

**A CROUCHING TIGER? A HIDDEN DRAGON?
TRANSITION, SAVINGS AND GROWTH IN VIETNAM, 1975-2006**

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CONTENTS

I. Introduction	1
2. Transition to the market: a review of the Vietnamese economy, 1975-2001 ...	3
2.1 Unification and initial reform, 1975-1981.....	4
2.2 Partial reversal, 1982-1985.....	9
2.3 <i>Doi moi</i> , 1986-1988.....	12
2.4 Intensive reform, 1989-1993	16
2.5 The FDI boom, 1994-1997	20
2.6 Regional slowdown, 1998-2001	21
3. A three gap model	24
4. Econometric results	29
4.1 Structural equations, three-gap results and policy implications.....	30
4.2 Simulation results	33
4.3 The policy implications of the simulation results.....	41
5. Conclusions	44
References	46
Appendix: Data sources and definitions.....	50

I. INTRODUCTION

Following the unification of Vietnam in 1975, the use of central planning as the principal tool of economic management was extended across the entire country. However, it quickly became apparent to Vietnamese policymakers that central planning was having little short of a disastrous impact on agricultural and industrial performance (Jansen, 1997: 2). Of particular importance was the catastrophic decline in per capita foodgrain availability in the late 1970s, a decline that was only partially compensated by a steep rise in foodgrain imports (Akram-Lodhi, 2001). By 1980, Vietnam's food crisis had festered into an agrarian crisis that threatened to become systemic. As a consequence of these deep seated, structural, problems, Vietnam implemented a series of economic reforms in the 1980s, which have collectively become known as *doi moi*, or renovation. The major focus of the initial round of reforms was the agricultural sector, where the state encouraged the development of contracts between individual farm households and collective institutions that stipulated that output produced in excess of an agreed quota could be sold in markets. Later in the decade, the scope of reform widened, to encompass industry, finance, and government. The common principle underpinning many of these reforms was an emphasis on microinstitutional change. Markets became increasingly accepted as the principal mechanism of resource allocation, and there was, as a consequence, steady erosion of the role of central planning. Among other things, reform sought to redirect industrial policy by seeking to enhance the role of the private sector, while at the same time vigorously pursuing external trade liberalization and internal de-regulation, including changes in agricultural markets, public sector restructuring, and financial sector reform. Moreover, at several critical points in the reform process, the state undertook macroeconomic stabilization.

The reform program was, on the face of it, a huge success. During the 1990s the average annual rate of growth of gross domestic product (GDP) per capita was 7.6 per cent, exports soared, while macroeconomic balance was maintained (World Bank, 2001a). As a consequence, poverty rates fell dramatically, and indeed it was claimed that 'almost no other country has recorded such a sharp decline in poverty in such a short period of time' (Government of Vietnam-Donor-NGO Poverty Working Group (PWG), 1999: iii). As a consequence of this performance, until the onset of the East Asian crisis in 1997, Vietnam appeared to be on the verge of entering the ranks of the 'tiger' economies of the region. Nonetheless, despite almost two decades of sweeping economic change, challenges remained at the end of 2001. The economy remained

heavily inwardly oriented, and had a large state sector. Exports were concentrated in a relatively small spectrum of manufactures and, more importantly, agricultural commodities whose falling prices threatened to dramatically erode rural incomes and reverse the impressive reduction in poverty witnessed during the 1990s. Savings rates were comparatively low when compared to other East Asian countries, and the financial sector continued to undertake policy-based rather than risk-based lending, with the predictable result that state owned commercial banks (SOCBs) maintained large stocks of debt. Perhaps most significantly, income inequality was rapidly growing, in part because of the aforementioned collapse in commodity prices and in part because employment growth failed to keep up with the growth of new entrants onto the labour market. Moreover, these challenges have to be set against the dramatic slowdown in global economic growth in 2001 which, through its effects on trade and investment flows, threatened to have a more significant impact upon Vietnam than the East Asian crisis. By the end of 2001 Vietnam was certainly not a tiger in its stride; it was, at best, crouching, a hidden dragon that had yet to reveal its underlying dynamism.

In Vietnam, as in many other countries, the shift from plan to market is commonly described as constituting a 'transition'. As a consequence, Vietnam is often grouped alongside the 'transitional economies' of central and eastern Europe, the former Soviet Union, Mongolia, China and Laos. However, placing Vietnam in such a grouping is deeply problematic because it fails to accommodate the unique characteristics of specific transitions. As has been succinctly stated by two leading Vietnam scholars, 'the particular process of transition actually adopted, by creating capital and processes of accumulation, will have an important influence on the nature of the resulting market economy' (Fforde and de Vylder, 1996: 38). This article therefore reviews the major institutional changes that have facilitated 'the particular process of transition' of Vietnam from plan to market. The review is conducted in order to evaluate the influence of these changes in shaping the main constraints on the economic performance of this hidden dragon, and in particular the role and significance of private, government and foreign savings on Vietnamese economic growth over the medium term. The evaluation is undertaken by formulating and estimating a simple structural three-gap model along the lines suggested by Bacha (1990) and Taylor (1993). Using the estimated values of the parameters that are generated, the model is simulated for the period between 2001 and 2006, a period that corresponds closely to the Government's Sixth Five-Year development Plan, which covers the period between 2001 and 2005. Four

distinctive policy simulations are conducted to assess the consequences of Vietnam striving to meet the ambitious growth targets laid out in the Sixth Five-Year Plan as well as those contained within the 10 year Socio-Economic Development Strategy. The first two simulations assess the broad implications of the neo-liberal policy advice offered by the World Bank and other donors, as outlined in the *Vietnam Development Report 2001*, for the investment-savings, fiscal and current account balances, using the Government's investment projections (World Bank/Asian Development Bank (ADB)/United Nations Development Programme (UNDP), 2000). This advice has recently been reinforced, albeit with qualifications predicated on the more pessimistic global outlook, in the *Vietnam Development Report 2002* (World Bank, 2001b). Scenarios III and IV explore two quite different and distinctive growth paths: a growth rate that is, in our estimation, most likely to occur; and a growth rate that meets 'socially desirable' ends.

The article is structured as follows. Following this introduction, Section II provides an overview of the evolution of Vietnam's economy since 1975. The section highlights the unique nature of Vietnam's transition, and notes the strengths and weaknesses of the transition process. In Section III the three-gap model is specified and estimated, using annual data for the period between 1986 and 2000. Using the parameter estimates of the model, Section IV provides the results of four policy simulations and examines the impact of the availability of foreign financing, domestic savings and public sector resources on the growth path of the Vietnamese economy. Conclusions are presented in Section V.

2. TRANSITION TO THE MARKET: A REVIEW OF THE VIETNAMESE ECONOMY, 1975-2001

It is generally acknowledged that Vietnam's transition from plan to market was a relative success, when compared to many other transitional economies, and that the transition was completed by the end of 1980s (Fforde and de Vylder, 1996; Jansen, 1997; Dollar, 1999; Watts, 1998; Beresford and Phong, 2000). However, there is no general agreement as to whether Vietnam's transition should be interpreted either as an Eastern European style 'big bang' or as an example of Chinese style 'gradualism'. The former view holds that Vietnam's bold orthodox stabilization and liberalization of 1989 was the main factor behind accelerated growth in output, the restoration of internal and external balance, agricultural productivity growth, and the rapid growth of small and

medium enterprises (SMEs) (Sachs and Woo, 1994; Dollar, 1999; World Bank, 1996). In this perspective, Vietnam is a successful example of the standard formulations of the Bretton Woods institutions, with macroeconomic stabilization laying the foundations of microeconomic change. The latter view holds that Vietnam's transition should be traced back to late 1970s and a series of bottom-up reforms implemented over the following decade, which laid the basis for the successful stabilization of 1989 (Fforde and de Vylder, 1996; Watts, 1998; Reidel and Turley, 1999). In this approach, Vietnam's transition reverses the standard Bretton Woods prescription: microeconomic change is what lays the foundation for macroeconomic stabilization. Notwithstanding the comparative merits of these two interpretations of Vietnam's transition, it is still useful to review some of the major institutional changes that Vietnam has been through since the beginning of the 1980s. This is because many of these earlier institutional reforms continue to shape and guide the behaviour of economic agents in general and the constraints to economic growth and structural change in particular well into the present.

2.1 Unification and initial reform, 1975-1981

At unification in 1975, Vietnam's economy was, not surprisingly, performing poorly. In the north, two decades of war and isolation combined with the inherent problems of applying Soviet style central planning to a highly populated, poor, subsistence agrarian economy had done little to improve the well-being of the population, let alone realize the planners' objectives of rapid modernization and industrialization (Beresford, 1989a; Fforde and de Vylder, 1996). In the south, war and the distorted structure of incentives that had resulted from large and sustained volumes of US aid had impoverished many and enriched a few (Dacy, 1986). Caught in both a low growth 'trap' and post-victory euphoria, the state quickly moved in 1976 to impose central planning upon the entirety of the country. In large-scale industry, factories were brought under the control of state ministries, foreign trade became a state monopoly, attempts were made to control the operation of commodity markets, and efforts were made, particularly in 1978 and 1979, to collectivize peasant agricultural production in the Mekong Delta. The ambitious Second Five-Year Plan of 1976-1980 aimed at achieving an overall annual growth rate of 13 to 14 per cent, and an industrial growth rate of as high as 16 to 18 per cent (Fforde and de Vylder, 1996: Table 4.1). Developmental priority was given to industry, and particularly heavy industry, with surpluses

from agriculture and foreign aid flows being envisaged as the main sources of finance for industrialization.

However, by the end of 1970s the negative impact of the application of central planning across unified Vietnam became acutely apparent. Table 1 presents selected macroeconomic indicators for Vietnam for the period between 1975 and 1985. As Table 1 indicates, total social product grew by only 0.5 per cent per year between 1976 and 1980¹. As population growth over the period was 2.3 per cent per annum, per capita social product declined by 1.8 per cent per annum between 1976 and 1980. The most marked indicator of the failure of central planning in this poor, agrarian economy comes, not surprisingly, from the agricultural sector. Over the course of the latter half of the 1970s there was a precipitous decline in per capita staples production, which dropped from 274 kilograms in 1976 to as low as 238 kilograms in 1978. Given that 250 kilograms was considered a minimum subsistence requirement, it is clear that Vietnam was facing a major food problem (Fforde and de Vylder, 1996: 180). Moreover, despite the high share of investment allocated to industry—some 35.3 per cent of gross fixed investment—industrial output grew at an annual rate of only 0.6 per cent between 1976 and 1980. The output of industries under direct central government control was the worst, actually dropping by 3.5 per cent per year between 1976 and 1980 (Fforde and de Vylder, 1996: Table 5.7). Domestic savings, which were very low to start with, declined over the period, as food expenditure as a share of all expenditure rose from 71.6 per cent in 1976 to 83 per cent in 1980. As a result, a high share of investment was financed by Chinese and, to a lesser extent, Soviet, aid (van Donge, White and Nghia, 1999). The poor performance of the economy between 1976 and 1980 meant that export targets, and especially agricultural export targets, could not be met. Exports fell 40 per cent below their target between 1976 and 1980, and the corresponding ratio for agricultural and processed product exports was 62 per cent (Beresford and Phong, 2000: Table 2.7). It is worth noting that contrary to other Asian countries that adopted an export-oriented trade strategy, Vietnam's planned economy relied heavily on the aid-financed import of capital, raw materials and wage goods, with ex-

¹. Prior to adopting the System of National Accounts in 1988, national accounts were calculated using the Net Material Product accounting System (MPS). The MPS data in Table 1 does not include certain nonmaterial services and depreciation. Moreover, production data are aggregated using the rather arbitrary fixed plan prices of 1982, which tended to undervalue agricultural output relative to industrial output (Dollar and Litvack, 1998: 25).

ports playing a rather negligible role (Beresford 1989b). Thus, as Table 1 indicates, during the period between 1976 and 1980 revenues from exports covered less than one quarter of import bills with loans (including arrears) and aid accounting for about 55 and 21 per cent of import bills, respectively (Beresford and Phong, 2000: Table 2.3).

