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Choosing Success:

The Lessons of East and Southeast Asia and Vietnam's Future

A Policy Framework for Vietnam's Socioeconomic Development, 2011-2020 [1]

[1] This study, which is based on a paper by David Dapice, incorporates research by Dwight Perkins, Nguyen Xuan Thanh, Vu Thanh Tu Anh, Huynh The Du, Jonathan Pincus, and Tony Saich, all of whom also contributed to the text, which was edited by Ben Wilkinson. Research funding was provided by the United Nations in Vietnam

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Overview

In the early 1990s the Harvard Vietnam Program compiled a series of strategy papers entitled *In Search of the Dragon's Trail*, the objective of which was to provide a framework for setting policy priorities and making economic policy decisions. *In Search of the Dragon's Trail* was tailored to the realities of an economic moment that has passed. The regional economic crisis in 1997 exposed underlying weaknesses of certain aspects of East and Southeast Asia's development. Perhaps more importantly, the structure of the global economy has continued to evolve. Trade liberalization has created truly global markets for manufactures and increasingly for services. Two decades of mergers and acquisitions on an unprecedented scale have created massive global corporations at the apex of supply chains that penetrate deeply into the production systems of developed and developing countries alike. Developing countries can no longer rely on industrialization strategies that have worked in the past and must continually reassess their positions in light of rapidly changing trends in foreign investment, financial markets, technology and demography.

Vietnam is also a very different country today. Many Vietnamese have escaped poverty and the country's economy has grown rapidly. This success is due in part to far-sighted decisions by the government to liberate the productive forces of society and integrate into the international economy. As a result of these changes, the Vietnamese economy is today much more complex, and deeply integrated. It is likely that the decision-making process is more heavily contested; political decentralization and the rise of influential interest groups make it easier to maintain equilibrium than to press ahead with additional reforms. In contrast to the urgency of the early years of *doi moi,* widespread optimism—nurtured by increasing foreign direct investment and lavish praise from donors and the international media—is breeding a sense of complacency and satisfaction with the status quo. In light of these changes, *In Search of the Dragon's Trail* is today perhaps more valuable to historians than to policymakers.[3]

This paper provides a new framework for setting priorities and making strategic decisions, one that is tailored to the realities of the Vietnamese and global economies of the early 21st century. The paper argues that from a development perspective, East Asia—defined here as Korea, Japan, Taiwan, Hong Kong and Singapore—has on the whole been more successful than Southeast Asia, defined here as Thailand, Indonesia, Malaysia, and the Philippines. This paper views China as a special case: its geographic location, cultural traditions, extremely rapid economic growth, and the high quality of its elite institutions of higher learning are decidedly East Asian, yet today China suffers from many of the weaknesses that derailed Southeast Asian countries. For Vietnam, whose development strategy is similar to China's in many respects, the implications of this analysis are significant. Vietnam must follow an East Asian development trajectory but does not have recourse to many of the policy

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[3] *In the Dragon's Trail* relied primarily on comparative experience; its primary authors were international experts who, with some exceptions, were not Vietnam specialists. Since this work was published, Harvard has developed a far more sophisticated and nuanced research capacity consisting of Vietnamese experts working closely with international colleagues. The center of Harvard's Vietnam-based activities is the Fulbright School in Ho Chi Minh City, which provides economics and public policy training to Vietnamese officials. More information is available at http://www.fetp.edu.vn.

instruments deployed by these countries during their rapid industrialization. Unfortunately in important ways Vietnam appears to be repeating the mistakes of Southeast Asia, East Asian, and China. Some will argue that by attempting to distill thirty years of development into a few core principals this paper is guilty of excessive oversimplification. To be sure, every country follows a unique development path that is a product of specific historical, cultural, and political circumstances. However, at a strategic level, the experiences of other Asian countries offer important lessons that Vietnam ignores at its peril.

One of this paper's central themes is that key government decisions taken now and in the near future will set the country on a path that will become increasingly difficult to reverse, and will shape Vietnam's political economy for years to come. Most crucially, Vietnam's future growth potential will depend to a great extent on the capacity of the state to construct a firewall between economic and political power. The defining characteristic of the East Asian development model—in particular in its Korean, Taiwanese and Singaporean forms—was the government's ability to discipline economic interests opposed to efficient capital accumulation, rapid industrialization and national economic competitiveness. Access to state favors was linked to performance rather than political connections. Even politically powerful groups and individuals were routinely denied government contracts, bank credits and other facilities if their plans were not feasible or socially beneficial or if past projects had been poorly implemented. The "crony capitalism" of Southeast Asia is in fact the failure of the state to achieve a clear separation of economic from political power.

We are not alone in this assessment. The Economist Intelligence Unit (EIU) forecasts a sharp slowdown in Vietnam's economic growth rate beginning in 2010. According to EIU, "vested political interests may impede reform, thereby preventing the necessary restructuring of some SOEs, which will hamper overall improvements in competitiveness and will constrain Vietnam's growth performance."[4] EIU sees growth slowing to 5.1 percent per annum for the period 2011-2020. This assessment may come as a surprise to Vietnamese officials who have grown accustomed to the high praise lavished on the government by donor organizations like the World Bank, many investment banks, and by the international media.[5]

Vietnam must act decisively to prevent the slowdown predicted by neutral observers like EIU. The quality of public investment will be a key indicator of the government's success in achieving reform. The state, like any investor, cannot allow its investment program to be diverted from the central objective of generating the highest possible returns. If it does, and allows powerful people to build personal fortunes from the misallocation of public resources, massive costs will be imposed on the economy. It is undeniable that Vietnam's public investment program is riddled with corruption and waste. Infrastructure projects are routinely subject to cost overruns and delays. The selection of projects is not based on clear economic criteria. For example Vietnam is investing in a string of deep sea ports in central Vietnam while the infrastructure in Ho Chi Minh City, Dong Nai, Binh Duong, and Ba Ria Vung Tau (which together are absorbing 60 percent of Vietnam's population and job growth) is stretched to the breaking point. The planned $40 billion high speed rail line would make a small contribution to growth while imposing a massive foreign currency debt on the public purse.

