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**VIETNAM AND ASIA:
SELECTIVE RECOVERY FROM THE ASIAN CRISIS?**

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This paper was prepared for the seminar entitled "Facing the Challenges of the Global Economy: Some lessons from the Asian Financial Crisis" organized on March 21, 2000 by the Social Science Research Council

VIETNAM AND ASIA: SELECTIVE RECOVERY FROM THE ASIAN CRISIS?

Most of Asia is Recovering Quickly

Many Asian economies had by the mid-1990's been growing rapidly with only minor interruptions since the 1960's. It is true that China and India joined in the rapid growth only about 1980, and Vietnam a decade later. However, the formula was clear: install good macroeconomic policies, create conditions for fast growth of manufactured exports, and run current account deficits only when mainly private foreign capital flows (or long term ODA) would cover them. Thus, when the 1997 "Asian Crisis" hit, there was much consternation and surprise. If Korea and ASEAN weren't doing things right, who was? Put another way, it appeared that the entire global system for investing capital needed a rethink. If capital could flow so freely into these countries and then suddenly reverse, it looked like there would have to be some circuit breakers, "sand in the gears" or even a "new economic architecture" for the world. Where are things now?

First, it appears that most countries are recovering faster and better from the 1998 recession than had been projected even six months ago. South Korea is the most notable, with 10% real GDP growth in 1999, but Malaysia, Thailand, Taiwan and Singapore also weighed in with respectable 4% to 6% figures in 1999 or 2000. Even hard hit Indonesia eked out a slightly positive growth number, and faster growth seems likely this year. In general (and this could be undone if the US enters a sharp recession), the downturn was "V" shaped with a steep decline and also a sharp recovery. See Table 1's growth rates in 1996-2000 for selected Asian economies.

Second, there has been research on the nature of the capital outflows. With the exception of Thailand and Hong Kong, it appears that speculators or foreigners of any kind had virtually no significant role in attacking the currencies of the other nations. Basically, local firms and banks had borrowed heavily in US\$, but were mainly earning local currencies. They also borrowed in the form of short-term loans when their projects would take years to generate adequate payments to service the debt. When they realized that their assumption of fixed exchange rates was no longer sustainable, they all ran to accumulate US\$ so they could repay their debts. Their panic caused immense pressures on the currencies, often aided by individuals fearing devaluation or even non-convertibility of their savings. Weak domestic banking systems, heavily indebted non-financial firms, and low levels of hard currency reserves held by the central banks aggravated this

problem. Private foreign investors, mainly banks, were scared off when they realized that there was so much systemic short term debt, so little foreign reserves, and the official data being released were not accurate.

Third, the major source of foreign capital outflow was bank loans. FDI actually increased through the period, while portfolio investment changed rather little. It was not the new “electronic herd” of Tom Friedman that fueled the capital outflows in later 1997 and 1998 but rather the old Japanese and European banks that had come running in only a few years earlier. They were looking to make high interest rate loans in Asia because of the softness of loan demand in their home markets. They ignored warning signs and continued lending even when low profitability and excess capacity should have alerted them to reduce their exposure. Better risk management is needed and certainly improved data reporting at a macro-economic level, but perhaps not a new architecture.

**Table 1: GDP Growth Rates for Selected Asian Economies, 1996-2000
And Their Decline from 1996 to 2000**

Country	\$GDP p.c.	1996 (%)	1997 (%)	1998 (%)	1999 (%)	2000 (%)	Decline (%)
<i>Vietnam</i>	310	9.3	8.2	3.5-5.8	4-5	4-5	4.3-5.3
Indonesia	1,100	8.0	4.5	-13.7	0.5	4.3	3.7
Japan	38,000	5.0	1.4	-2.8	0.7	1.3	3.7
Malaysia	4,500	8.6	7.5	-7.5	4.9	6.3	2.3
Thailand	2,740	5.5	-1.3	-10.0	4.0	5.4	0.1
China	860	9.6	8.8	7.8	7.1	7.4	2.2
Korea	10,500	6.8	5.0	-5.8	10.2	7.6	+0.8
Bangladesh	360	5.4	5.9	5.6	5.2	6.2	+0.8

Note: GDP growth for 2000 is projected based on the April 15th Economist data, except for Bangladesh and Vietnam, which are from the IMF. Historical data are from the IMF. China's GDP growth is widely believed to be 2-3% below the official figures. Vietnam's recent official growth rates have been higher than independent estimates by the IMF and some multilateral banks. Thus, a range is given. The final column is growth in 1996 less in growth in 2000.