Table 1 *Selected Macroeconomic Indicators for Vietnam, 1975-1985*

Macroeconomic indicator	1976-80	1981-85	1979	1980	1981	1982	1983	1984	1985
Growth rate (% per annum)									
Total social product ^a	0.5	6.4	-2.0	-1.4	2.5	8.9	6.7	8.3	5.7
Per capita social product	-1.8	4.2	-4.2	-3.6	0.3	6.7	4.5	6.1	3.5
Total industrial output	0.6	9.5	-5.5	-1.4	1.0	8.1	12.8	13.1	11.9
Total agricultural output	1.9	4.9	1.7	5.2	4.9	10.9	7.0	4.2	4.7
Retail price index	60.0	74.2	119.4	125.2	69.6	95.4	49.5	64.9	91.6
Free market retail sales (% of total market sales)	44.3	42.2	46.2	52.0	46.0	47.5	47.0	43.0	27.0
Gross investment (as % of net material product)	13.1	13.0	14.0	13.3	11.7	10.8	12.8	14.9	15.0
Government deficit (as % total government expenditures)	2.5	14.0	5.2	1.0	17.5	8.0	4.5	4.0	36.0
Export coverage of imports (% export/imports)	24.2	33.8	33.1	30.3	29.1	32.6	37.5	35.0	35.0
Per capita staples production (kgs)	259	295	266	268	273	300	296	303	304

Notes: a. The net material product national accounting system is explained in footnote 1.

Sources: See the Data Sources and Definitions Appendix.

Vietnam's invasion of Cambodia in 1979, the consequent cessation of Chinese aid and invasion by the Chinese army, the expansion of the US economic embargo to include other western nations in 1979, and two years of poor harvests all served to intensify shortages of inputs and many basic consumer items brought about by poor economic performance. As shortages became widespread inflation accelerated. In the state controlled, or 'organized', market, prices rose at an average annual rate of 3.5 per cent between 1976 and 1980 (Riedel and Turley, 1999: 14). Free market prices rose at an average annual rate of more than 60 percent over same period. Thus, not only did inflation accelerate, but the gap between organized and free market prices widened, creating rent seeking opportunities for those with access to resources.

Within this constrained economy, the potential for growth remained. Thus, with the bulk of the economy engaged in the production of basic wage goods using tech-

niques characterized by low capital labour ratios, the potential existed to change the output mix. Moreover, the underutilization of resources within the planned economy meant that it was in principle possible to boost capacity utilization. As Fforde and de Vylder (1996) astutely note, ‘ plan distortion—short run slack—was a resource capable of being used’ . However, the central planning system and its economic institutions—state owned enterprises (SOEs) and co-operative farms—were unable to use these resources to cope with the crisis. This led to the rapid development of a non-plan economy alongside the crumbling centrally planned economy. To overcome some of the severe imbalances generated within the planning system, individuals, SOEs, local authorities, and central ministries become increasingly involved in direct horizontal exchange that took the form of both barter and market transactions (Beresford and Phong, 2000: 4). As the non-plan economy grew these spontaneous activities of economic actors engaged in bending the rules by increasingly participating in the non-plan economy became popularly known as ‘ fence-breaking’ . As fence breaking expanded, a debate emerged within the leadership about its implications. A strong current, led by the Chair of the State Planning Commission, advocated accepting the need for and indeed encouraging economic liberalization as the best means of dealing with the crisis (Economist Intelligence Unit (EIU), 1991). The ascendancy of this current was, at the time, short lived. However, it was ascendant long enough for what is now known as the Vietnamese Communist Party (VCP) to make concessions granting more autonomy to rural producers and SOEs and thereby legitimizing the fence breaking activities of the microinstitutions of central planning. As a consequence, the government was able to push through what Fforde and de Vylder (1996) describe as ‘ the defining documents of transition’ : CT-100 of 13 January 1981, on agricultural output contracts; and 25-CP of 21 January 1981, on SOEs. Building upon an earlier policy initiative towards a limited liberalization of internal trade in August 1979, Directive 100 saw the state encourage the partial decentralization of agrarian economic management. Directive 100 encouraged the development of contracts between individual farm households and agricultural co-operatives. These contracts stipulated that output produced in excess of an agreed quota could be retained and sold in markets. Similarly, SOEs were given more autonomy to expand and sell in markets their above plan as well as non-plan output. Decree 25 introduced the ‘ three-plan system’ , which in theory established SOEs as self-financing and self-accounting enterprises and in so doing made them, again in theory, more accountable to consumers. In order to generate the resources necessary for self-financing,

Decree 25 also loosened the quantity targets of central planning, enabled SOEs to freely obtain inputs, and allowed SOEs to produce for and sell in the market output that was not subject to a state monopoly, although under controlled prices (Fforde and de Vylder, 1996: 138-139). Decree 25 also allowed SOEs to import and export directly, albeit under license, and in so doing created competition for the state trading companies. Decree 25 can, in effect, be viewed as an attempt by the state to address the failure of the heavy industry emphasis of the Second Five-Year Plan. The state recognized the desirability of shifting industrial strategy towards the fostering of light industry and the production of a wider range of wage goods, as well as stimulating exports.

The 1981 agricultural reform, the introduction of the three-plan system, and internal and external trade liberalization all had positive effects on the economy (Fforde and Vylder, 1996). However, as Table 1 demonstrates, the outcome of the initial round of reforms does not, in the aggregate, appear significant. The area where probably the most benefit of initial reform was felt was in trade. As Table 1 shows, beginning in 1980 a rising share of imports were covered by export earnings that were primarily products of light industry, agriculture and fisheries. Thus, between 1980 and 1981 exports increased by 15.6 per cent, compared with a meager increase of only 1.6 per cent between 1977 and 1980 (Fforde and de Vylder, 1996). Moreover, interregional trade expanded within Vietnam following initial moves to liberalization in 1979. Perhaps most notably, the share of the state sector in produced national income started to fall following the initial round of reforms, as did the share of the state controlled ‘organized’ market, as demonstrated in Table 1. Thus, while the outcome of the initial round of reforms does not, in the aggregate, appear significant, the reforms did lay the microinstitutional foundations necessary to facilitate the deepening of processes that encouraged transition.

In particular, the mode of operation of the microeconomics of the planned economy changed as a consequence of the reforms of 1979 to 1981. As markets developed within the centrally planned economy, the state sector began assuming the functions and behavioural motivations of a private sector by beginning to allocate resources according to the microeconomic logic of the market (Fforde and de Vylder, 1996). Moreover, the development of market-driven behaviour within the state sector started the process of creating new and diverse constituencies within the state sector, constituencies that had a stake in further reform.

However, the tensions that emerged during the initial phase of reform were also very clear. While the symbiotic relationship between the planned economy and the non-plan economy served to reduce the impact of chronic shortages within the planned economy and improve the efficiency of SOEs and agricultural cooperatives, at the same time it undermined state and VCP control over capital resources and their allocation, and in so doing contributed to a deepening of macroeconomic imbalances (Beresford and Phong, 2000). The widening gap between organized and free market prices encouraged the development of the free market, created rents for those with access to low-priced goods within the planned economy, and pushed inflationary pressures to the surface. As Table 1 indicates, the high inflation rates of the latter half of the 1970s continued well into the mid-1980s. Similarly, the increased commercialization of the economic activities and the erosion of the monopoly power of the state trading companies meant that the authorities had to pay higher prices for supplies of goods. Higher prices of inputs combined with higher wages for state employees to widen fiscal imbalances. As Table 1 shows, deficits as a percentage of total government spending rose from an average of about 2.5 per cent between 1976 and 1980 to 17.5 per cent in 1981 and 8 per cent in 1982. Although trade deficits with capitalist countries declined considerably due to declines in imports, trade deficits with the socialist countries, Vietnam's major trading partners, rose steadily. In this light, it is not surprising that the initial round of reforms, a set of reforms introduced to deal with a major crisis, started to lose impetus early in 1981. Indeed, in 1981 the political balance within the leadership shifted against further liberalization (EIU, 1991).

2.2 Partial reversal, 1982-1985

The steady erosion of VCP control over resources and their allocation, combined with the deepening of macroeconomic imbalances, served to undermine support for continued reform and led to a resurgence of attacks within the Party on liberalization and on markets. While not seeking to eliminate markets, dominant currents within the Party leadership began to argue that markets and the private sector could be rendered subservient to the plan. In the 1982 Fifth Party Congress, the leadership reasserted its commitment to defending the institutions of central planning and socialist transformation while acknowledging the importance of a prosperous agricultural sector and balanced foreign trade position as the basis for industrialization. Subsequently, policies started to be framed to implement this perspective, leading to a partial reversal

of some of the reforms that had been implemented between 1979 and 1981. Private retail trade in agricultural produce was repressed through a series of tax rises and bureaucratic hostility, leading to a decline in the free market's share of retail trade, as indicated in Table 1. The state also sought to reestablish its primacy in industry through a series of 'carrot and stick' measures. On the 'carrot' side, as Table 1 demonstrates, gross investment increased considerably between the 1982 to 1985 period. About four fifths of total state investment was allocated to industry during this period (World Bank, 1990: Table 2.2), which opened up new opportunities for SOEs. As a result, in 1984 the share of the state sector in produced national income began to revive relative to the share of the private sector. On the 'stick' side, since 1981 SOEs had been allowed to import and export under license, and to retain hard currency earnings from such trade, as part of the move to self-financing and self-accounting. As these hard currency resources increased, the control of the CPV over resources diminished. Therefore, the government moved to reassert its control over these earnings, and in so doing its control of the SOE sector.

However, despite partial attempts to recentralize, the response of SOEs and agricultural co-operatives to the early reforms meant that the economy had already started to change. As Table 1 demonstrates the economy experienced moderate growth rates between 1982 and 1985. Fiscal balances also improved, although inflation continued to remain high. Exports grew at a rate almost twice that of imports between 1980 and 1985. Export coverage of import bills rose from 24.2 per cent during the Second Five-Year Plan to 33.8 per cent during the period of the Third Five-Year Plan, as indicated in Table 1.

Nonetheless, Table 1 shows that the static efficiency gains in agriculture engendered by Directive 100 were all but exhausted by 1983, when per capita staples production again started to level out at a subsistence level, indicating that the potential for a resurgence of crisis in the sector was possible. The potential to sustain agricultural growth was also undermined by further attempts by the state to collectivize agriculture in the Mekong Delta in 1984, by increased state control of staples food markets, and by the decline in the share of investment allocated to agriculture. Thus, as Table 1 shows, there was a considerable drop in the growth rate of agricultural output in 1984 and 1985.

The attempt of the state to reassert its control over the private sector and the market, rendering both subordinate to the plan, had however failed to recognize one

key microeconomic factor. By the early 1980s the state sector was already heavily involved in the markets that had developed. However, SOEs were not competitive with the private sector in markets. This was true of both input and output markets. As a consequence, SOEs had to start paying higher prices for goods and for services, including labour. Having to pay higher prices for goods and services severely reduced the real resources available to those enterprises that had previously relied upon the state for what had been relatively cheap goods and services. The high organized-free market price differential for domestically traded goods offered a further squeeze on real resources, a squeeze that was exacerbated by the overvalued exchange rate. The response of the state was to make concessions to SOEs, in the form of subsidies, including the provision of highly subsidized imported inputs, which were provided by Soviet commodity aid (van Donge, White and Nghia, 1999). However, such concessions served merely to induce price increases in the free market, as demonstrated in Table 1, and in so doing contributed, along with poor agrarian performance, to the onset of the second economic crisis in six years.