Politically powerful Vietnamese are transforming public property into personal wealth through murky land deals and an equitization process that leaves insiders in control of state companies and their assets. In Vietnam, where the average per capita income is approximately $800 per year, land prices

[4] Economist Intelligence Unit, *Vietnam: Country Forecast*, September 2007, p. 36.
[5] For some years now, Vietnam has been subject to what is known as "poster boy" syndrome. The World Bank and allied donor groups are uncritical of Vietnam because they need at least one success story to show that ODA works. Indonesia was the World Bank's poster boy until the East Asia crisis and the ensuing political turmoil destroyed the country's growth prospects for a decade. Vietnam now fulfills that role. The problem with poster boy syndrome is that, as in Indonesia, the World Bank will continue to praise the government until growth has ground to a halt, after which they will be ruthless in their criticism.

in urban areas rival those in the world's wealthiest countries. Thanks to an extremely weak and opaque regulatory environment, a tiny Vietnamese elite reaps super profits from speculative investments in real estate. The equitization of state-owned companies could significantly enhance the efficiency and competitiveness of state-owned corporations if pursued in a transparent and accountable manner. But in practice equitization has too often been used as a tool to enable insiders to build personal fortunes through the misuse and misappropriation of state assets.

The operation of the financial system also reflects a failure to separate political from economic power. Ninety percent of job creation and 70 percent of industrial output is generated by the private and non-state sectors, yet the Vietnamese financial system allocates a majority of credit and capital to the state sector. The stock market is rife with insider trading, and minority shareholders have no protection from managers and "owners" seeking to extract rent from equitized corporations.

This paper also stresses the central role of education to the East Asian model, and the urgency of thoroughgoing reform of the Vietnamese education system. Although we focus on higher education, it is important to recognize that Vietnamese education is in crisis at all levels. We will show that university quality is closely related to economic prosperity; given this relationship, it is extremely worrying that Vietnam's universities are the worst in the region. The state of Vietnamese education is not only a brake on economic growth but is also a source of enormous popular dissatisfaction and therefore a threat to political stability.

None of the trends described below are, individually, fatal to Vietnam's development prospects. However, ensuring that Vietnam realizes its immense potential requires urgent action in a number of policy areas. In its final section the paper presents a series of policy recommendations in six key areas. In addressing a limited set of high priority issues, our approach is selective rather than comprehensive. We have not shied away from controversial issues. Indeed, the paper is motivated by the perception that that the Vietnamese policymaking process is characterized by the near absence of critical, constructive debate. Effective policies will *only* emerge from rigorous analysis and reasoned, vigorous discussion.[6] There are solutions to the challenges Vietnam faces—many countries have overcome similar ones—but implementing needed policies will require political will. By the decisions it makes, or doesn't make, the Vietnamese state will decide how fast and how far it develops. In other words, for Vietnam, success is a choice.

[6] The Harvard Vietnam Program looks forward to participating in this process, through the policy analysis and dialogue initiative it is pursuing in partnership with the Vietnamese government and the United Nations in Vietnam.

CONTENTS

PART ONE. **A TALE OF TWO REGIONS**

I. Introduction

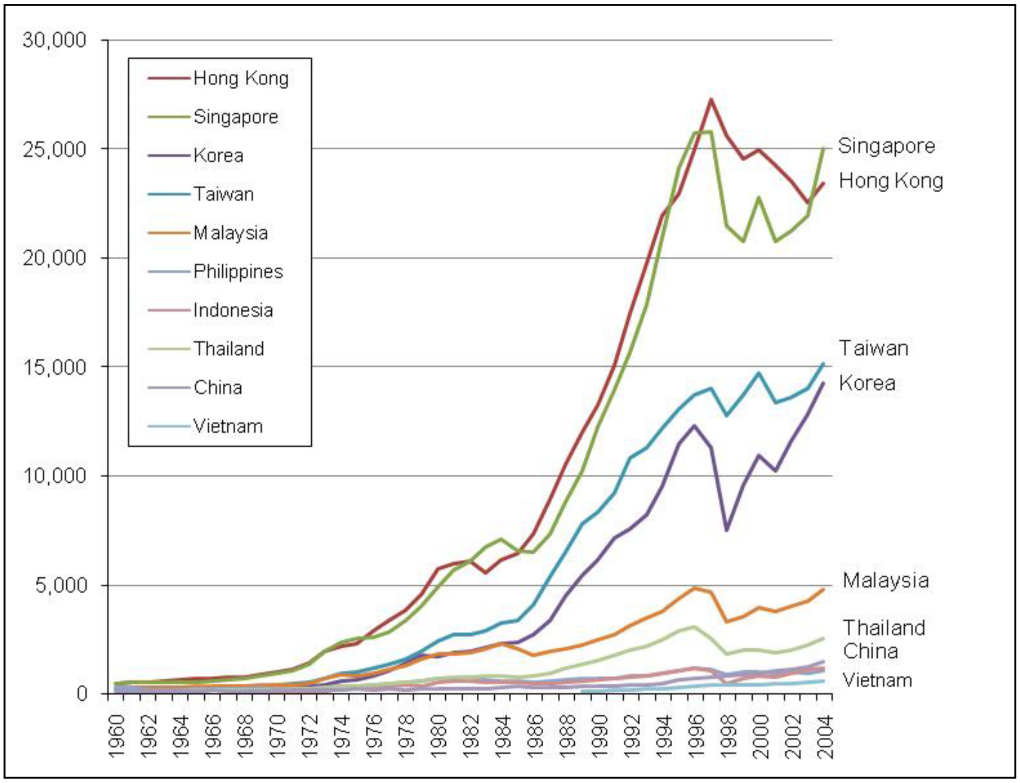
Vietnam's development goals are ambitious: achieve industrial country status by 2020, and, more broadly, build a "prosperous people, a strong country, [and] an equitable, democratic, and civilized society." If present trends and policies persist, however, it is unlikely that Vietnam will reach these objectives, at least within a politically acceptable time frame. This paper explains why, and suggests a framework for a more successful strategy.

Failure to achieve these goals would be an immense setback for the Vietnamese people, but, from an objective economic perspective, it would not be surprising. Of the many countries that have escaped poverty and achieved lower middle income status, as Vietnam is expected to do shortly, only a handful have continued to develop into rich, powerful, modern countries. In other words, the odds are not in Vietnam's favor, but this does not mean that Vietnam's future is unavoidably bleak. To the contrary, few developing countries possess Vietnam's immense potential. In just twenty years Vietnam has built a dynamic, internationally integrated economy. This paper will demonstrate, however, that past performance is no guarantee of future success. Seizing globalization's opportunities and skirting its pitfalls place new, heavy demands on the Vietnamese state.