The country by country analysis is interesting. China and Vietnam, of course, have closed or tightly controlled capital accounts, while Malaysia (in spite of low foreign debt) used capital controls and Japan is the largest supplier of capital to the region. None of these nations should have been so much affected by the fluctuations in capital flows, if capital flows were the main cause of the slowdown. On the other hand, Thailand and South Korea were heavily indebted, held few reserves, and had weak banking systems. Indonesia, including its corporate debt, shared these problems and also had profound political tensions. Bangladesh is included as a kind of control, as it was little affected by the crisis and represents a nearby but poor developing

nation.

It is not surprising that Indonesian growth declined precipitously. There was the end of a long-running authoritarian ruler, rioting, looting, burning, violence, and political uncertainty. This was not just in 1997, but extended over several years. The Chinese-Indonesians are especially nervous about reinvesting. Yet in the fourth quarter of 1999, real GDP was 5.8% higher than in the fourth quarter of 1998. It could be that projections for 2000 of 4.3% are too low, and in any case as the political tensions are resolved it is likely that investment and growth will pick up. It is not just foreign flows that caused this problem, but they helped to precipitate the “crisis” and should help end it.

It is more surprising that Thailand and Korea are doing so well. Thailand’s growth this year is projected to be about equal to 1996, while Korea’s growth in 1999 and 2000 will average out higher than in 1996. Thus, the most connected “normal” countries faced brief, wrenching recessions that helped propel needed reforms. These reforms increase confidence and restart the growth process. The lesson that is drawn is that there are tremendous advantages to joining the global economy, but also dangers. These dangers can be minimized by lower debt levels, higher foreign exchange reserves, and better accounting, legal structures and supervision of banking operations. The lost year of 1998 is unfortunate, but perhaps a necessary step on the way to a sustainable global integration and continued growth. It is certainly in contrast to the “lost decade” of the 1980’s in Latin America, when excessive debt was mixed with high government deficits and inward looking economies that had immense difficulty improving their competitiveness.

Malaysia has resisted many fundamental reforms and employed variable but largely temporary capital controls on outflows. This was done even though Malaysia had *reserves* larger than total private debt and needed less than 2% of exports to pay interest on its debt. In other words, it should have been in a very strong position *if* foreign flows were indeed the main problem. Yet Malaysia’s growth slowdown was over 2%, making it one of the moderately affected. It is not surprising that an independent study found little or no foreign outflows involved in Malaysia’s devaluation. It turned out to be local firms with high levels of foreign currency debt trying to sell ringgit and buy dollars. Most capital flight had already occurred by the time controls were imposed. Removing them had little impact.

We can pass over the slowdown in China and Japan. The former has seen a sharp drop in growth driven largely by local over-capacity and a weak banking system that directs funds to unproductive state enterprises. The government realizes the problem and wants to speed a transition so that more resources go to productive uses and fewer to dead-end transfers and corruption. The latter has yet to resolve fully the structural problems that arose out of the collapse of their “bubble economy” in 1990-91, and the emergence of a fast-moving global economy. Neither of these nations suffered primarily from fluctuations in foreign capital flows. However, their home grown problems led to growth declines of 2.2% and 3.7% from 1996 to 2000. (China’s growth is thought to be over-stated by 2% to 3% a year, but this may not influence the change in growth.)

