.

5. There is still an expectation that the bureaucracy actually controls firms, even foreign firms. There have been complaints that a decision to change machinery or increase capacity, if not in the original license needs specific approval. This is impossible for a fast moving business. Various arrangements sometimes hasten approvals or soften the restrictions. But, it would be wise to understand what these restrictions are, and if they can be reduced or eliminated from the beginning. Aside from pollution, there is virtually no objective basis for the government to decide on these matters if only exports are involved. This is also changing, but perhaps not fast enough.

There is a good reason why rather few US investors have committed serious money to Vietnam. With a few exceptions, it has been a tough place to do business and a hard place to make money. Management time is scarce and decisions need to be quickly. Vietnam has been a place that eats time and creates delays. It is changing, but perhaps not fast enough. By looking at the kinds of issues raised here, you will be able to decide if the advantages of good location and superior labor are offset by the other problems. Expect things to improve, but not right away.