In order to cope with the fresh crisis, the state attempted to introduce a comprehensive currency, price and wage reform in 1985. The Vietnamese currency, the dong, was redenominated. The number of goods subject to price controls was dramatically reduced, and efforts were made to eliminate producer and consumer subsidies. However, the attempt to reform subsidies and prices resulted in heavy losses for SOEs, which the state covered. The coverage of SOE losses had a dual impact. First, it boosted the budget deficit, which rose to an unsustainable 12 per cent of GDP in 1985 (World Bank, 1990: Table 5.1). Second, the soft budget constraint of SOEs fuelled further inflation. The GDP deflator, which rose from 307 in 1984 to 588 in 1985, took off in 1986 to reach 3451 (World Bank, 1990: Table 2.1). Hyperinflation had arrived, and with it, domestic savings collapsed (Fforde and de Vlyder, 1996). The attempt to rein in the fiscal crisis of the state, a crisis that was a function of a retreat from SOE reform, through price and currency reform, had badly failed (van Donge, White and Nghia, 1999). The attempt by the state to subordinate the logic of the market to the logic of the plan had also clearly failed; the macroeconomic imbalances created by attempts to retreat from microeconomic reforms were beyond the capacity of the state to manage.

Vietnam's productive structure had not greatly changed between 1979 and 1985; agriculture and light industry continued to dominate the economy. The plan dis-

tortions and capacity underutilization in the economy that had previously offered resources that could be used to boost static efficiency remained in these sectors. What was required was a set of policy initiatives that would utilize such resources. The first set of reforms had provided the microeconomic foundations that had unleashed the process of transition; a second set were needed to create the preconditions that would successfully embed the process of transition.

2.3 *Doi moi*, 1986-1988

In 1986 the VCP leadership reached an impasse. While the state's earlier attempts to preserve central planning and its institutions did succeed in slowing down the growth of the non-plan economy, the symbiotic relationship between the planned and non-planned sectors continued to mature and created pressure for further reform. The severe macroeconomic imbalances of the mid-1980s exposed once again the inherent contradiction of a state-led, market-subordinate development strategy. In addition, the onset of hyperinflation led to a collapse in real spending and a liquidation of domestic savings (Fforde and de Vlyder, 1996).

Within the CPV, the market orientation of the state sector that had proceeded during the attempts between 1982 and 1985 to reverse liberalization meant that a growing constituency in favour of markets was starting to emerge. This constituency was not strong in the Politbureau of the CPV; but several key voices within the Politbureau openly supported further economic reform. These voices shaped the debate that occurred during the Sixth Congress of the CPV, when the policy regime that had given rise to stagnation came under attack, and the general acceptance of a strategy of economic renovation (*doi moi kinh te*) was secured (Ljunggren, 1993; Fforde and de Vlyder, 1996). The economic crisis of 1985 gave formal legitimation to the early reforms when, as a result of the Congress, reformers moved into the position of general secretary of the CPV and into the position of prime minister. While the latter appointment lasted less than two years, the replacement, an orthodox technocrat, accepted the evidence when it was presented that the central planning model was not working. Plans were for the first time widely mooted to replace central planning entirely (EIU, 1991). The transition was well underway by this time, however.

The first priority of the new leadership was to try and stabilize the economy. This they sought to achieve in a fiscally orthodox way, through spending cuts. Table 2 presents selected macroeconomic indicators for the period between 1986 and 2000,

and, in conjunction with Table 1, shows that the budget deficit fell from 12 per cent of GDP in 1985 to 5.9 per cent between 1986 and 1988. Similarly, government capital expenditures fell from 8.6 per cent of GDP in 1985 to less than 4 per cent of GDP between 1986 and 1988 (World Bank, 1990: Table 2.2). As a result, gross investment fell to 8.4 percent of GDP, the lowest level since unification. Increased levels of Soviet aid did help to finance the growing external deficit, though they did little to help SOEs—and particularly less efficient SOEs—a dapt to the rapidly developing market economy.

Table 2 *Selected Macroeconomic Indicators for Vietnam, 1986-2000*

Macroeconomic indicator	1986-88	1989-93	1994-97	1998-2000
	Growth rate (% per annum)			
Real GDP (constant 1994 prices)	4.4	6.5	9.0	5.1
Per capita real GDP	2.0	4.8	7.3	4.1
Consumer price index	365.3	38.9	8.8	2.9
	as a share of GDP (current prices, %)			
GDP by sector:				
Agriculture	40.0	35.6	27.1	25.6 ^a
Industry and construction	32.8	25.9	29.9	33.5 ^a
Services	27.3	38.5	43.1	40.9 ^a
GDP by ownership				
State	35.8	34.9	40.2	39.8 ^a
Non-State	64.2	65.1	59.8	60.2 ^a
Gross investment	8.4	16.4	27.3	25.1
State budget	3.8	n.a.	5.7 ^b	5.6
Public enterprises	2.4	n.a.	7.0 ^b	8.9
Other domestic	2.0	n.a.	6.3 ^b	5.5
Foreign	0.5 ^c	n.a.	8.1 ^b	5.1
National saving	-1.4	11.3	16.5	24.0
Government deficit	5.9	4.9	0.8	1.7
Current account balances	-9.8	-5.1	-10.8	-1.1
External debt ^d	329.3	186.6	84.8	87.1
	(In kilograms)			
Per capita staples production	296	332	382	436

Notes: a. For the period 1998-1999 only.
b. For the period 1996-97 only.
c. For the year 1988 only.
d. Total outstanding external debt at the end of each sub-period.

Sources: See the Data Sources and Definitions Appendix

As in the late 1970s, the state moved to foster growth in agriculture and light industry, so as to expand the range of wage goods available to consumers (van Donge,

White and Nghia, 1999). This was achieved once again by altering the relationship between plan and market, and in so doing promoting a deeper ‘marketization’ of the economy (Fforde and de Vylder, 1996). As a consequence, the reform process was given a significant boost, in that the authorities embarked on a series of reforms in industry, agriculture, foreign trade and pricing.

The key reforms were once again microeconomic. The most visible set of reforms began in 1987, when price controls on all commodities bar rice, kerosene and some public utilities were lifted. In the same year, internal trade was significantly eased when control posts were abolished, providing another boost to the interregional trade that had started to expand in the early 1980s. Moreover, hyperinflation forced both the private sector and SOEs to try to rapidly adapt to the commercial realities of the market if enterprises wanted to secure their inputs and be able to sell their outputs. As a result of these reforms, the share of the free market in total retail sales started to grow rapidly after 1987, increasing from 43 per cent of total retail sales in 1987 to as high as 65 per cent by the end of the decade (Fforde and de Vylder, 1996: Figure 3.14). The state retail sector could only compete with the assistance of Soviet aid, which allowed it to sell goods at subsidized prices.

The authorities also embarked on a series of reforms in foreign trade. The key reforms occurred in 1988, when tariffs began to replace quantitative restrictions (van Donge, White and Nghia, 1999). Concurrently, the government ceased its exclusive control of foreign trade through state trading companies and import export licenses. Finally, to bolster the competitive position of the economy, the value of the dong was devalued for trade purposes and for invisibles. The benefits of these reforms were, unsurprisingly, not immediately felt, as the current account balance remained in deficit, as demonstrated in Table 2.

A set of microeconomic reforms were also introduced into agriculture (Akram-Lodhi, 2001). Among the most important of these measures was Decree 10 in 1988, which formally decollectivized agriculture, allocating 15 year usufruct rights to land to households on the basis of household size and, in effect, reestablishing Vietnam’s independent peasantry. In addition, Decree 10 eliminated all output quotas, thus allowing farmers to make all decisions regarding resource allocation, production and sales. At the same time, and consistent with reforms in price policy noted above, crop and input prices were liberalized. By the end of 1988, Vietnam’s farmers were no longer working

under any kind of planning guidelines, but were working within a functioning market economy.

Consistent with the easing of internal trade and further efforts to reinvigorate the role of markets in allocating resources, policy measures were taken which granted more autonomy to SOEs, primarily by removing the role of planning targets in the decision making processes of these enterprises. The implementation of these measures meant that the only target levied by the state on SOEs was the contribution of the SOE to the state budget. However, perhaps of greater importance in the reforms of the period between 1986 and 1988 were the efforts to strengthen the economic role of the private sector. Until the *doi moi* reforms, the private sector had not played a significant role in the transition process. Rather, market relationships had, to an increasing extent, begun to dominate the economic decision making of the state sector. Thus, markets were emerging from within the state, even in the absence of clearly defined property rights (Fforde and de Vlyder, 1996). This changed dramatically in 1987 and 1988. In 1987, the first law on foreign investment was introduced, which opened the door to investors seeking to supply the internal market behind still significant trade barriers. In 1988, Resolution 16 provided the legal framework for an expansion of private SMEs.

The state buttressed these reforms with significant reforms in the financial sector. In 1987 the state devoted a great deal of effort to reform of the mechanisms used by the state to manage the economy. As a consequence, a number of ministries were created, and a number of ministries were amalgamated. One of the ministries to be created was the Ministry of Finance, and following its creation it sought to remove the performance of commercial banking from the central bank when 4 SOCBs were created (van Donge, White and Nghia, 1999). The newly created Ministry also liberalized access to foreign exchange. It did this by permitting the establishment of foreign currency bank accounts in the SOCB sector; by establishing mechanisms outside the control of the state for the transfer of foreign exchange out of Vietnam; and by liberalizing the right of importing and exporting companies and individuals to retain foreign exchange (van Donge, White and Nghia, 1999).

However, as Table 2 indicates, the benefits of these structural reforms were, as in the 1979 to 1981 period, not immediately felt. The supply response that the state believed would be engendered by microeconomic reform was, to an extent, offset by some of the contractionary aspects of the attempted, half hearted, stabilization. In particular, state investment dropped and was not offset by an increase in private invest-

ment, as the expansion of private SMEs was also slow. Fiscal and current account deficits remained high, as did the rate of inflation. Although SOEs were given more autonomy and their commitment to state planning was reduced to only contributing to the state budget, they, and especially the less profitable ones, continued to be the predominant user of state resources, in the form of both subsidies and administratively-directed bank credit. Between 1986 and 1988 contributions of SOEs to the budget dropped to 7.3 per cent of GDP, from 10.7 per cent during 1984 and 1985. Their net contributions to the budget, defined as transfers to the budget minus transfers from the budget, amounted to less than 2 per cent of GDP (World Bank, 1990: Table 5.2; International Monetary Fund (IMF), 1995: Table 25). Concurrently, bank credit to SOEs accounted for 9.6 per cent of GDP (IMF, 1995: Table 25). The expansion of bank credit to SOEs threatened to increase an already stubbornly high inflation rate, and thus fostered internal imbalances. Moreover, credit provisions facilitated imports that were ultimately financed by Soviet aid, and in so doing fostered external imbalances. Thus, although trade with the non-socialist countries was almost in balance, exports to socialist countries covered only 26.8 per cent of import bills over the period between 1986 and 1988, as compared to 31 per cent over the period between 1981 and 1985 (Beresford and Phong, 2000: Table 2.10).

Clearly, the attempted stabilization of the period between 1986 and 1988 fell short of addressing the inherent macro- and inter-sectoral imbalances embedded in the continuing symbiotic relationship between the planned and non-planned sectors of the economy. They prevented Vietnam from even aspiring to be a crouching tiger.

2.4 Intensive reform, 1989-1993

The microeconomic reform measures undertaken during the first two years after the launch of *doi moi* succeeded in getting the process of institution building and marketization back on track. However, the inability to stabilize the economy legitimized discussions within the CPV and the state about the relevance of the remaining vestiges of central planning. By 1989, reform was well advanced and had gained legitimacy (Fforde and de Vylder, 1996: 19). More specifically, by this time ‘prices mattered and autonomous capital had been accumulated outside as well as within the state and cooperative structures’ (Fforde and de Vylder, 1996: 19). The collapse of the centrally planned economies of Eastern Europe reinforced the need for the rapid restoration of internal and external balance. As a consequence, 1989 witnessed an effective attack on

macroeconomic imbalances through an unleashing of reform measures that sought to stabilize the economy and simultaneously build upon microinstitutional reforms by encouraging a wholesale shift to a market economy. Central planning was abandoned. The authorities hastily implemented an orthodox IMF type stabilization program, albeit without IMF funding. The program called, among other things, for a tight monetary policy, a reduction in government spending, deeper, more profound market liberalization, the introduction of user fees for publicly provided services, the broadening of the tax system, the unification of multiple exchange rates, and a drastic devaluation of the dong (Ljunggren, 1993; Fforde and de Vylder, 1996).