But Vietnam is Among the Most Affected Nations in Asia

For this analysis, the slowdown in Vietnam is of particular interest. **Vietnam appears to be the most severely affected nation during the Asian Crisis, measured by the 1996 to 2000 growth slowdown.** The fluctuations in short-term international capital flows have little relevance for Vietnam, because the main source of inflows (aside from official aid, which is rising) is foreign direct investment. FDI rose in all of Asia from 1996 to 1998, doubling in Korea and tripling in Thailand, but contracted very sharply in Vietnam. Approved FDI in Vietnam fell from \$8.6 billion in 1996 to \$4 billion in 1998. (If allowance is made for withdrawn or defective projects, the 1998 figure should be \$2 billion.) In 1999, the official commitment figure for FDI is below \$1.5 billion, the same as in 1991! This decline, from 1996 to 1999, is over 80% -- while inflows were increasing in other Asian nations. This is a stark difference. Since FDI rose elsewhere, the slowdown in Vietnam is evidently due to country-specific factors.

The official FDI disbursement data suggest realizations falling from \$3.3 billion in 1997 to \$2 billion in 1998 and \$1.5 billion in 1999. Yet separate official import data record only \$600 million in 1998 and also 1999 of FDI capital imports. Since FDI disbursement data include items like overpriced land contributed by the Vietnamese partner, it may well be that actual foreign inflows are below \$1 billion now. Short-term trade credit also fell, and imports have been essentially level from 1996 to 1999. Export growth, however, has held up well. Exports doubled in dollars from 1995 to 1999. In spite of this growth, Vietnam’s decline in the GDP growth rate was roughly the same as in Indonesia and Japan. Indeed, if the IMF is correct in its estimates,

Vietnam may have slowed down more than any other nation in Asia. In any case, it is among the worst affected nations.

Why should most of Asia be recovering smartly and one of the least connected and poorest nations in the region face such a severe slowing of growth? A poor economy naturally tends to grow faster than a richer one, and Vietnam's educated labor force is productive and relatively inexpensive. There are several reasons, and they are discussed at more length in another paper. In summary, the following reasons are relevant:

1. The unexpected refusal to approve a trade deal with the US that Vietnam had negotiated over the previous three years disappointed foreign investors and reduces the accessibility of the American market for Vietnamese exports. (Reports that the US inserted new conditions at the last minute are incorrect. The problem is that the Politburo disagreed with the government.) Export oriented FDI suffered as a result.
2. The shortage of foreign exchange has made it clumsy or impossible for foreign investors to repay debt, get spare parts, or even inputs – even when they are making profits in the local currency. This, along with increasingly glutted and slow-growing domestic markets, has made it less attractive to invest in import substitution.
3. The banking system remains heavily controlled, small relative to GDP, and obliged to make uneconomic loans to money-losing state enterprises. The division of the banks into commercial and “policy” (subsidy) sections does little to change this. As a result, successful firms cannot get adequate finance.
4. The domestic non-state sector remains small and weak. Through 1999 it had a shrinking share of total GDP. This means any shortfall in foreign investment cannot be balanced by any dynamism in the local private sector. This hurts services especially.
5. The progress of reforming or equitizing (putting into a joint stock company ownership form) state enterprises is slow and unlikely to have a major impact any time soon. The state firms, on the whole, are losing money and cannot compete.
6. The geographic and sectoral allocation of public investment is gravely flawed, responding to political rather than economic criteria. This is causing growing congestion in the area around HCMC and adding to debt without much helping add to productive capacity elsewhere in the country. Meanwhile, expensive projects are added in poor regions that cannot use them. (The HCM Trail highway, for example.)

Poverty Was Dramatically Reduced During the 1990's

These problems, the result of slowed economic reform, are doubly disappointing since the progress from 1988-1998 had been so promising. Income rose quickly, social indicators improved, and income distribution changed little with regions, though some regions grew faster than others did. The incidence of poverty fell from an estimated 75% in 1988 to 58% in 1993 and 37% in 1998 if a “high” World Bank poverty line is used. The depth of poverty (the difference between actual and needed income) also fell sharply. By any reasonable standard, the decade ending in 1998 was a great success when measured by either overall growth (around 8% a year) or by the reduction in poverty and increases in health and education indicators. However, the progress was built upon rapid increases in economic growth, fueled by large increases in agriculture, exports and FDI. The future now looks much less likely to produce continued gains of a similar magnitude. This is because the rural sector has already benefited from the efficiency gains of rural reform and will grow more slowly, while the import-substituting industrialization has much less scope for further growth than in the previous decade. With no trade deal, the prospects for sustained rapid export growth are also dim.