The development of East and Southeast Asia offers important lessons for Vietnam.[7] East and Southeast Asian countries entered the post-World War II period at similarly low levels of income and development. The East Asian countries, particularly since the 1960s, have grown at historically unprecedented rates. Today, these countries boast dynamic, powerful, effective states, and highly advanced societies. They have achieved, or are rapidly achieving, world-class standards of education and healthcare for their people. Their cities are culturally vibrant, orderly, and relatively unpolluted. In contrast, as represented in Figure 1, despite periods of rapid growth Southeast Asian countries have yet to achieve the economic, political, and social transformation that sets East Asia apart from the rest of the developing world. Southeast Asia remains reliant on low-cost labor and natural resource exploitation. With the exception of Malaysia, Southeast Asian countries have all experienced extended periods of political and social turmoil. Governments are weakened by corruption and money politics. Mass protests and military coups have overthrown governments in Indonesia, Thailand, and the Philippines. Urbanization has proceeded in a haphazard manner, with millions living in squalid slums that line the rivers and fringe areas of Jakarta, Bangkok, and Manila. Decent healthcare and education services are a luxury that only the rich can afford. In short, the path followed by East Asian countries has lead to prosperity, stability, and international respect. Southeast Asia has followed a more circuitous route to a tenuous present and an uncertain future, haunted by the specters of social inequity and instability. There is no doubt which path Vietnam should follow.

[7] For the purposes of this paper, "East Asia" refers to Korea, Taiwan, Japan, and the city-states of Hong Kong and Singapore. (Although Singapore belongs geographically to Southeast Asia, it has followed an East Asian growth pattern.) China, while undeniably "East Asian" with respect to geography and cultural traditions, has little in common with the development paths taken by its East Asian neighbors. For this reason we view it as a special case. "Southeast Asia" refers to Thailand, Malaysia, Indonesia, and the Philippines. We do not include the oil-rich mini-state of Brunei or the region's least developed countries (Laos, Cambodia, Myanmar, and Timor Leste). It is not in Vietnam's interest to compare itself to this second group of Southeast Asian nations.

Figure 1. GDP growth per capita in Asia, 1960-2004[8]



Vietnam's economic take-off is just beginning; it is still poorer than the Southeast Asian countries (although the gap is narrowing rapidly) and far behind advanced East Asia. An advantage of starting late is that Vietnam can learn from the successes and failures of countries that have gone before it. One overarching lesson of Asia's development is that countries determine how fast they grow by making, or not making, strategic policy decisions that are often politically contentious. Vietnam's future will to a large degree be determined by the quality of the government's policy decisions.

The next section compares and contrasts development in East and Southeast Asia. Part Two considers the social implications of China's current economic policy. Part III evaluates current Vietnamese policies in six policy areas that together have a significant impact on how countries develop. Part Four analyzes the current structure of the Vietnamese economy to identify drivers of and obstacles to growth. In Part Five we make a series of policy recommendations to get Vietnam on an East Asian growth trajectory.

[8] Source: World Development Indicators.

II. East Asia's Success and Southeast Asia's (Relative) Failure[9]

Southeast Asian countries grew quite rapidly for a period of time and then slowed down. Malaysia had a long period of expansion from 1969 to 1995, with only a mild growth pause in 1984-86. During that period, real GDP grew 7 percent per year. Indonesia also enjoyed several decades of rapid growth, growing 6.8 percent per year on average from 1967-96. Thailand grew at an average rate of 7.6 percent per year for almost forty years. Yet growth in all three has slowed down to the 4-6 percent range. The deceleration of growth has come at relatively low levels of income per capita, for example, $1280 in Indonesia, $2700 in Thailand, and under $5000 in Malaysia.[10] By contrast, incomes per capita in South Korea and Taiwan now exceed $15,000. In fact, these are the only two countries (other than the city states and Japan) that have managed to reach levels of per capita income of well over $10,000. Compared to Southeast Asia, the East Asian economies have sustained higher rates of economic growth for longer periods of time, with the result that the countries of the region (with the exception of China) now rank among the most prosperous in the world.

East Asia's success can largely be attributed to its superior response in six key policy areas. Vietnam's continued success will in turn largely be determined by its ability to address these same areas. A comprehensive analysis of the economic development of East and Southeast Asia is far beyond the scope of this paper. Instead, the following discussion highlights the basic elements of sustainable economic growth and provides a framework for assessing Vietnam's current situation.

1. Education

Analysts offer many explanations for East Asia's success, some emphasizing the "market friendly" nature of economic policy and others focusing on the role of state intervention to accelerate the industrialization process. Both camps agree on one thing: East Asian countries invested heavily in education at all levels.[11] East Asian countries possessed a comprehensive vision for the development of human resources. Vocational training equipped migrants from rural areas with skills to secure better paying jobs in factories. Access to higher education expanded rapidly.[12] All countries stress technical education. In 1971, for example, the average number of engineers per 1,000 of the population among all middle income countries was 4.6. In Singapore and Taiwan, the corresponding figures were 10 and 8.[13] Great importance was attached to the development of top-flight research universities capable of educating the engineers, scientists, managers, and officials a sophisticated modern society requires. Foreign study was encouraged, and attractive incentives offered to returnees. Even the state-directed industrial strategies of Japan and Korea often began with investments in human capital. For example, during the 1970s and 1980s, hundreds of Koreans traveled abroad to study shipbuilding related disciplines, such as naval engineering, at the world's top universities. These individuals returned to play key roles in the emergence of the Korean shipbuilding industry. The same pattern was replicated in the 1990s in the burgeoning semiconductor industries of Taiwan and China. Both governments invest considerable time and effort developing networks of students

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[9] The characterization of Southeast Asian countries as relative failures will undoubtedly strike many as provocative and perhaps unfair. However, by not maintaining high growth and repeatedly succumbing to social and political unrest, Southeast Asian countries have not realized the twin development priorities of the Vietnamese state. Through the optics of Vietnam's own objectives, then, Southeast Asia can only be regarded as a *relative* failure.

[10] These data refer to income per capita valued at exchange rates in 2005 and come from Table 1 of the *2007 World Development Indicators* of the World Bank. In 2005, Vietnam had similarly measured income per capita of $620, or roughly one-half of Indonesia's level and a quarter of Thailand's.

[11] Over the past year Vietnam has received two senior Asian statesmen, Lee Kuan Yew and Tomiichi Murayama. Both men stressed education as the key to Vietnam's continued developed.

[12] By 1982, 80 percent of senior secondary school graduates in Taiwan went on to some form of higher education.