In order to encourage a shift to generalized commodity production and bury what was left of central planning, a major reform of SOEs took place. Of course, to an extent, the collapse of Soviet aid in 1991 forced the pace of SOE restructuring, because without reform a major crisis would have quickly emerged. Nonetheless, under the terms of Decree 176 SOEs had devolved onto them the bulk of the key managerial and financial decisions made by enterprises, as ministries removed themselves from production decisions. Thus, SOEs were freed to determine investment decisions, input procurement, employment and wage levels, and the output mix. They were also freed to negotiate prices with suppliers and buyers. As part of the restructuring, SOEs had to 'reregister', a mechanism that was used to dissolve some key loss makers and merge others. The result was, over time, a reduction in the number of SOEs, and more than a million lost jobs (EIU, 1991); total SOE employment was cut by a third between 1988 and 1992 (Dollar and Litvack, 1998: 6). As part of Decree 176, direct subsidies to SOEs ended. This was followed, in 1991, by the cessation of subsidies for imported inputs, and, in 1992, by the cessation of subsidized credit (van Donge, White and Nghia, 1999).

In order to support this restructuring, the distinction between organized prices and free market prices, the so-called 'two-price system', was abolished in 1989. This was followed, in 1991, by the cessation of all price controls, with the exception of electricity. Price liberalization did not only apply to the goods market. It also applied to real interest rates, which became positive for the first time. Further financial reform followed. In 1990 an ordinance formally and completely removed the central bank from commercial banking while at the same time formally allowing, for the first time, the establishment of private financial institutions. However, the state did direct SOCBs to

provide credit through the financial system to SOEs, effectively replacing direct and indirect subsidies with policy-based lending from SOCBs.

At the same time, the state opened its border to trade by lifting quotas, by dramatically increasing the number of issued trading licenses, by allowing private sector enterprises to engage in international trade, and by promulgating regulations governing the establishment of export processing zones. As a result of this deep external liberalization consumer goods not only began to be imported in large volumes but exports also started to pick up, increasing the share of imports that they covered (EIU, 1991). The lifting of price controls meant that prices in the state sector were capable, finally, of adjusting upwards, while the elimination of subsidies meant that prices had to adjust upwards.

As Table 2 illustrates, the period between 1989 and 1993 witnessed a pickup in the real rate of growth of GDP per annum, and the highest rate of growth of per capita GDP per annum since the early 1980s. The resource reallocations of 1986 to 1988, along with the stabilization conducted between 1989 and 1992, facilitated a dramatic increase in gross investment and domestic savings. As Table 2 indicates, gross investment almost doubled from 8.4 per cent of GDP during the period between 1986 and 1988 to 16.4 per cent during the period between 1989 and 1993. Between these two periods, domestic savings rose from minus 1.4 per cent of GDP to plus 11.3 per cent of GDP. Increases in private investment and FDI spurred on the improvement in the investment rate. Moreover, this investment was used more efficiently than had previously been the case; productivity improvements were responsible for a substantive share of output growth (World Bank, 1996). High oil export revenues combined with the rapid growth of exports of agricultural commodities to provide the government with sufficient foreign exchange to finance growing imports. Thus, crude oil exports rose from US\$79 million in 1988 to US\$200 million in 1989 and to as much as US\$756 million in 1992. Oil and rice exports, which accounted for 17 per cent of total exports in 1988, rose to 49 per cent of total exports by 1992 (World Bank, 1993). As a consequence, export coverage of imports stood at about 93.6 per cent between 1989 and 1992. The reforms of 1989 also led to a major shift in inflationary expectations, and a sharp fall in the consumer price index.

The macroeconomy thus adapted quickly to tight stabilization measures, the termination of Soviet aid in 1991, the loss of access to high levels of state subsidies, as well as the severe profit squeeze resulting from higher interest rates and open borders.

The restructuring of economic incentives and resource allocation mechanisms were not however fully accepted within the Vietnamese political economy (Fforde and de Vylder, 1996: 282). Pressures for tax breaks, credit write-offs, and the provision of generous credits mounted, and, more importantly, were granted by the government under the pretext of preserving social stability through employment-protection measures (Fforde and de Vylder, 1996: 282). A short period of destabilization once again threatened macro balances. Thus, inflation rose from 36 per cent in 1989 to 67 per cent per annum between 1991 and 1992. In response, the state reinforced its tight stabilization measures, and by 1993 Vietnam was firmly on a high growth path.

Stabilization was, as a general rule, successful in those areas where institutions were developed that were capable of effectively implementing policy before the actual policy measures were introduced. Stabilization was less successful in areas where policies were introduced prior to the establishment of effective institutions. The health sector and the financial sector both serve to illustrate this latter failure. In 1989 user charges were introduced in the health sector without putting in place a proper monitoring mechanism for the collection and allocation of fee revenues. Similarly, pharmaceutical production and distribution was liberalized with little or no attention to dispensing regulations. As a result, it was common for patients to pay user fees to more than one hospital worker, and for these payments not to be properly entered into financial accounts (Sepehri and Akram-Lodhi, forthcoming). Moreover, user charges were introduced at a time when the quality of publicly provided health facilities was declining, as was public confidence in the health care system. The cessation of supplies of highly subsidized drugs from the Soviet Union, along with the growing demoralization of health workers, whose real wages had already been severely squeezed by years of hyperinflation, made it very difficult for even highly committed health workers to provide services of a reasonable quality (World Bank, 1993; Dung, 1996). The burden on the vulnerable and the poor was considerable (Sepehri and Akram-Lodhi, forthcoming). Although the poor were supposed to be exempt from user charges, few were in practice and the likelihood of being exempt was the same for the poor as it was for the rich. Faced with a steady deterioration of publicly provided health services and user charges, both the poor and the rich resorted increasingly to self-medication and the purchase of drugs without prescription.

Similarly, the liberalization of financial markets and interest rates were implemented well before proper formal financial markets and institutions were developed,

when almost all financial intermediation within the private sector was carried out informally, and when public confidence in existing financial institutions was very low. In this light, it is not surprising that in comparison with other low income countries financial intermediation is very low in Vietnam, with a significant share of savings being held in non-liquid assets or in the US dollars outside the formal banking system (O' Connor, 2000). According to the first Vietnam Living Standards Survey undertaken in 1992, household savings in the SOCBs and credit co-operatives accounted for only 7.9 per cent of total household savings, and about 44 per cent of household saving was kept in gold (General Statistical Office (GSO), 1994: Table 8.1.6). According to one estimate, only 4 percent of those people eligible to open a bank account actually had one in the late 1990s (quoted in O' Connor, 2000: 55). Clearly, the institutional setting is extremely important for successful policy implementation in Vietnam. Indeed, one might go so far as to say that getting institutions right can be more important than getting prices right, and that it can even be the case that getting institutions right requires getting prices wrong (Spoor and Visser, 2001).

2.5 The FDI boom, 1994-1997

As Table 2 demonstrates, the period between 1994 and 1997 was, in retrospect, a golden age for newly reestablished Vietnamese capitalism. It was this period in which it appeared that the Vietnamese economic dragon would finally emerge from hiding. Growth of real GDP averaged almost 9 per cent per annum, while growth of per capita real GNP rose by over 7 per cent per annum. The gains of the macroeconomic stabilization of 1989 were solidified, and inflation fell to under 10 per cent per annum, for the first time since unification. Growth was driven by unprecedented levels of investment, which reached a high of 27.3 percent of GDP, as the market economy modernized the efficiency of its productive structure, and FDI levels accounted for almost 29 per cent of gross investment. The most important factor driving inflows of FDI was undoubtedly the normalization of relations with the United States in 1994, and the resulting resumption of relationships with the IMF and the World Bank. Private investment was also becoming more significant. As Table 2 demonstrates, the national saving rate improved considerably and the state budget deficit moved roughly into balance. Although the current account deficit reached as high as 9.8 per cent of GDP, higher FDI inflows and debt relief made the overall balance of payments situation quite manageable. Cheap labor and a competitive exchange rate delivered impressive export growth in import-

intensive manufacturing activities such as garments in the 1990s; garment exports rose from about US\$27 million, or 5 per cent of total exports, in 1988, to US\$1163 million, or 17.2 per cent of total exports, in 1996 (Hill, 2000: Table 1).

Reforms continued during the period between 1994 and 1997, but at a slower pace than before. Many of these reforms served to consolidate what had gone before. Perhaps the most significant structural reforms of the period were in the area of trade policy. Export quotas ceased, with the exception of rice. Import quotas were reduced to only 7 items, and import permits were introduced for most remaining controlled items. In 1995 Vietnam joined the Association of Southeast Asian Nations (ASEAN) and subsequently acceded in 1997 to the agreements designed to introduce an ASEAN Free Trade Area (AFTA) by 2006, agreements that are predicated upon a substantial lowering of tariff and non-tariff barriers to trade. Perhaps most significantly, in terms of institutional reform, the civil code was revised in order to provide an institutional foundation for a market economy that protected industrial property rights (van Donge, White and Nghia, 1999).

2.6 Regional slowdown, 1998-2001

The East Asian crisis presented Vietnam with its third shock in less than a decade, following the hyperinflation of 1989 and the collapse of Soviet aid in 1991. There was a major concern that the devaluation of regional currencies, and the resulting relative appreciation of the dong, would harm the Vietnamese economy. In the event, while the East Asian crisis did have an effect on the Vietnamese economy, that effect was substantially less than had been feared. As is demonstrated in Table 2, real GDP growth fell between 1998 and 2000, but, at 5.1 per cent per annum, was still significant. Consumer prices continued to fall, so that by the end of the 1990s the inflation rate was negative. The most dramatic impact of the East Asian crisis was the significant decline in FDI, which reduced total gross investment to 25 per cent of GDP. The government deficit also expanded, as the state raised its expenditure to cushion the impact of the regional slowdown, as well as boost domestic demand in an economy that was increasingly characterized by repressed consumption. Nonetheless, as Table 2 indicates the budget deficit remained small, amounting to 1.7 per cent of GDP. In order to prevent the regional crisis from infecting the local economy, imports were curtailed, and as a result net exports moved into a rough balance. Clearly, the failure to liberalize the

capital account had, in retrospect, protected Vietnam from contracting the East Asian contagion.

It is widely believed that the East Asian crisis led to a ‘reform retreat’ amongst the CPV leadership. Certainly, the ascension to the post of general secretary of the former political commissar of the army seemed to indicate a hardening attitude to reform once the rural unrest that plagued parts of northern Vietnam in 1997 subsided (Akram-Lodhi, 2001). However, it would perhaps be more appropriate to characterize 1998 and 1999 as, at best, lulls in the pace of reform. As a commitment to economic reform, and after much negotiation, in 2000 the state agreed a bilateral trade agreement with the United States. The agreement not only opened up the US market to Vietnamese firms but also implied substantial reductions in the level of protection afforded the economy in a number of sectors, including several where foreign investment had been prohibited. Concurrently, the state unilaterally removed some remaining quantitative restrictions on trade. In a highly publicized move, in 2000 a stock market opened in Ho Chi Minh City that, although small, quickly became the best performing stock market in the world.

Nonetheless, despite almost two decades of sweeping economic change, challenges continued to confront the Vietnamese economy. As Vietnam’s growth is mainly driven by domestic factors, growth in real GDP, driven by industrial production, retail sales, and increased private investment, exceeded expectations when the global slowdown hit in 2001 (World Bank, 2001b). However, although the current account looked, at 0.4 per cent of GDP, quite favourable, given the global economic climate, there can be little doubt that Vietnam’s external position was facing a threat. Exports were concentrated in oil, a relatively small spectrum of manufactures and agricultural commodities. Falling oil prices at the end of 2001 threatened export earnings. Recession in Vietnam’s Asian trading partners reduced demand for Vietnam’s manufacturing exports. Perhaps most importantly, falls in commodity prices for rice, coffee, pepper, rubber, tea, cashews and groundnuts significantly reduced export earnings (World Bank, 2001b). At the same time, the global supply of FDI rapidly diminished during the latter half of 2001. Clearly, maintaining access to the foreign exchange needed the sustain growth during the global slowdown was a major policy challenge.