Table 2: Incidence of Poverty by Region in Vietnam, 1993 and 1998

Region	(Millions) Population	Poverty Rate			Income 1998	Real Per Capita Income Growth 1993-1998
		1993	1998	% Fall		
Northern Upland	13.5	79%	59%	20%	1921	31%
Red River Delta	14.9	63%	29%	34%	2938	55%
North Central	10.5	75%	48%	27%	2197	46%
Central Coast	8.1	50%	35%	15%	2641	29%
Central Highlands	2.8	70%	52%	18%	1942	25%
Southeast (HCMC)	9.7	33%	8%	25%	5052	78%
Mekong Delta	16.3	47%	37%	10%	2548	18%

Source: *Vietnam: Attacking Poverty*, Joint Report of the Government-Donor-NGO Working Group, 1999
Income is thousand dong per capita per month in 1998. The dong/\$ exchange rate was about VD13,000 to 1.

The pattern of growth is interesting. The richest area, around HCMC, grew the fastest and the second richest area (around Hanoi) grew second fastest. This is not entirely surprising since they have benefited most from foreign investment and aid. Indeed, per capita income grew twice as fast in cities as in rural areas -- 60% vs. 30% in five years. However, the two poorest regions grew at 25% and 31%, while two middle-income regions grew at only 18% and 29%. A lower-middle province grew at 46%. Thus, all regions grew quickly in this period, and the

poorest were not the slowest. Indeed, if a region can sustain a growth in per capita income of 25% every five years, it can double in fifteen and quadruple incomes per capita in thirty years. If migration reduces population pressure in the poorer areas, and increases population growth in the richer areas, there would be an even greater tendency towards per-capita income growth in the poorer regions. Migration appears to have been minor except in the lightly populated central highlands, which had a high inflow. (Its income growth may also have been higher than reported, though this depends on who received large gains in coffee and rubber output.)

In terms of social indicators, the growth seems to have supported a considerable improvement in a short time. While primary schooling was already nearly 90% in 1993 and rose only 5% in terms of enrollment rates, secondary schooling doubled from 30% to 61% of the relevant age group in five years! Stunting dropped from 51% to 34%, and electricity use rose from 48% to 77% of the population. Ownership of a television rose from 25% to 58%. Taken together, these data support the plausibility of the overall decline in poverty from 58% to 37%. (Poverty level expenditures in 1998 were \$10 per capita per month, or \$50 a month for a family of five people.) They also support the finding that the depth of poverty has declined, falling in half. That is, in 1993 those in poverty fell 19% short of a poverty income, while the figure was 9.5% in 1998. As incomes rise, even if people are still in poverty, they can afford more food and services. Except for the poor in especially difficult circumstances, such as those in isolated ethnic settlements, old age, or poor health, the general rise in incomes appears to be helping most people improve their situation. Even for the others, higher incomes means higher tax revenues and the capability of the government to intervene for those unable to take immediate advantage of the growing economic opportunities.

Poverty Reduction Was Helped by Dramatic Gains in the Rural Sector

The startling gains in income and poverty reduction would not have been possible without the reforms in agriculture. Three-fifths of households have agriculture as their main source of income and, even in 1998, they accounted for nearly four-fifths of all of those in poverty. The reforms started in the later 1980's but if we take 1990 as a base, Table 3 shows some of the astonishing gains: 50% in rice output, 150% in sugar cane and 540% in coffee! (Vietnam is now the largest producer of Robusta coffee in the world.) Real agricultural GDP rose 40% from 1990 to 1998 according to official sources, and relative prices of some agricultural goods improved over the period. This, along with some gains in services, spurred the rural

income growth. Industry remains largely an urban activity, with only about one-fifth of the total originating in rural areas.