[13] Robert Wade, *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization*, Princeton University Press, 1990, p. 65.

studying technical subjects at the best US institutions, and the most promising young scientists are offered attractive packages to return home either to teach at domestic universities or to start up their own businesses.[14] By any comparison, East Asian countries have been more successful than Southeast Asian countries. Today a number of Chinese, Korean, and Taiwanese institutions appear on Shanghai Jiao-Tong University's annual ranking of Asia's top 100 universities. No Southeast Asian institution (outside of Singapore) even makes the list.[15]

2. Infrastructure and Urbanization

Building the infrastructure needed to support rapid economic growth and urbanization requires efficient use of public resources. Here too, with the notable exception of China, East Asian countries boast a much better track record than their Southeast Asian counterparts. One need only contrast Tokyo, Seoul and Taipei with Bangkok, Manila, and Jakarta to appreciate the dramatic difference; East Asian cities are engines of economic growth and innovation, while Southeast Asian cities are congested, polluted, over-priced, and often underwater. Poverty, crime, and an inability to provide core urban services like transportation, electricity and clean water have plagued Southeast Asia's cities. It is no surprise that urban protest movements have helped topple governments in Bangkok, Manila, and Jakarta. While failing to manage urbanization effectively, Southeast Asian countries have shown a propensity to over-invest in high-profile "mega-projects" that too often have proven unnecessary and wasteful. In general, East Asian countries have exercised restraint and have only added capacity when it is needed.[16] Why have the East Asian countries been so much more successful? One important factor is that infrastructure decisions were made by technocrats largely insulated from political pressure. In Southeast Asia, by contrast, public investment decisions were oftentimes political decisions subject to manipulation by special interest groups. As will be discussed further below, in the area of public investment in infrastructure and in urbanization, China looks very 'Southeast Asian." The Chinese government has thus far failed to shield these decisions from political interference. China's rapid urbanization is creating massive environmental challenges. In some cases, pollution and environmental degradation have driven urban residents to participate in street protests.

3. Competitiveness of Firms

The rapid growth of competitive industries is the key to maintaining a high GDP growth rate for all countries with a per capita income below US$15-20,000. The emphasis is on the word competitive. Industrial firms will not grow rapidly if they cannot compete with both their domestic competitors and, of even greater importance, with their international competitors. Firms that rely on a near monopoly over their domestic market with support of the government and are not subject to the pressures of international competition will not expend the required effort or assume the risks associated with seeking out new markets and upgrading products and production processes. The energies of management will be devoted to maintaining government support rather than learning how to innovate, lower costs, raise quality and move into new product lines. In East Asia, when government supported particular industries and even particular firms, managers, with rare exceptions, knew from the outset that government support was temporary and that they would have to be exporting within a few years to survive. The major exception to this rule of "export or die" was Korea

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[14] Technology transfer from Silicon Valley in California to Taiwan in the 1980s has been replicated in new forms in the 1990s linking US firms to Taiwan and Shanghai. See AnnaLee Saxenian, "Brain Circulation and Capital Dynamics: Chinese Chipmaking and the Silicon Valley-Hsinchu-Shanghai Triangle," in Victor Nee and Richard Swedberg, eds., *The Economic Sociology of Capitalism*, Princeton University Press, 2005.
[15] See http://ed.sjtu.edu.cn/rank/2007/ARWU2007_TopAsia.htm.
[16] For an example of the differing approach to infrastructure investments, one need only compare the airport in Taipei with those in Bangkok and Kuala Lumpur—the former was built thirty years ago and remains in use. Both Bangkok and Kuala Lumpur have invested in major new airports that have been plagued by cost overruns and are generally regarded as ill-conceived and poorly executed.

in the 1990s where many believed that the *chaebol* were “too big to fail” meaning that the government would always come to their rescue. Yet in the late 1990s the government was unable to save them from the effects of the East Asian financial crisis of 1997-1998. Although Chinese industries are increasingly integrated into the global economy, they remain competitive on the basis of cost-cutting rather than innovation or economies of scale. Even large firms in China often consist of small core businesses accompanied by numerous small subsidiaries operating in sectors unrelated to the core. The inability of the largest country in the world to achieve economies of scale in industries such as steel, automobiles and machinery is due primarily to the ability of local authorities to direct investment and other forms of support to “local” rather than national champion firms.[17] The government’s efforts to achieve consolidation in the steel sector have failed, as unsuccessful companies were repeatedly bailed out by regional authorities. As a result, despite China’s massive domestic market, productivity levels remain far below international market leaders.[18]

Vietnam’s industry today relies heavily on labor intensive products such as shoes, garments, and furniture much as did most of East Asia thirty years ago. Reliance on labor intensive products in the early stages of industrialization provides employment, needed foreign exchange, and experience in running modern industrial organizations. But countries that compete on the basis of cheap labour cannot, by definition, move beyond lower middle income status. They end up struggling for wafer thin margins in markets in which new competitors appear with each passing day. Japan, Taiwan, Korea and Singapore embarked on long term processes of learning and innovation that eventually enabled them to enter markets for more sophisticated, technology and capital intensive products.,As average wages have risen their labor and resource intensive factories have moved to China and Southeast Asia. This transition does not happen automatically. It takes enormous focused effort by firms, individuals and the government to make this transition possible.

East Asian countries in this respect engaged in what can only be characterized as the single-minded and at times ruthless pursuit of advanced technologies, knowledge, and skills to enable firms to enter markets for new products and to revolutionize the production process. They have developed national innovation systems to acquire and deepen technological capabilities and to access, adapt and improve on imported technologies. They have used trade, finance, education, land and tax policy to drive domestic firms to upgrade their skills and product lines.[19] The government in Taiwan revamped its education system to supply the economy with well trained engineers and scientists. It created demand for computer services by first computerizing government offices, and set up world class research institutes to develop leading edge technologies. The Hsin-Chu Science and Technology Park was set up to attract Taiwanese scientists and entrepreneurs back home from Silicon Valley and elsewhere. The Taiwan Semiconductor Manufacturing Company (TSMC), now the world’s leading semiconductor foundry processor, was an outgrowth of the government’s Industrial Technology Research Institute, established with Philips in 1987. With the exception of a very small number of very capital intensive firms (such as the TSMC), the government did not set up firms itself but created the conditions that made it possible for private entrepreneurs to succeed. Taiwanese firms are now global leaders in computing, electronics and a range of other sectors. By contrast, Indonesia and Thailand managed to attract large volumes of foreign direct investment but generally did not create the supporting environment that would allow either domestic or FDI firms to move up the technology ladder. Thailand has enjoyed more success than Indonesia in sectors such as auto parts and disk drives, but even these firms have not managed to penetrate the design and innovation sides of these businesses.