At the same time, Vietnam’s financial system is still underdeveloped. It continues to be dominated by debt-laden SOCBs undertaking policy-based rather than risk-based lending. Policy-based lending has substantially increased the exposure of the financial sector to non performing loans, while constraining the ability of the private

sector to access credit for investment (O' Connor, 2000; Gates, 1995; Le Dang and McCarty, 1994). Moreover, the economy remained strongly inwardly oriented, and had a state sector that comprised 42 per cent of industrial output. Vietnam currently has over 5655 SOEs, some of which, especially SME SOEs, have been a drain on public resources. It was estimated in 1997 that 60 per cent of SOEs were either loss makers or were only marginally profitable (World Bank/ADB/UNDP, 2000: 9). There has been growing pressure, especially from the donors, on the government to restructure the SOEs. Nonetheless, the pace of restructuring has been sluggish, in part due to state concerns about the employment implications of restructuring (World Bank, 2001b). The poor state of health of the financial system, policy-based lending to SOEs, and poor SOE profitability all help explain, at least in part, why savings rates remain comparatively low when compared to other East Asian countries. Low savings rates, in conjunction the emergence of questions around access to foreign exchange, suggest that understanding the role of savings in contributing to or constraining Vietnamese economic growth over the medium term remains a salient issue.

Vietnam's need for private, government and foreign savings to fuel development remained pressing at the end of 2001. Despite the remarkable decline in poverty between 1993 and 1998, poverty and inequality remain major problems. While the total population below the poverty line in the whole country dropped from 55 per cent in 1993 to 37 per cent in 1998, the decline was far smaller for ethnic minorities, from 86 to 75 per cent, and for children, from 64 to 45 per cent (Haughton, 2000: Table 12). Indeed, although Vietnam has one of the lowest infant mortality rates in the region, it has one of the highest rates of child malnutrition, indicating a widespread lack of access to sufficient income (World Bank, 2001b). Moreover, inequality, as measured by the Gini coefficient for per capita income, rose 'significantly' from 0.356 to 0.407 between 1995 and 1999 (National Centre for Social Sciences and Humanities, 2001: 46). Falling agricultural commodity prices have been used as an explanation for the rapid growth in inequality, as has employment growth, which currently fails to keep up with the projected entry of one million new entrants onto the labour market in each and every year to 2010 (World Bank/ADB/UNDP, 2000). There can be little doubt that the impressive reduction in poverty witnessed during the 1990s in Vietnam is under threat, and that a critical means of addressing that threat is to reinvigorate growth in Vietnam, even in the face of the global slowdown.

The reforms and the challenges they engendered were the backdrop to the Ninth Congress of the CPV, in 2001. The congress set an ambitious agenda, in the form of quantified targets, for the decade ahead (World Bank/ADB/UNDP, 2000; World Bank 2001b). These targets included: a doubling of GDP by 2010; an increase in investment to 30 per cent of GDP; an increase in exports to a rate of growth double that of the rate of growth of GDP; a decline in agriculture's share of GDP and a rise in the share of GDP accounted for by industry and services; a decline in rural employment; and an increase in the urban population. In an effort to attain the targets of this agenda, the Congress ushered in a number of fresh faces in senior policymaking positions, including, most notably, a general secretary who appeared to support a deepening of the reform agenda. The response of the multilateral community to the plans of the government was extremely positive: in 2001 the IMF agreed a Poverty Reduction and Growth Facility, and the World Bank agreed a complementary Poverty Reduction Support Credit. The recent *Vietnam Development Report 2002* (World Bank 2001b) offers an extremely favorable 'scorecard' of reform in Vietnam. Both the state and the donor community remained firm in their view that Vietnam was a hidden dragon waiting to emerge.

3. A THREE GAP MODEL

There is general agreement among Vietnamese policymakers and donors that domestic investment and savings have to improve significantly for Vietnam to negotiate the global slowdown and replicate the high economic growth rates of the 1990s over medium and long-term (World Bank/ADB/UNDP, 2000; World Bank, 2001b). Nonetheless, there has been no published systematic analysis of the relative importance of private, public and external resources in providing the foundations that underpinned investment and growth in Vietnam in the 1990s. There has also not been an in-depth analysis of the domestic and foreign resources required for Vietnam to meet its medium and long-term GDP growth target of 7 per cent per annum to 2010. To assess the role and significance of domestic private and government savings, as well as foreign savings, on economic growth, this section specifies a three-gap model of growth along the lines suggested by Bacha (1990) and Taylor (1993). In contrast to full employment macroeconomic growth models, the three-gap model explicitly considers the interaction between capacity expansion and capacity utilization. Moreover, the limited data requirement of the model makes it well suited to countries such as Vietnam, where the coverage and availability of time series data is very limited.

According to the three-gap model, the utilization and expansion of existing productive capacity is constrained not only by domestic and foreign savings, as was initially discussed by Chenery and Strout (1966) in the context of the two-gap model, but also by the impact of fiscal limitations on government spending and thus on its public investment choices. In the absence of well-developed financial markets, the available methods of financing public investment are mostly confined to foreign borrowing, budget surpluses and inflation. Foreign resources can play a particularly significant role, especially if cutting current expenditures and inflation-based financing are not possible, either due to political circumstances or to external pressures on the fiscal authorities to curtail inflation.

The model's formulation is presented in Table 3. All variables in the model are defined as a percentage of potential output (Q), which was estimated by passing a linear line through output peaks for the period between 1986 and 2000. Equation (1) defines real output (X) as the sum of gross domestic product (GDP) and real intermediate imports (M_k)². Capacity utilization (u) is defined by equation (2) as a ratio of output (X) over potential output (Q). The rationale for working with (X) and (Q) as separate variables is that many developing and transitional economies often operate at less than full capacity, mainly as a result of the unavailability of foreign exchange and other structural bottlenecks. The capacity utilization rate, then, allows an exploration of the way the three gaps interact in the process of economic growth.

² Output is here defined in somewhat non-standard fashion, reflecting the importance of intermediate imports in production for a transitional economy country such as Vietnam.

Table 3 *Specification of the three-gap model*

Real output:	$X = \text{GDP} + M_k$		(1)
Capacity utilization:	$u = X/Q$		(2)
Growth rate:	$g = g_0 + \kappa i$	$g_0 > 0$ or $g_0 < 0$; $\kappa > 0$	(3)
Equilibrium:	$i = s$		(4)
Total investment:	$i = i_p + i_g$		(5)
Total saving:	$s = s_p + s_g + s_f$		(6)
Private investment:	$i_p = i_0 + \alpha i_g + \beta u$	$\alpha > 0$ or $\alpha < 0$; $\beta > 0$	(7)
Private saving:	$s_p = \sigma_0 + \sigma_1 u$	$\sigma_0 > 0$ or $\sigma_0 < 0$; $0 < \sigma_1 < 1$	(8)
Public sector saving:	$s_g = z - \zeta j^*$	$0 < \zeta < 1$	(9)
Fiscal effort:	$z = z_0 + z_1 u$	$z_0 > 0$ or $z_0 < 0$; $z_1 > 0$	(10)
Public sector borrowing requirements:	$\pi u = i_g - s_g$		(11)
Intermediate imports:	$m_k = a_0 + a_1 u$	$a_0 > 0$ or $a_0 < 0$; $0 < a_1 < 1$	(12)
Capital goods imports:	$m_z = m_0 + m_1 i$	$m_0 > 0$ or $m_0 < 0$; $0 < m_1 < 1$	(13)
Foreign saving:	$s_f = m + m_k + m_z + j^* - e = \phi = \Delta \delta + \delta g + r$		(14)
Three Gap Equations:			
Growth-investment equation:	$i_g = [1/(1 + \alpha)][(\bar{g} - g_0)/\kappa - (i_0 + \beta u)]$		(15)
Saving gap:	$(1 + \alpha) i_g - (\sigma_1 + z_1 - \beta) u = z_0 - \zeta j^* + \sigma_0 + \phi - i_0$		(16)
Foreign exchange gap:	$m_1(1 + \alpha) i_g + [a_1 + m_1 \beta] u = \phi - m - j^* - m_0 - m_1 i_0 - a_0 + e$		(17)
Fiscal gap:	$i_g - (\pi + z_1) u = z_0 - \zeta j^*$		(18)

Output growth is determined along Harrod-Domar lines, according to which the rate of growth of potential output (g) is specified in equation (3) as a linear function of the investment rate (i), which is in turn defined as investment as a percentage of potential output. The parameter (κ) denotes the incremental output-capital ratio, while (g_0) denotes other factors affecting the rate of growth of output, such as labour productivity growth. Equation (4) states the equilibrium condition, or savings constraint, according to which investment (i) is equal to savings (s). Total investment in equation (5) is specified as the sum of private investment (i_p) and government investment (i_g), with government investment defined as excluding investment by state-owned enterprises. Equation (6) specifies total savings as consisting of private saving (s_p), public sector saving (s_g) and foreign saving (s_f). Private investment is defined in equation (7). It is assumed that private investment varies with changes in demand conditions, as measured by (u), and with government investment. Private sector investment can vary positively with government investment, a so-called ‘crowding-in’ effect, or negatively with government investment, a so-called ‘crowding out’ effect, depending on whether these two types of investment are complements or substitutes. Private savings are defined in

equation (8) and are specified in a standard way, according to which savings are assumed to vary positively with the capacity utilization variable (u).

Public sector savings, investment and borrowing requirements are explained by equation (9) through (11). Public sector savings are defined in equation (9) as the difference between the fiscal effort variable (z) and interest payments on the government's foreign debt (ζj^*), where (j^*) denotes interest payments on foreign debt and (ζ) the government's share. In equation (10) the variable (z) defines the fiscal effort rate, also known as the public sector operating surplus, as the difference between current revenue net of transfers and subsidies plus the operating surpluses of public enterprises less government consumption expenditures and interest payments on the public sector's domestic debt. According to equation (10), the public sector operating surplus is assumed to be primarily determined by the capacity utilization rate (u), in that taxes, surpluses from public enterprises, and other receipts rise more rapidly than current spending when economic activity goes up. The strength of this response is measured by the parameter (z_1), the marginal fiscal effort rate. In addition to the rate of capacity utilization, the fiscal effort rate is influenced by other factors such as size of the tax base and the effectiveness of tax collection system. The strength of these other factors is captured by the parameter (z_0). Equation (11) defines the public sector borrowing requirement (πu), or the public sector saving constraint, as the difference between government investment (i_g) and public sector saving (s_g). Note that in equation (11) the public sector borrowing requirement (π) is measured as a proportion of output (X), while (πu) denotes the public sector borrowing requirement as a percentage of potential output (Q).

The external sector is summarized by equation (12) through (14). The import demand for intermediate goods (m_k) is specified as a function of the capacity utilization rate (u) in equation (12), while import demand for capital goods (m_z) is specified as a function of domestic investment (i) in equation (13). Equation (14) defines foreign savings, or the balance of payments constraint. The first part of equation (14) defines the current account deficit as competitive imports (m) plus intermediate imports (m_k) plus capital goods imports (m_z) plus interest payments on foreign debt (j^*) less exports (e). The capital account is presented in the second part of equation (14), where ($\Delta\delta$) denotes changes in the ratio of foreign debt over potential output, (δ) denotes the ratio of foreign debt over potential output, (g) is the growth rate, (r) the ratio of other capital inflows--such as foreign direct investment--over potential output, and (ϕ) total capital

inflows as a percentage of potential output. Exports and capital inflows are treated as exogenous variables.