It is clear that agricultural output grew about as fast as population up to 1990, and then accelerated. The gains in agriculture were shared among different regions, though the Mekong Delta and the Central Highlands did especially well. The same pattern as in overall income applies within agriculture. Deregulation caused a general improvement in incomes, but also an increase in inequality as those areas with more potential or capital were able to grow faster than those with more difficult conditions or more remotely located. Still, the fact that *overall* (not agricultural) real income growth was lowest in the Mekong Delta and second highest in the relatively poor Red River Delta suggests that deregulation allowed a broadly based gain that did not only help the already better-off rural areas. Indeed, the Central Highlands had been one of the poorest regions, but the boom in coffee and rubber has lifted incomes there, albeit somewhat unevenly. Still, given the pervasiveness of poverty and even hunger in the 1980's, few would wish to return to a system that created equality as such a low level.

Table 3: Agricultural Output Growth in Vietnam, Selected Crops (million tons)

<u>Crop</u>	<u>1985</u>	<u>1990</u>	<u>1995</u>	<u>1998</u>	<i>Growth in Period: Total / Annual</i>	
					<u>1990-98</u>	<u>1985-90</u>
Rice paddy	15.9	19.2	24.9	29.1	52% / 5.3%	21% / 3.9%
All Grain,						
Paddy equivalent	18.2	21.5	27.9	31.8	48% / 5.0%	18% / 3.7%
Sugar Cane	5560	5405	10691	13844	156% / 12.4%	-3% / NM
Coffee ('000 tons)	35.7	64.2	216.8	408.9	537% / 26.0%	80% / 12.5%
Rubber ('000 tons)	47.9	57.9	124.7	225.7	290% / 18.4%	21% / 3.9%
Tea ('000 tons)	28.2	32.2	66.7	79.2	146% / 12%	14% / 2.7%
Pigs (millions)	11.8	12.3	16.3	18.1	47% / 5%	4% / 0.8%
Real Agricultural						
GDP, 1990 = 100	88	100	124	140	40% / 4.3%	14% / 2.7%
Population, 1990=100	90	100	112	118	18% / 2.1%	11% / 2.1%

A major question facing Vietnam is if this kind of growth can be sustained. It appears unlikely from both the demand and the supply side. In terms of demand, Vietnam is already a major exporter of rice and *robusta* coffee. Prices of these commodities are already low and further rapid output and export gains would quickly destroy their profitability. Sugar output is already reaching a level of self-sufficiency, and local prices are two or three times the \$170 per ton world price of white sugar, or \$110 per ton of raw sugar. Large subsidies would be needed to maintain growth to the projected level of 3 million tons, from the current 1 million tons. Rubber

prices are already 60% below their 1995 levels. There is little underutilized land, and arable land is under a tenth of a hectare per capita. If there is to be output growth much above 3% a year, it will have to come from a sharper focus on foreign demand in fruits, vegetables, and meat. This will require higher quality inputs, more quality control, and better processing and marketing. These are not strengths of the state enterprises. Further growth of especially domestic and also foreign agro-processing is a pre-condition for future profitable growth in the rural sector. Yet such enterprises have been slow to develop due to barriers to all private firms.

Industrial Growth is Facing Major Problems

Since 1995, industrial growth has been rapid, though slowing. Growth of over 14% a year in 1995 and 1996 has slowed to about 11% annually in 1998 and 1999. However the major sub-sector driving this growth has been the foreign sector. Both state owned and private domestic industry averaged less than 9% a year after 1995, while output in the foreign-owned sector more than doubled, reflecting an annual growth of 22%. The growth of local industry in 1998-99 is in the 5% to 8% annual range, less than half of the foreign growth. However, the pattern of foreign investment is skewed sharply towards goods with high levels of protection. Only a quarter of industrial FDI went to products with an effective rate of protection of 30% or less, while over half went to products with effective protection of 90% or more. These are very high levels of protection, especially given the commitments made to join the ASEAN free trade area. If the foreign producers cannot cut costs very sharply, they will be unable to compete with imports. However, even if protection is somehow prolonged, the outlook is still poor. As growth rates slip, and there are few imports left to displace, the potential rate of growth of protected industry falls to single digits. Unable to export, hurt by smuggling and even legal imports, and hampered by foreign exchange shortages and regulations, they are left with poor prospects. In spite of having a population of about 80 million, Vietnam's GDP is only \$30 billion – half that of Hong Kong 20 years ago! This small size, combined with sluggish prospects, explain much of the virtual disappearance of interest in many import-substituting projects. As suggested previously, actual imports of capital equipment of all kinds by foreign firms is only about \$600 million or 2% of GDP. Given total industrial output of \$10 billion and foreign industrial output of \$4 billion, it may be that investment net of depreciation is dropping so much that there will be little future impetus to growth. (If the capital/output ratio is 2 and equipment depreciates in 12 years, then net foreign investment is zero!)