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[17] Edward S. Steinfeld, “China’s Shallow Integration: Networked Production and the New Challenges for Late Industrialization,” *World Development*, 32:11, 1971-1987, 2004.
[18] Pei Sun, “Is the State-Led Industrial Restructuring Effective in Transition China? Evidence from the Steel Sector,” *Cambridge Journal of Economics*, 31, 601-624, 2007.
[19] Sanjaya Lall, “The Technological Structure and Performance of Developing Country Manufactured Exports, 1985-1998,” *Oxford Development Studies*, 28:3, 337-369, 2000.

Another lesson from the East Asia experience is that international trade not only provides needed competitive pressure, it also provides a useful yardstick with which to measure the competitive capacity and progress of domestic firms. Successful Korean exporters were generously rewarded with favored access to local markets and government contracts, and unsuccessful firms were penalized. Even when receiving government support, as was provided to the Korean shipbuilding industry, it was always clear that Korean firms would need to become internationally competitive Although many of these tools are no longer available in the post-WTO world, the principle that success on international markets is a reliable gauge of competitiveness still applies. By way of contrast, Southeast Asian countries protected domestic industries for too long, creating uncompetitive, money losing dinosaurs in both the public and private sectors. Malaysia with the Proton automobile or Indonesia with Krakatau Steel, are good examples of what happens when government tries to move up the technology ladder behind a high and sustained wall of protection. After thirty years of protection Indonesia's steel industry is effectively moribund, and its heavily subsidized aircraft industry was wound down in the wake of the financial crisis and having failed to make an impression on the intensively competitive international market for small airplanes.

4. Financial system

East Asian countries invested a large share of national income but they invested it efficiently. Taiwan grew at the exceptional rate of 10 percent per year from 1962 to 1980, while investing on average 26 percent of GDP over this period. *Taiwan required little more than half as much capital as Vietnam now needs to generate an additional unit of output*. Southeast Asian countries have succeeded in driving up investment rates but did not achieve East Asian growth rates largely because rates of return on their investments were on the whole much lower. Corruption certainly played a role, as public investment funds were diverted from their intended purposes and the cost of doing business increased for everyone. But another important factor in Southeast Asia was premature and poorly designed liberalization of the financial sector, which led to speculative investments and the formation of asset bubbles. The 1997 crisis revealed the extent of overinvestment in speculative real estate ventures in Thailand and Indonesia, and the systematic hollowing out of corporate finance and bank balance sheets in Indonesia largely due to the inabilty of the Indonesian authorities to enforce their own rules. The 1997 crisis was just the most recent in a long series of events in Latin America, North America, Europe and Africa linking simplistic approaches to financial liberalization to banking and financial crises.[20]

The primary function of the financial system is to mediate between savers and investors. The market is a powerful instrument to stimulate saving and channel capital to investments that promise the highest returns. Yet it is also important to remember that money is different from other commodities because information flows and trust are so important to the functioning of financial markets. Moreover, investment is subject to risk and uncertainty about the future. Because of these differences, government has an important role in reducing systemic risk. For example, Taiwan placed tight restrictions on wealth accumulation through land ownership and financial speculation. The Taiwanese and Korean governments also blocked industrial groups from opening banks to prevent the merger of financial and industrial power, although in Korea this policy eventually was subverted by the *chaebol*. Industrial groups were to focus exclusively on increasing profits through raising productivity and competitiveness, not through financial engineering and speculation.

5. State Effectiveness

[20] The incidence of financial crisis appears to have accelerated in recent years, beginning with the US Savings and Loan crisis and extending through crises in Mexico, Asia, Brazil, Turkey, Russia, Argentina and the collapse of the trillion dollar Long Term Capital Management hedge fund. The sub-prime mortgage crisis is the most recent event, but certainly not the last.

East Asian countries, not including China have built smart, effective states, typified by the following features:

First, as discussed above, they managed for some specific historical reasons to insulate economic policymakers from political interests, especially interest groups opposed to rapid and sustainable industrial development. The "autonomy" of East Asian governments enabled them to stimulate investment and capital accumulation without becoming captured by business groups. The government was able to discipline even leading corporations and conglomerates, and applied stringent performance criteria in distributing state assistance.

Second, they got the basics right. Governments provided economic infrastructure, education, health care, and public security at a reasonable cost that met the quality expectations of their citizens. Macroeconomic management was generally cautious, competent and favored national development over particularistic interests. With the exception of security, Vietnam is currently failing to provide the majority of its citizens with essential services, and the government's hard-won reputation for careful macroeconomic management is now under threat from repeated missteps and a failure of policymakers to keep up with the growing sophistication of the domestic economy.

Third, East Asian countries have generally demonstrated the political will to change when needed. South Korea responded vigorously to structural weaknesses in its economy that were exposed by the 1997 economic crisis and has emerged even stronger.

Fourth, East Asian governments promoted the development of the rule of law and impartial courts to provide a conducive environment for investment and exchange. Singapore, and later Hong Kong, were the first East Asian countries to prioritize the strengthening of their legal systems. Impartial economic courts emerged later in Japan, Taiwan, and Korea. The development of the rule of law is also the key to fighting corruption.[21]

Fifth, East Asian leaders could draw upon high quality policy analysis to make decisions, and encouraged an open and active debate within government, academic and business circles on the content and direction of economic policy.

The results in Southeast Asia have been mixed. The Philippines represents an extreme case. As recently as the 1950s, the Philippines was regarded as the Southeast Asian country with the greatest economic potential. But its political system was captured by a small elite that made its money by controlling land and heavily protected domestic industries. Large, horizontally diversified conglomerates that are internationally uncompetitive rely on government connections to dominate the domestic economy. Politicians allied themselves to these interest groups to the detriment of economic development and the wider public. Although the Philippines has a highly educated population and some good universities, decades of slow growth, environmental degradation and corruption have turned this once promising country into a major exporter of skilled labor. In general, Southeast Asian countries have too often failed to marshal the political will needed to institute politically contentious reforms. This is why experts fear that the underlying structural problems that led to the 1997 crisis have not been completely resolved.