The growth-investment equation, the savings gap equation, the foreign exchange gap equation, and the public sector savings gap equation are obtained from equations (1) through (14) and are presented as equations (15) through (18)³. In equation (15), government investment (i_g) and the capacity utilization rate (u) are treated as variables which can be traded off to give macroeconomic equilibrium, meaning that the growth rate of capacity output (g) can be treated as a target policy variable. Indeed, as explained above, one of the innovative features of the three-gap model is its explicit consideration of the interaction between capacity expansion and capacity utilization. This specification of growth, which is consistent with the work of Taylor and others, may be more relevant in circumstances where structural and foreign exchange bottlenecks prevent the full utilization of existing capacity. Equation (15) thus relates government investment (i_g) to the capacity utilization rate (u) and targeted potential output growth (\bar{g}). The savings gap equation (16) gives the maximum government investment attainable from a given rate of capacity utilization (u) that satisfies the equilibrium condition defined in equation (4). Assuming that government and private investment are complimentary, higher total government investment increases private investment and capacity utilization, thereby generating sufficient savings to finance the higher investment. Moreover, even if total government investment crowds out private investment, as long as the crowding out effect is incomplete higher government investment will increase capacity utilization. According to the foreign savings gap equation (17), there is a trade off between government investment (i_g) and the capacity utilization rate (u). Higher capacity utilization generates a higher demand for intermediate imports that can only be met, given available foreign exchange, by cutting into capital goods imports and hence by lowering the growth rate of capacity. Lastly, the fiscal gap equation (18) shows government investment (i_g) and the capacity utilization rate (u) to move together as higher capacity utilization generates more net fiscal revenue that can be channeled into capital formation.

³. The growth-investment equation (15) is obtained by substituting the total investment equation (5) into the growth equation (3) using the private investment equation (7). The savings gap equation (16) is obtained by substituting equation (7) through (10) and (14) into equation (3). Substituting equation (12) and (13) into the foreign savings equation (14) yields the foreign savings gap (17). Finally, the fiscal gap (18) is obtained by substituting equation (9) and (10) into equation (11), the public sector borrowing requirement.

4. ECONOMETRIC RESULTS

The model specified in Table 3 was estimated using annual data for the period between 1986 and 2000, using an ordinary least-squares technique. Data sources and definitions are presented in the Appendix. Since capacity utilization (u) is estimated separately, simultaneity does not pose any problem. The results of the estimated behavioural equations are presented in Table 4. However, before examining the regression results it should be noted that private investment is here defined to include both investment by the domestic private sector and by SOEs. This unorthodox definition is necessitated by the fact that national income data on investment by the private domestic sector is only available for the period between 1996 and 2000. Clearly, such a definition is problematic. However, combining investment by the private sector and SOEs is less problematic than might be supposed in the case of Vietnam, where the difference between the private and the SOE sector is often blurred. As Fforde notes ‘Vietnamese SOEs operate mainly according to local and quasi private interests, and should not be seen as fundamentally “public” in nature’ (quoted in van Donge, White and Nghia, 1999: 21), in large part because the process of transition in Vietnam has resulted in a great deal of ‘private profit making within SOEs’ (Fforde, 2001: 6). Moreover, a growing number of SOEs have been partially privatized. This has occurred not just through ‘equitization’, where the pace of change has been slower than originally anticipated, but also, and perhaps even more significantly, by “spinning-off” competitive activities to an entity established by management and held in the names of relatives’ (Gates, 1995: 36). Of course, the fact that many SOEs are run along market lines has facilitated processes of spinning off, partial privatization, and private profit making within SOEs (van Donge, White and Nghia, 1999: 20).

Table 4 *Econometric results of the structural equations and the three-gap equations*^{a, b}

Private investment:	$i_p = -0.160 + 0.14 u_{-1} + 1.11(i_g)_{-1} + 0.734 (i_p)_{-1} + 0.006 \text{ dum}$	$R^2=0.943$
	(-4.28) (3.11) (5.16) (14.1) (1.49)	
Private saving:	$s_p = -0.227 + 0.254 u + 0.844 (s_p)_{-1} + 0.0181 \text{ dum}$	$R^2=0.824$
	(-2.02) (2.17) (9.74) (1.29)	
Fiscal effort:	$z = -0.141 + 0.167 u + 0.159 \text{ dum}$	$R^2 = 0.437$
	(-1.70) (1.90) (1.19)	
Import demand:		
Intermediate goods	$m_k = -0.328 + 0.612 u - 0.056 \text{ dum}$	$R^2 = 0.777$
	(-1.29) (2.15) (-2.44)	
Capital goods	$m_z = 0.017 + 0.358 i - 0.007 \text{ dum}$	$R^2 = 0.350$
	(0.55) (1.98) (-0.34)	
<u>Three-gap equations:</u>		
Saving gap:	$i_g = -0.062 + 0.11 u$	
Fiscal gap:	$i_g = -0.13 + 0.178 u$	
Foreign exchange gap:	$i_g = 0.551 - 0.504 u$	

Notes: a. t-statistics are given in parenthesis under the coefficients, and the coefficients of determination (R^2) are adjusted R^2 . All equations were tested and corrected for autocorrelation.

b. All equations were estimated using a dummy variable (dum) to represent the Asian financial crisis of 1998-2000.

Sources: See the Data Sources and Definitions Appendix.

4.1 Structural equations, three-gap results and policy implications

Considering first the private investment equation presented in Table 4, the estimates generated by equation (7) suggest that both the capacity utilization rate and government investment are statistically significant determinants of private investment. The private investment estimate suggests that government investment is a complement to private investment. This result is consistent with other studies for Asian developing countries such as India, the Philippines, Thailand, Sri Lanka and Malaysia (Taylor, 1993: Table 2.2). The lagged private investment variable is also statistically significant, suggesting that it takes up to almost four years for actual private investment to adjust to its planned level.

The capacity utilization variable also appears to be a statistically significant determinant of private saving, fiscal effort and intermediate imports. Thus, the greater the degree of productive activity in the economy, the greater the rate of private savings, which can be used to finance investment, the greater the rate of government revenue collection, and the greater the rate of imports which are used as inputs in productive

activity. It can be noted that the estimates for intermediate imports indicate a high degree of dependence on imports. Finally, the estimates for imports of capital goods demonstrate that the marginal propensity to import with respect to capital formation is statistically significant. It is also relatively large, indicating Vietnam's high degree of dependence on imported capital goods. Thus, the greater the rate of investment the greater the extent of capital goods imports.

Using the estimated values of the parameters and the values of the exogenous variables, the model was calibrated for 1997. The resulting three-gap equations for the 1997 base year and for 2000 are shown in Table 4 and visually displayed in Figure 1. Figure 1 demonstrates a sharp trade-off between government investment and capacity utilization under the foreign exchange constraint. The savings constraint line is positive, as the stability condition of equation (4) is satisfied, and is flatter than the fiscal constraint line. This indicates that private saving, when defined as noted above to include saving by SOEs, is more binding than the government fiscal constraint as more foreign capital becomes available. In such circumstances, an attempt to raise government investment in order to stimulate economic growth will be frustrated by the lack of domestic savings, even though the government savings are in principle available to finance additional government investment. The domestic private saving constraint to economic growth suggests, among other things, the urgent need to encourage domestic savings by private enterprises, SOEs, and Vietnamese households if Vietnam is to achieve a higher rate of economic growth. This point will be discussed in more detail later.

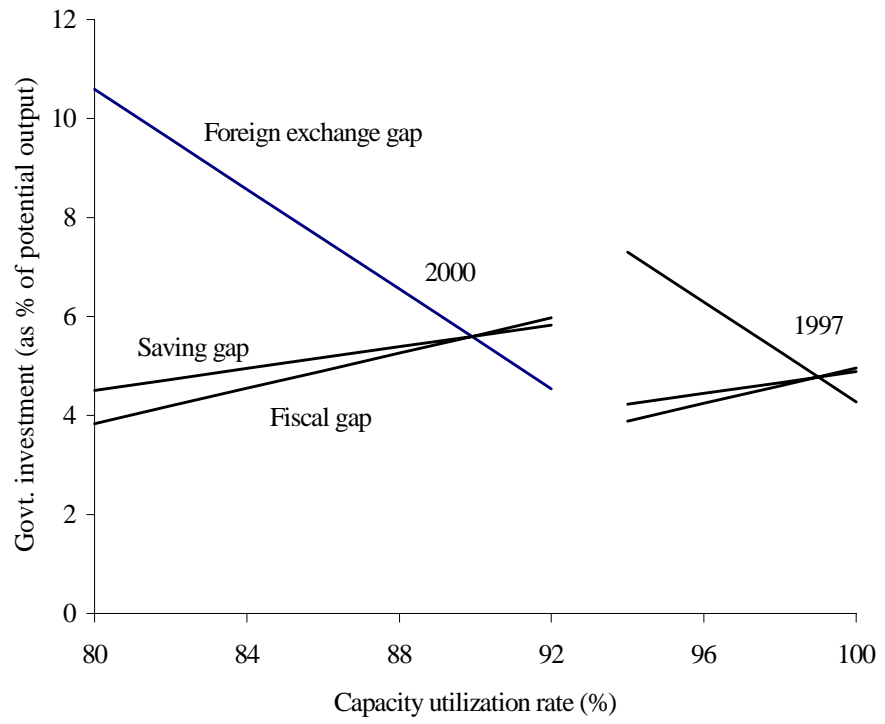


Figure 1. Foreign exchange, saving, and fiscal gaps

4.2 Simulation results

The estimated model can be used to simulate the effects of alternative policies by altering the values of individual variables such as the targeted growth rate of output, investment, exports and imports and then assessing the effect of such a change on the other variables contained in the model. In what follows, the model was simulated for the medium-term period between 2001 and 2006, which corresponds closely to the Government's Sixth Five-Year Plan. The medium-term simulations were undertaken under four growth path 'scenarios'. The first two simulations assess the broad implications of the neo-liberal policy measures advised by the World Bank and other donors, as outlined in the *Vietnam Development Report 2001* for the investment-savings, fiscal and current account balances, using the Government's investment projections (World Bank/ADB/UNDP, 2000). Of course, global slowdown in 2001 affected these projections. However, the simulations are conducted over the medium, and thus remain broadly valid provided the global slowdown remains brief. The first two scenarios differ in terms of their underlying assumptions about the supply response and the growth rate of potential output. Scenario I adopts a rather pessimistic growth path, in which the decline in the actual growth rate of output over the period between 1998 and 2000 has less to do with the Asian financial crisis than to do with an increasing tightening of the supply constraints under which the Vietnamese economy has operated during the 1990s. This rather pessimistic growth path is adjusted in the second path scenario, according to which the significant drop in economic growth after the Asian financial crisis is viewed as a temporary random shock. As a consequence, potential output is assumed to continue to grow at its pre-crisis rate over the period under consideration.

Scenarios III and IV explore two quite different and distinctive growth paths: a growth path that, in our estimation, is most likely to occur; and a growth path that meets 'socially desirable' ends. The most likely growth path scenario assumes that the global slowdown is brief, that there is a noticeable increase in the domestic private investment rate, that there is a partial recovery in FDI flows, and that growth of manufacturing exports mirrors that experienced by Vietnam before the onset of Asian crisis. By way of contrast, according to the 'socially desirable' growth path scenario potential output and per capita output are assumed to grow at an average annual rate of 9 per cent and 8.2 per cent respectively. These rates of growth are almost identical to those rates achieved by Vietnam during the 1990s. Unlike the first three scenarios, external resources are assumed to be both available and adequate under scenario IV, so that for-

eign exchange gaps, if any, can be filled. The results of the simulations are summarized in Table 5.