The other hope for industry, and especially for employment, is that of export-led growth. There has been tremendous growth in footwear and garment exports since 1995. The exports of each have risen by about \$1 billion from 1995 to 1999, and electronics have also risen sharply to about \$600 million from nearly zero. However, the value-added of these exports is typically only 15% to 20% of the export value. (Thus, footwear and garment value-added was adding only about \$100 million per year, or 1% of total industrial value-added.) And the total amount of manufactured exports of Vietnam, about \$4 billion, is less than the annual increase in the manufactured exports of the Philippines from 1996 to 1997. It will take a massive annual increase, sustained over time, if the export sector is to lead the entire industrial sector, much less the economy, into a period of rapid growth. Yet, excepting only a few provinces in the south, there is very limited export-oriented FDI. The long delay, which could well stretch into years, in arranging a trade agreement with the US, is apt to set things back further.¹ In addition, the reputation of Vietnam among foreign investors is currently very poor. Even if a deal with the US and then the WTO were approved, it would be a challenge to persuade many firms to reconsider the country, given the very negative experiences and losses that many have sustained. A number of objective surveys of foreign investors put Vietnam near the bottom in transparency and near the top of Asian nations in corruption and stress. Thus, the path to developing a strong manufactured export sector will depend not only on a trade agreement, but also on improving the “brand name” of Vietnam and creating conditions for the supplier industries that would support the exporters. These would have to be private, probably often domestic, and these industries are severely constrained under current *de facto* policies. Overall, unless a number of trade, credit, and regulatory changes are made, it is hard to see how manufactured exports will become an important engine of growth for the entire country. Indeed, even in areas where Vietnam could be competitive, such as software, the very high telecom rates and restrictive and limited access to high speed data lines and the internet make it unlikely that much of consequence will develop without policy changes.

Prospects

It is odd when a country has gone through a wrenching change and managed to cut poverty rates in half, double enrollment ratios, improve other social indicators and increase

¹ Ambassador Pete Peterson recently indicated publicly that if the trade agreement is not approved soon, it was likely that the entire trade deal would have to be renegotiated with the next administration. This would probably mean including labor and human rights and religion in addition to purely commercial issues. Such topics may be unacceptable to the Vietnamese, leaving them without access to the US market.

growth rates to levels that double output every nine years – and then decides that the whole process is just too much. It is fair to describe Vietnam as in a state of stalemate. The combined forces of the state enterprises and the Party are not simply resisting, but actually reversing, attempts by the government to press ahead with global integration, more private industry, and greater transparency in banking, administration and regulation. The decrease in FDI, the misuse of aid and the increasing social strains in many parts of the country are symptoms of this state of affairs. The goal of policy is not simply economic growth, but it is hard to envision rapid and sustained progress in any other positive dimension unless the economy again speeds up. So long as an additional 1.2 million young people seek jobs each year, the relative sluggishness in the rural sector and the lack of urban jobs will create problems that will create tensions. While these can certainly be held in check, they will further sap the legitimacy of and support for the government. As Vietnam's ASEAN neighbors again start to grow, they will far outstrip Vietnam in income, options for well-trained people, and industrial competitiveness. Vietnam will still grow slowly, albeit falling further behind in a relative sense. Only when a coalition decides that this is not good enough is it likely that further reforms will be possible. It is ironic that an insulated economy (Vietnam) has ended up relatively weaker after the Asian Crisis, while its richer and more connected neighbors have ended up stronger. Until this fact and its implications are better understood, Vietnam will remain a lagging member of the region.