East Asia's track record is not perfect. No country gets all of its policies right all of the time. China in particular faces massive challenges such as controlling endemic corruption, haphazard urbanization, environmental degradation and the rapid rise in economic inequality. Moreover, the world has changed in important ways since Japan, Taiwan, Korea, Hong Kong and Singapore began the process of rapid industrialization. Today World Trade Organization rules prohibit countries from

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[21] Taiwan, Korea, Japan, and the city state all score higher on Transparency International's corruption perception index. They also score higher even after adjusting for per capita income. http://www.transparency.org/policy_research/surveys_indices/cpi/2006

sheltering infant industries behind protective tariffs and other trade barriers. Even if these policies were still permitted, it is unlikely that they would work in precisely the same ways.[22] The global business revolution of the late 20th and early 21st century has rendered old models irrelevant. The question is no longer whether individual countries can make the long trek from shirts to steel to automobiles. Now there are only a handful of independent automobile manufacturers left in the world, and the challenge facing late industrializers is to link up with these global production systems on the basis of cost reduction, productivity and innovation. Trade protection is not a useful tool to achieve this objective.

6. Equity

The ultimate objective of development policy is to create a prosperous and equitable society. One of the hallmarks of the "East Asian model" is rapid economic growth combined with a relatively equal distribution of income. Even today with their high levels of per capita income, Korea and Taiwan have income distributions far more equal than Malaysia, the Philippines, Thailand, Singapore or Vietnam. However, these Southeast Asian countries are more equitable than those in Latin America or Africa.[23] Nevertheless, yawning inequalities remain. Three of the most important human development policies are education, healthcare, and social safety nets. Education and health are essential if individuals are to be productive members of society. Social safety nets protect the most vulnerable segments of society, such as the rural and urban poor, from the shocks and vicissitudes of the global economy. It should be emphasized that until recently, East Asian countries have generally not provided generous social insurance programs. However, as noted above, they have achieved high levels of social equity by getting the basics right, chief among them high quality public education and affordable healthcare.

Low levels of quality education not only slow down national development, but also create inequalities that persist. Well-to-do families make sure their children are well educated, and their skills are scarce and so very well paid. Children of average families cannot go to foreign universities or even top domestic high schools, and are less well prepared and earn much less. Thus, the failure of Southeast Asian schools and universities to excel has implications for long-run equity in the society. In Vietnam, where basic education is widespread, the progress from low income levels has been rapid and broad. However, concerns with educational quality make the sustainability of recent rapid job gains uncertain as incomes continue to rise. Both conditions attracting investment and a quality workforce have to be improved to allow the recent favorable record to be maintained.

Public health is itself a contributor to welfare and a source of productivity and security. If people get sick, their entire families suffer, especially if there are ruinous medical bills as well as lost income. A health system that overcharges for services or delivers services poorly tends to throw the unlucky into poverty and their children out of school. While most of Asia has raised life expectancy past 70 years, the cost of illness remains a threat to many of average means. This part of the safety net is frayed.

A key to improving equity is creating the conditions to help workers move out of low-income jobs to those that pay better wages. This typically means moving off of a small plot of land as a farmer and

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[22] The Japanese *keiretsu* model of diversified corporate groups centered around a bank and bound by cross-shareholdings is now widely regarded as an obsolete solution, if not a failure. After twenty years of economic stagnation, the Japanese financial system has yet to repair the damage wrought by the *keiretsu* system. Korean *chaebol*, although barred from owning banks, were permitted to borrow at will from state-controlled banks. The danger of this system was finally revealed in 1997 when a number of *chaebol* faced bankruptcy. Vietnam appears to be replicating certain aspects of these two systems.

[23] One measure of income inequality is the Gini index. It is zero if all incomes are equal and 1.0 if one person has all income. A very equal Gini is .25 and a very unequal Gini is above 0.5. Korea's Gini is .32. The Gini of Taiwan and Indonesia is .34, while Vietnam is .37. Thailand is .42, the Philippines is .45 and Malaysia is .40. China has a Gini of .47.

taking a nonfarm job, often in the city. If cities are dirty and lack decent jobs or housing, this move is not a happy one. Successful management of land, urbanization and job creation create desirable patterns of migration to cities. Mismanagement results in disease, misery and social unrest. A high quality of urbanization and urban job creation is one of the hallmarks of an equitable country.

One of the least satisfactory aspects of development in Southeast Asia has been the ability of the wealthy to avoid paying even modestly significant levels of taxes. Fortunes are being made in land speculation, yet taxes on land and property holdings are typically low or almost non-existent. Income taxes are routinely evaded or minimized. While large transfers from the rich to the poor are probably not desirable, those who do well should pay a modest share of their much higher incomes to help fund needed public services. China has government spending at only 11% of GDP, while most of Southeast Asia is in the 15-20% range – except Vietnam, which is at 28%, helped by its oil. This is one area where Vietnam is spending enough, but perhaps not always spending wisely.

A final aspect of equitable income distribution is land distribution that is relatively equal. The Philippines has many landless laborers in rural areas and some very large land holdings. This pattern also developed in parts of Indonesia due to both population densities and land accumulation by politically favored companies. Thailand and Malaysia also have somewhat unequal land distribution. In China and Vietnam, the initially equal land holdings have become more concentrated as government officials buy land at low official prices and then use it for private development, selling the taken land at much higher prices and often benefiting in the process.[24] This did not happen so much in Korea or Taiwan. As farms are consolidated in those countries, farmers can sell out when they are ready at fair prices rather than be displaced and given little relative to the true value of their land.[25] Obviously, being landless in a rural area is often very difficult if the workers do not have valuable skills, so a highly unequal land distribution often implies a very unequal income distribution, especially if health and education services are also deficient.

Overall then, the experience of East Asia teaches that creating jobs of ever-higher productivity and wages for all is a key to equity. Much has been written about the remarkable capacity of Taiwan and Korea to penetrate export markets and develop new industries. This rapid industrialization had the positive social effect of creating millions of jobs for skilled and semi-skilled workers that provided steady incomes for the growing labor force. The employment elasticity of growth, in other words, the rate of growth of job creation for each one percentage point of economic growth, ranged between 0.7 and 0.8 in Korea and Taiwan during the period of rapid industrialization. Also crucial to this process was the universal access to good quality education provided in both countries. In addition, the education systems in both Korea and Taiwan focused heavily on vocational training and technical skills required by their countries' growing manufacturers. Affordable health care also helped many families avoid the poverty trap of lost wages and high hospital bills.