Table 5 Projected Growth Path Scenarios: 2001-2006

	Growth path scenarios					
	Base year (1997)	2000	Neo-liberal		Most likely III	Socially desirable IV
			I	II		
Real growth rate (% per annum):						
Actual GDP	8.2	6.1	7.4	9.6	7.0	9.0
Potential GDP	11.3	6.9	7.4	9.6	7.4	8.2
Exports ^a	16.2	20.0	14.0	15.6	14.0	14.6
As % of potential output (period average):						
Actual output						
(capacity utilization rate)	99.0	89.9	99.0	98.8	97.2	99.0
Total Investment	21.8	18.2	22.6	22.6	19.9	21.8
Government	4.8	5.6	5.2	5.2	4.4	4.7
Private ^b	10.2	10.0	14.2	14.3	12.4	14.1
Foreign	6.8	2.6	3.1	3.0	3.1	3.1
Current account balances	-7.2	1.4	-3.3	-4.4	-2.1	-3.3
Government borrowing	1.1	1.7	3.0	2.0	2.0	3.0
Total external debt (in billions of US\$)^c						
	10.3	14.0	23.0	25.5	20.0	24.0
Debt service (as % of exports)	11.1	12.1	8.5	9.6	7.2	9.0

Notes: a. In nominal US dollars.

b. Includes investment by state-owned enterprises.

c. For 2000 onwards, includes rescheduled non-convertible Russian debt.

Sources: Calculated from data described in the Data Sources and Definitions Appendix.

4.2.1 *Scenarios I and II: A neo-liberal growth path*

Considering first growth path scenarios I and II, it is necessary to begin by noting that economic reform and liberalization over the transition period and the rising investment rate in the 1990s led to a significant supply response in the Vietnamese economy (van Dong, White and Nghia, 1999). Whether the supply response has exhausted itself and hence whether there is a need for further reform is not clear. The recent deterioration in Vietnam's economic performance has, according to the World Bank and IMF, reflected not just changes in global circumstances but also an increasing tightening of the supply constraint and the consequent need for further economic reform and liberalization (World Bank, 2001b). Annual potential GDP growth has, according to this view, been declining steadily, from about 11 per cent in 1990 to about 5.5 per cent in 1999, and is expected to drop further, to 4.8 per cent in 2001 (World Bank, 2001b: Table 2.1). It is thus argued that the government's medium- and long-term growth rate target of 7 per cent per annum is not achievable unless the government adopts and implements a series of bold neo-liberal policy measures, including the privatization of SOEs, banking reform, market liberalization and price reform, as outlined in the *Vietnam Development Report 2001* (World Bank/ADB/UNDP, 2000) and reinforced in the *Vietnam Development Report 2002* (World Bank, 2001b).

Assuming that these policy measures are implemented and effective in terms of increasing the investment rate and hence the supply response over the medium-term, growth path scenarios I and II examine the implications of these policy measures for the investment-savings, fiscal and current account balances. These two growth path scenarios differ in terms of their underlying assumptions about the supply response. Growth path scenario I assumes that the supply response to the economic reforms and liberalization of the 1980s and 1990s has fully exhausted itself. Further economic liberalization is estimated to increase the growth rate of potential output to a maximum achievable rate of 7.4 per cent per annum over the period between 2001 and 2006. This is slightly higher than the Government's projected growth rate of 7 per cent per annum.

However, there is no clear indication that the supply response to earlier economic reforms and liberalization has indeed exhausted itself fully. Despite the low investment rate recent performance has witnessed continued growth, of 5.5 per cent per annum in 2000 and an expected 4.8 per cent per annum in 2001. Rates of growth of these magnitudes, when set alongside the current global slowdown as well as the current deflation in Vietnam, suggest a significant underestimation of the supply response

by the IMF and the World Bank. Our growth equation estimates suggest that actual and potential output can grow by as much as 9.6 per cent per annum over the period between 2001 and 2006, provided that further liberalization unshackles private investment and increases the investment rate to 30 per cent of GDP, or 22 per cent of potential output. Growth path scenario II therefore uses this growth rate and examines its implications for the savings, fiscal and foreign exchange gap. The implications are summarized in Table 5.

Under growth path scenario I the increase in capacity utilization, when combined with the liberalization of the investment environment, is projected to increase the private investment rate—which includes investment by SOEs—by almost 43 per cent, from 9.9 percent of potential output in 1997 to 14.2 per cent of potential output over the period between 2001 and 2006. To finance higher investment in general, and private investment in particular, the private saving rate—which includes savings by SOEs—is projected to grow by as much as 36 per cent over the period between 2001 and 2006. Higher capacity utilization and the broadening of the tax base is also projected to increase government tax revenues, though not enough to finance the increase in government investment, the costs of reforming the banking system and SOEs, and the potentially negative tax revenue effects of trade liberalization under the AFTA and the US-Vietnam bilateral trade agreement. These costs are assumed to reduce the fiscal effort schedule (z_0) by almost 17 percent. Consequently, the government borrowing requirement is estimated to rise to about 3 per cent of potential output, up from 1 per cent in 1997. Higher investment rates also increase imports of capital goods, as does the increase in the propensity to import intermediate (a_1) and capital goods (m_1), which is assumed to occur with the implementation of the AFTA. These increases in imports result in projections of a current account deficit equivalent to 3.3 per cent of potential output. This is higher than 2.3 per cent projected in the *Vietnam Development Report 2001*.

Although the current account deficit is much lower than the recorded deficit for the base year, it implies a heavier reliance on non-concessional loans. To meet the current account deficit and debt servicing, including FDI related loans, the total foreign exchange requirement is projected to amount to about US\$4.4 billion per annum. This is larger than the projected US\$3.2 billion estimated in the *Vietnam Development Report 2001* (World Bank/ADB/UNDP, 2000: Table 1.7). Because of the low projected growth rates of Vietnam's Asian trading partners, as well as because of the decline in

the absorptive capacity of those sectors that attracted FDI in the past, such as real estate and construction and heavy industry, FDI flows are assumed to fall below the peak they reached in the mid 1990s. Moreover, the liberalization of foreign trade and the consequent decline in tariffs and other trade barriers under the AFTA and the US-Vietnam bilateral trade agreement is assumed to make import-substituting FDI less attractive to foreign firms. The decline in FDI flows from their peak in the mid-1990s is thus assumed to recover partially, amounting to about US\$1.5 billion per year⁴. To meet its current account deficit, Vietnam thus has to rely on non-concessional loans, resulting in a total external debt stock of about US\$23 billion at the end of 2006, which is far greater than the projected US\$19 billion estimated in *Vietnam Development Report 2001*. Projected external debt would be even larger than US\$23 billion if FDI flows were adjusted downward, from US\$1.5 billion per year to US\$0.9 per year, as assumed in the *Vietnam Development Report 2001*.

As shown in Table 5, the projected fiscal and foreign exchange requirements are even greater under growth path scenario II. Higher economic growth, combined with an increase in capacity utilization and private investment of a similar magnitude to those witnessed under growth path scenario I, are projected to increase the current account deficit to 4.4 per cent of potential output. Assuming the same rate of FDI and official development assistance (ODA) flows, as well as changes in the marginal propensities to import noted in growth path scenario I, the achievement of an annual growth rate of 9.6 per cent per annum depends on whether Vietnam can access non-concessional loans of about US\$2 billion per year, as well as on the government's willingness to accept a foreign debt load that by the end of 2006 would, as Table 5 shows, be about US\$25.5 billion, or 82 per cent higher than total debt at beginning of 2001.

Whatever may be the merits of adopting further economic reforms and liberalization along the lines suggested in the *Vietnam Development Report 2001*, the estimates of the foreign exchange requirements under these two growth path scenarios suggest that the implications for the current account deficit and foreign debt are more severe than has been acknowledged. However, despite the government's acceptance of many of the recommendations made by the donor community, these two growth paths

⁴ This projected FDI flow is obtained by taking the mean of the Government's projection of US\$2.5 billion per year and the projection of the World Bank and other donors' of US\$0.9 billion, as reported in the *Vietnam Development Report 2001*. The World Bank's projection has been revised down in the *Vietnam Development Report 2002*.

appear less likely to transpire because of the government's record of conservative foreign debt management practices.

4.2.2. *Scenario III: The most likely growth path*

Unlike the previous two growth path scenarios, scenario III, the most likely growth path, assumes a steady but cautious adoption of 'market friendly' policy reform measures over the medium-term. The government's fiscal conservatism is assumed to remain unchallenged, as does the government's cautious approach to foreign debt management. Moreover, the slow pace of restructuring of SOEs, combined with the growing cost of banking reforms, are assumed to impose a far larger burden on public resources than acknowledged in the Government's development plan and the *Vietnam Development Report 2001*. Finally, the global slowdown is assumed to be brief. Assuming a government investment rate of about 6 per cent of GDP, or 4.4 per cent of potential output, and a maximum achievable potential growth rate of output of 7.4 per cent per annum, while maintaining similar assumptions about changes in the tax rate, marginal propensities to import, export growth and FDI inflows as those made under scenario II, the simulation results under the growth path scenario III are reported in column five of Table 5. High investment and growth will increase capacity utilization from its level in 2000, although the increase will not be sufficient to restore capacity utilization to its 1997 peak. Lower capacity utilization, combined with a modest increase in public investment, are projected to increase government borrowing requirements to 2 per cent of potential output, up from 1.6 per cent in 1997. The restructuring of SOEs and improvements in the climate for private investment are also assumed to increase private investment modestly, from 9.9 per cent of potential output in 1997 to 12.4 per cent of potential output. Similarly, the private savings rate is projected to grow modestly from 12 per cent of potential output in the base year to about 14.5 per cent of potential output in 2006. Lower capacity utilization and total investment rates under this growth path scenario are also projected to lower the current account deficit. Assuming the same rate of export growth as under the first growth path scenario, lower capacity utilization and investment rates would reduce both the demand for intermediate and capital goods imports. As can be seen from Table 5, the current account deficit falls considerably short of its level in 1997. With FDI inflows falling far below their peak level of the mid 1990s, financing the current account through non-concessional

foreign loans is projected to increase Vietnam's total stock of foreign debt to about US\$20 billion by the end of 2006.

4.2.3 *Scenario IV: The socially desirable growth path*

Given Vietnam's relatively lower rate of economic growth between 1998 and 2000, projected economic growth under scenario III, the most likely growth path, might fall short of meeting the population's expectations and aspirations, as well the growth rates achieved by Vietnam in the mid 1990s. Scenario IV examines the implications of a socially desirable growth path, in which actual output is assumed to grow at an average annual rate of 9 per cent. This growth rate is slightly lower than the growth rate under neo-liberal growth path scenario II, as is government investment and total investment. These lower investment rates suggest a potential growth rate of output of about 8.2 per cent per year between 2001 and 2006. These assumptions imply a steady increase in the capacity utilization rate over the period, so that by 2006 capacity utilization reaches almost 99 per cent, recovering the ground it lost after the onset of the Asian financial crisis. Higher capacity and the broadening of the tax base increases total tax revenue. With no changes in the government investment rate these higher tax revenues can be channeled toward the social sectors, such as education, health and poverty reduction programs, which have traditionally been highly underfunded (World Bank, 1992; Deolalikar, 2000). Higher capacity utilization, improvements in the private investment environment, and the restructuring of SOEs are assumed to increase private investment from about 10 per cent of potential output in 1997 to about 14 per cent over the period to 2006. As can be seen from Table 5, total investment is projected to reach 21.8 per cent of potential output, or 27 per cent of GDP, a rate which is lower than that achieved by Vietnam in the base year of 1997.

Improvements in capacity utilization rate and investment also increase imports of capital and intermediate goods. To fill the foreign exchange gap export earnings are supplemented by FDI and ODA inflows, as well as by an increase in foreign debt. Assuming similar magnitudes of FDI and ODA inflows as under the previous growth path scenarios, external debt is projected to grow to US\$24 billion by the end of 2006 and debt servicing to 9 per cent of the total export of goods and non-factor services.

4.3. The policy implications of the simulation results

These simulation results should be interpreted with great care, especially for a relatively small economy such as Vietnam, whose high degree of vulnerability to internal and external shocks has been amply demonstrated over the past two decades. Since 1997 Vietnam has experienced severe weather in the south and center of the country, weak commodity prices for its agricultural exports, the aftermath of the East Asian crisis and the onset of the global slowdown. These shocks, which were in many ways quite minor compared to those experienced previously, nonetheless reduced the rate of growth of real GDP, cut private and foreign investment, led to an increase in the government deficit, and boosted external debt, as demonstrated in Table 2. Although the economy had started to rebound by 2000, the onset of recession in the US triggered major economic difficulties in Vietnam's key Asian and European trading partners. This means that caution must be exercised when interpreting the results from the four simulation scenarios. Certainly, government and donor planning exercises did not foresee the speed with which growth in the global economy would slip, and thus the capacity to achieve the targets that underpin growth path scenarios I and II must be open to doubt if the global slowdown is anything other than short. This same caveat applies to scenario III, the most likely growth path.