[24] Inequality has been rising in China and become a concern of the leadership. Corruption in land dealings and public spending has led to massive protests. If Vietnam continues to follow in China's footsteps with respect to concentrating land ownership, it is likely that it too will see increasing income disparities over time.
[25] Of course, it must be remembered that Taiwan, Korea, and Japan all lavished subsidies on their agricultural sectors, a strategy that is infeasible for Vietnam and China.

PART TWO. **CHINA: THE SOCIAL IMPLICATIONS OF GROWTH**

III. China Today

In many ways China would seem to be the obvious model for Vietnam to follow. Like Vietnam, China has made the transition from a centrally planned command economy to a market economy only China began this process a decade earlier than Vietnam. But is China an example of the East Asian model or of the Southeast Asian model? Or is China a unique model of its own and, if so is that model a guide to where Vietnam is heading or ought to head? With respect to transition issues such as the return to household agriculture, the problems connected with the reform of state owned enterprises, and the difficulties connected with the creation of a modern and healthy financial system, there is much that Vietnam can learn from the Chinese experience. Another area in which China has enjoyed great success is in its development of an elite cohort of universities and research institutions. Today the best Chinese universities are engaging in cutting edge research and enjoy increasingly strong and productive linkages to industry. In other respects, however, China is unique and its experience not replicable in the Vietnam context. Indeed, this section argues that the Chinese government itself has concluded that in key respects the country's development strategy is failing and must be re-calibrated.

The essence of the East Asian success was that these countries created economies that were internationally competitive across the board. For Japan, South Korea, and Taiwan, the method was to provide infant industry support to key industries but only for a short time after which those industries were required to export their products around the world. The pressure to become internationally competitive was what drove the high growth in productivity and in GDP per capita. In this respect China is also an East Asian economy in that it has also successfully promoted the export of manufactures but China has had to do so without being able to use many of the infant industry protection measures that played an important role in the first phases of export oriented growth elsewhere in East Asia. The current international economic system governed by the rules of the WTO no longer allows most of these infant industry protection measures and China effectively abandoned most such measures when it agreed to the terms required for membership in the WTO. In fact China began trade liberalization of this sort well before it was a member of the WTO and did so with the conscious objective of putting pressure on many of the poorly performing state owned industrial enterprises. In this respect, China clearly presents a viable model for Vietnam to follow. It is possible to pursue the East Asian model of development even though some of the protective measures that played an important role in the early phases of growth elsewhere in East Asia were not available to China just as they are also not readily available to WTO member Vietnam.

Is China reproducing the East or a Southeast Asian model? China's quarter century of exceptionally rapid growth, as well as its geography and cultural traditions, would seem to place it securely in the "East Asian" group, albeit with a later start. Yet Southeast Asian countries such as Indonesia also produced decades of high level growth before slow down occurred. In fact, China exhibits crucial differences with the East countries such as Japan, Korea and Taiwan and shares many of the problems of government interference in the economy, corruption, low state investment in education and rising inequality that have produced problems in Southeast Asia. The areas where the Chinese economy have shown the greatest success have been where it has shaken off the negative legacies of state planning and have not slipped in to the practices of Southeast Asia. Thus, the non-state sector of the economy has been experiencing the best returns on investment and has created most employment; the abolition of dual-pricing reduced one route to corruption, and integration into the global economy has provided better discipline for enterprises. Last but not least, the terms on which China has entered the global economy are significantly different than the external environment faced by the earlier East Asian industrializers. A number of practices that they adopted to cultivate and develop domestic industry would not be feasible under current WTO regulations.

Yet, we are dealing with spectacular growth. China's population and its continental size make it unique and thus renders attempts to categorize its development in terms of a particular model irrelevant. While China's economic development has been successful to date, it cannot provide a model for others to learn from, even countries like Vietnam that share many of China's cultural and institutional traditions. What might provide a model is the experience of specific provinces of China. Zhejiang and Guangdong provinces have been at the forefront of economic growth in China and they share features that resemble more closely the development path of East Asia with less government interference, a higher level of non-state sector enterprises and employment, and extensive trading integration. By contrast, those provinces that have higher levels of state employment have suffered from lower growth, less effective investment and greater social problems.

It is clear that the state sector will never again be the main engine for urban employment neither for those laid off nor for the estimated 11 to 12 million new entrants each year on the job market. Even with an improved growth rate, it is clear that growth in employment generation has been dropping as enterprises have been forced to become more efficient. Employment growth over the next decade will be 1.4 percent per annum slightly up from the 1.1 percent in the decade prior to 2000 but well below the annual employment growth of 4.2 percent in the previous decade.

This means that there is a clear policy priority to expand other avenues for employment growth but producing sufficient jobs will remain a major headache for the leadership over the next decade. Official accounts from the Development Research Center of the State Council calculate that currently the Chinese economy needs to generate around 24 million jobs to absorb the new labor force, including migrants and college graduates.[26] Current growth is generating around 10-12 million jobs per annum. They do not see the employment pressure alleviating for 20 to 30 years. Yet while the former major sectors of the economy have been shedding jobs, the more vibrant sectors of the economy are prevented from sufficiently rapid expansion because of the lingering state bias against the non-state-sector of the economy. How destabilizing these trends will be depends in part on the continued growth in the economy, the ability of the non-state sector to generate sufficient employment and the capacity of the authorities to keep unrest in check.

The best option for employment growth is the service sector, which in China employs a low percentage of employees in comparison with other countries at a similar level of development. Allowing effective foreign investment into this sector could generate a boom of 40-50 million jobs. The other main option for employment expansion is enhanced development of the private sector. Geographically private enterprises are heavily concentrated in the coastal areas with Jiangsu, Guangdong, Zhejiang, Shanghai and Beijing home to 54 percent and the western provinces with only 14 percent. It is clear that those provinces with a higher growth rate and standard of living are also those with a higher level of private enterprise.

At the Seventeenth Party Congress, China's senior leaders confirmed that the growth model that had worked in the past was no longer viable in the next stage of development and needed significant modification. General Secretary Hu Jintao has put forward the notion of a "scientific view of development" that focuses on ensuring that growth is sustainable with greater energy efficiency and creating less environmental pollution, and that comprises greater social justice. Rapidly rising levels of inequality, especially between urban and rual China has been a major bi-product of reforms. To realize growth potential China must generate the demand that will impel increased production. Over the last decade, the two principal drivers have been the growth of state investment and of net exports followed by consumption. If we look to the future, investment, especially in infrastructure and industry will remain important but there is little room for the ratio of investment to GDP to rise much further. While China's exports are likely to continue expanding given the current scale, the rate of increase is bound to diminish. China's total trade is around 70 percent of GDP, a ratio usually only found in small, export-driven economies (ASEAN and Taiwan) and not in continental economies.