Notwithstanding the evident need for caution when interpreting the results, the size of the foreign financing gap under all four scenarios illustrates quite vividly the centrality of the foreign exchange constraint on the medium-term growth rate. The scenarios demonstrate quite clearly that the costs of the next stage of Vietnam's transition have not been properly evaluated. Whether growth follows the most likely route, a neo-liberal path, or a socially desirable path, external debt is going to rise substantially over the period to 2006. While increases in concessional aid for a low-income economy such as Vietnam are possible, the volume of ODA will not be sufficient to meet foreign exchange requirements. The state is therefore left with the options of borrowing in international markets, attracting FDI, and boosting exports, in order to meet the foreign exchange requirements of a socially acceptable growth rate. Borrowing on the international market has its own costs, as the experience of East Asia in 1997 clearly demonstrated (Baer, Miles and Moran, 1999). By way of contrast, Vietnam was without doubt very successful in attracting FDI during the mid-1990s. Granted, the record of the mid-1990s is that the bulk of FDI entered into import substituting sectors, and thus did little to boost exports (Center for International Economics, 1998). It is only in the past few

years that FDI has been attracted into the export sector, and that the state has played an active role in seeking to encourage such FDI (World Bank, 2001c). This indicates a growing awareness of the critical role of exports in dealing with the foreign exchange constraint.

Clearly, easing the foreign exchange constraint goes beyond attracting FDI. There is a more general need to further diversify exports in a range of higher value-added activities. Vietnam's advantage is its workforce: for its level of per capita income, Vietnam's labour force is relatively well educated, comparatively well skilled, and is healthy. Nonetheless, given the modest growth prospects for Vietnam's main trading partners, increasing the size of private capital inflows does present itself as a means of both easing the foreign exchange constraint and possibly achieving a socially desirable growth rate in the medium-term.

However, achieving the growth targets developed for all four scenarios requires not only an increase in foreign capital inflows but also an improvement in domestic savings. The three-gap equations clearly demonstrate the constraint on growth generated by domestic savings rates. Domestic savings have, of course, two components: private savings, including savings by SOEs, and government savings. Improvements in private savings, as noted above, requires, among other things, a restructuring of SOEs. Recently, the government has undertaken several measures aimed at the restructuring of SOEs, including the most recently announced plan to equitize half of the SOE sector within the next five years (*Saigon Times Daily*, 27 November 2001). Moreover, the government has already, with the assistance of donors, started independent diagnostic audits of over 100 large SOEs and has commenced work on the development of restructuring action plans for three large 'general corporations' which group together a number of larger SOEs (World Bank, 2001b). By dismantling weak SOEs, and particularly by removing the state from the SME sector, where it does, no doubt, hinder the efficient allocation of resources, and increasing the exposure of those that remain to more stringent market disciplines, the state may be able to enhance domestic savings by boosting profitability. Furthermore, enhancing the productivity of the SOE sector can facilitate an increase in the rate of self-financed investment by SOEs above its current rate of around 50 per cent. A higher rate of profit, combined with a higher share of investment coming from retained profits, can significantly reduce the need for the SOE sector to secure resources from the financial sector. In so doing, SOE reform can not only allow the financial sector to increase its flows to the private sector, and particu-

larly the SME sector, but can also complement reforms being undertaken in the financial sector that could, in the aggregate, enhance domestic savings.

Improvements in the domestic savings made by households and private enterprises requires, among other things, fostering improvements in the financial sector. There is, more particularly, a need to promote the deepening of financial intermediation and to increase the confidence of Vietnamese savers in the financial system as a whole. As part of a set of activities to strengthen the banking sector the government has already adopted a detailed restructuring plan for its four largest SOCBs, has required that banks adopt more realistic provisions for non performing loans, has made banks assume responsibility for all aspects of the credit cycle, including the assessment of the viability of a proposed investment, and has, in addition, permitted interest rates to become more flexible in the past two years. However, perhaps the most significant set of reforms designed to enhance the efficiency of the financial system are those commitments that Vietnam has undertaken as a result of agreeing to the bilateral trade agreement with the US. The trade agreement substantially liberalizes the operation of the financial sector by, in effect, permitting an increase in the role of American financial institutions in the operation of the Vietnamese financial sector. The bilateral trade agreement has, in effect, imposed a demanding competitive constraint, in the form of American firms, upon the operation of the sector. The trade agreement also permits a significant expansion of US equity in non-bank financial services and insurance. Although the fledging private banking sector has demonstrated both the capacity to attract savers and impressive growth in recent years, it remains small. The US-Vietnam bilateral trade agreement will probably offer a substantial boost to the sector, and in so doing will facilitate an improvement in the private savings performance of the Vietnamese economy.

Of course, the parameter estimates presented in Table 4, as well as the simulation results based on these estimates, should be treated as highly tentative. The model specified in Table 3 is, as already noted, a highly aggregated one-sector growth model in which price variations are not explicitly incorporated. Projected growth rates are in particular very sensitive to changes in world oil prices and other non-oil commodity prices as well as the performance of Vietnam's manufacturing exports. The length of the global slowdown has implications for the results that have been presented. Finally, and obviously, the quality of the data can always be better, especially for a country

such as Vietnam where the transition from the net material product accounting system to the national income accounting system has yet to be completed.

5. CONCLUSIONS

The purpose of this paper has been to review Vietnam's microinstitutional transformation and macroeconomic performance since unification in 1975, and to assess the relative significance of foreign savings, domestic private savings, and domestic public sector savings on Vietnamese economic growth. After unification in 1975 the central planning system and its two key institutions, agricultural co-operatives and SOEs, was immediately imposed on the entire country. In the late 1970s Vietnam's economy was in a serious crisis that was threatening to become systemic as the inherent problems of applying Soviet style central planning to a highly populated, poor, subsistence agrarian economy surfaced. These, combined with a number of contingent events in 1978 and 1979, all served to intensify shortages of inputs and many basic consumer items. Widespread and growing shortages forced individuals, co-operatives and SOEs to increasingly engage in illegal but tolerated activities outside the planned economy. These 'grassroot' spontaneous initiatives were legitimized by the state through a series of policy measures that gave agricultural production co-operatives and SOEs more autonomy and space to engage in market-mediated activities. However, the tensions that emerged during the initial phase of reform were also very clear. The symbiotic relationship between the planned economy and the non-plan economy served to reduce the impact of chronic shortages within the planned economy and improve the efficiency of SOEs and agricultural co-operatives. However, at the same time it undermined state and Party control over capital resources and their allocation, and in so doing contributed to a deepening of macroeconomic imbalances. The state's loss on control over resources and the deepening of macroeconomic imbalances served to undermine support for continued reform and led to a resurgence of attacks on liberalization and on markets in the first half of 1980s. While the state's earlier attempts to preserve central planning and its institutions did succeed in slowing down the growth of the non-plan economy, the symbiotic relationship between the planned and non-planned sectors continued to mature and created pressure for further reform. By the mid-1980s the economy was once again in a serious economic crisis. The economic crisis of 1985 gave formal legitimation to early microinstitutional reforms when the strategy of *doi moi* was accepted in 1986. Further microeconomic reform measures undertaken during the two

years after the launch of *doi moi* succeeded in getting the process of institution building and marketization back on track, and thereby, getting prices to matter. The collapse of the centrally planned economies of Eastern Europe reinforced the need for the rapid restoration of internal and external balance. As a consequence, in 1989 the authorities hastily implemented an orthodox IMF type stabilization program, albeit without IMF funding, that sought to stabilize the economy and simultaneously build upon microinstitutional reforms. By 1993 Vietnam was firmly on a high growth path.

By 2000 Vietnam was a very different economy that that which had undergone stabilization in 1989. The economy grew during the stabilization program and growth accelerated in the mid-1990s as higher investment by the non-state sector and by the foreign invested sector, as well as exports, soared. Inflation remained low though the 1990s and prices were actually falling in 2000. Domestic savings rose considerably, although there was little financial intermediation in the formal sector to channel the growing savings by households into large-scale investment projects. The economy remained heavily inwardly oriented, and had a large state sector. Exports were concentrated in agricultural commodities and a relatively small spectrum of low value-added and import-intensive manufactures. The transition period also witnessed a sharp decline in the poverty rate. However, income inequality grew and the introduction of user charges in the social sectors imposed a heavy burden on the poor and vulnerable.

To assess the relative significance of domestic private saving, public sector saving and foreign saving on the Vietnam's economic growth, the paper formulated and estimated a three-gap model. The estimated model demonstrated a sharp trade-off between investment and capacity utilization under the foreign exchange constraint. The savings constraint was also shown to be more binding than the government fiscal constraint. To assess the significance for Vietnam of the foreign exchange and domestic savings constraints the model was simulated for the period between 2001 and 2006. The medium-term simulations were undertaken under four growth path 'scenarios'. The first two simulations assessed the broad macroeconomic implications of the neo-liberal policy measures advised by the World Bank and other donors, using the Government's investment and export projections. Scenario III posited a growth path that, in our estimation, is most likely to occur in the medium-term, while scenario IV offered a growth path that met 'socially desirable' ends. The size of the foreign financing gap under all four growth path scenarios illustrated quite vividly the centrality of the foreign exchange constraint in general on Vietnam's ability to achieve a socially acceptable rate

of growth in the medium-term. The results from the first two scenarios suggest that the increase in investment required to boost capacity utilization and actual GDP result in much higher levels of external debt than that estimated by the government and by the donor community – US\$23 to 25.5 billion, versus US\$19 billion.

These findings suggest that the challenge for Vietnam's policy makers is to intensify export diversification efforts and to improve the domestic savings rate if the economy is to no longer be a crouching tiger. The former requires, among other things, a set of coherent and consistent export promotion efforts directed at utilizing Vietnam's comparatively well educated and skilled workforce, and increasing FDI inflows. Export diversification increases and increases in FDI inflows should, however, be accompanied by an improvement in domestic savings if an acceptable rate of growth is to be achieved in the medium-term. This requires increasing the efficiency of the SOE sector and reforming the financial sector. Although the private banking sector is small, the US-Vietnam bilateral trade agreement will probably offer a substantial boost to the sector, and in so doing may facilitate an improvement in the private savings performance of the Vietnamese economy.

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APPENDIX: DATA SOURCES AND DEFINITIONS

The data in Table 1 comes from the following sources:

1. Social product and its components: Asian Development Bank, 1992 and GSO, 1998;
2. Retail price index: State Planning Committee/United Nations Development Programme, 1990 and Reidel and Turley, 1999;
3. Free market retail sales and per capita staples production: Fforde and de Vylder, 1996;
4. Gross investment: World Bank, 1990;
5. Government deficit: Reidel and Turley, 1999;
6. Export coverage of imports: Beresford and Phong, 2000.

The data in Table 2 and those used for the estimation of the 3-gap model defined in Table 3 and presented in Table 4 comes from the following sources:

1. Real GDP, per capita GDP, the consumer price index, the components of GDP by sector and ownership, investment, savings, exports and imports: World Bank, 1990, 2000, 2001a, 2001c and GSO, 2000;
2. Balance of payments and debt: World Bank, 1990, 2000, 2001a, 2001c and IMF, 1995, 2000;
3. Tax revenues, government spending and fiscal deficits: IMF, 1995, 2000 and World Bank 1990,2000, 2001a, 2001c.

Potential output (Q) was estimated simply by extrapolating lines through peak actual output (GDP + intermediate imports) over the period 1986-2000. Private savings (s_p) were estimated as a residual from the Keynesian national income identity, which can be written in normalized form as:

$$s_p = i - (s_g + s_f)$$

where other terms are as they are defined in the text.

Private saving includes savings by SOEs.

All real variables are in 1994 prices.