[26] http://www.chinadaily.com.cn/english/doc/2006-02/20/content_521725.htm

Meanwhile with its production needs imports are booming and the overall trade surplus will be small if not eroded all together.

As a result this leaves consumption as the main force that can drive the economy forward. Effective expansion of consumption has been held in check by the high rates of savings because of people's legitimate fears about social security, medical care and education and this in turn shifts more responsibility for growth back on to investment. The savings rate in China climbed to over 43 percent of income in 2004 from about 26 percent in 1985 and this may well increase further. In major OECD economies, the savings rate averages around 10 percent (with the notable exception of the US at under 1 percent). China is on a par with Singapore but much of Singapore's savings consists of mandatory contributions to a social security program. To meet the objective, China will have to integrate better its domestic market and to develop more effective financial instruments.

The shift to domestic consumption as the primary driver together with the changing demographics will lead to slower growth rates over time. Further constraints will be set by access to and the prices of energy resources as well as water supply. Last but not least, the growth runs the risk of creating an environmental nightmare. What is worrying is that such major environmental problems of water and air pollution (2 out of 3 cities fail to meet resident ambient air quality standards and 10 percent of adult deaths in Shanghai have been attributed to air pollution) have developed so early in the transition—per capita income is only $1100 and still over half of the population is living in rural areas. To reduce energy demand, the government set a target of using 20 percent less energy far each percentage point of output growth: a target that stands no chance of being met.

China has a population of 1.3 billion people and a labor force of nearly 800 million. The central issue in Chinese industrialization is the transformation of this enormous pool of rural workers into an industrial wage labor force. This is the source of China's unrivaled capacity to accumulate capital at extraordinarily rapid rates, and also the source of the central social and political tensions of China's reform process.

China's reforms started with dramatic institutional changes as farmers rushed to abandon collective farming and return to a household-based system of production, something that was resisted by many in the leadership. This had two effects, it increased demand for small-scale agricultural inputs and released a significant pool of labor to enter higher productivity jobs. State-owned industry could not respond to the demands but the legacy of commune and brigade-run enterprises (now called township and village enterprises—TVEs) could respond. At their height, these enterprises had absorbed almost 120 million laborers providing the necessary economic stimulus. With the terms of trade favoring agricultural commodities, living standards rose as did demand for light industry and the rural-urban economic gap narrowed significantly. Beginning in 1985, however, China allowed prices to turn in favor of industry, lowering returns to investment and incomes in agriculture. At the same time, the growth of large scale, foreign invested enterprises took off on the eastern seaboard. These firms were more capital-intensive and better linked into foreign markets than TVEs, which were no longer able to serve as the shock absorber for surplus rural labor. In the most successful areas meant TVEs closed down or converted to more genuinely private enterprises. The ability of local governments to use such industries to meet their social obligations declined as a result and inequality increased. Administrative restrictions on internal migration created a two-class urban population of longtime urban dwellers who enjoyed access to social security through their state-owned enterprises, and unprotected new arrivals.

These unprotected new arrivals, referred to as the floating population, have provided the basis for China's urban transformation. They have staffed the construction sites, the servoice sector and the foreign-invested enterprises. There are estimated to be some 140 million such migrants and their huge numbers suppress wages and their illegal status leaves them vulnerable to exploitation, poverty, poor health and crowded and dangerous living conditions. They are by any realistic definition absolutely poor.

Income security among traditional urban dwellers has also grown increasingly tenuous as state-owned enterprises shed workers and unemployment rates rise even among this previously privileged group. Some 55 million workers have been laid-off from state-owned enterprises and while official statistics show only a rise from 3 percent unemployment in the mid-1990s to almost 5 percent in 2005, independent estimates would place unemployment at around 12-14 percent and underemployment at up to 23 percent. The imposition of user fees for health and education has similarly undermined the formal social security system in both rural and urban areas. The cost of medical care is now one of the more important causes of extreme poverty in China. The health insurance system introduced in 2003 has mainly benefited better off rural dwellers who can afford co-payments and informal hospital levies.[27]

At the other end of the income distribution, Chinese investors, many holding state positions or linked in some way to state owned enterprises, have reaped windfall gains from the privatization process. Most of those listed in the top ten richest people have real estate business, an enterprise that benefits from good government contacts. Insider trading and corruption are rife, leading to a concentration of wealth not only unprecedented in China but in fact unseen in Asia. One study found that 0.16 percent of the population controls 65 percent of China's $1.5 trillion dollars in liquid assets.[28] It is little wonder then that between 1985 and 2002 China transformed itself from one of the most equal societies in Asia to one of the most unequal.

Rising inequality, poor job prospects in rural areas, land grabbing by local officials and a bloated,grasping government bureaucracy have intensified political tension in China's countryside and increasingly in the cities. According to the journalist Will Hutton, the number of people involved in protests increased form 740,000 in 1994 to 3.7 million in 2004. The number of strikes rose from 1,909 in 1994 to 22,600 in 2003. These are official figures and therefore almost certainly underestimate the actual level of political unrest.[29] But they do point the pressing need to improve the ways in which the benefits of growth are shared across regions and groups in China. The most fundamental reasons for social unrest are government malfeasance, unpaid pensions or unpaid wages. Local governments are driven by their need to raise revenues to cover their obligations. The central government has introduced a number of mandatory spending programs but has not provided sufficient financial resources requiring the local government to take on major financial burdens. Sub-national expenditures as a share of total public spending are very high at around 70 percent. This is higher than other countries within the region; for example, Vietnam it is 48 percent, Indonesia 32 percent and 10 percent in Thailand. The response from local governments is to either run businesses to cover the shortfall or to find ways to extract revenue from the local population. The most effective way to do this in recent years has been to reclaim rural land from the farmers, paying them low compensation, and reclassify the land as residential or commercial thus allowing much higher prices to be charged for the land use. With an opaque system much of the revenue finishes up in individual pockets rather than collective coffers.

China's massive, underemployed pool of labor is the driving force in the nation's aggressive export strategy—a strategy based on low wages, foreign direct investment and access to the US market. China accounted for ten percent of world trade in 2007, up from just four percent as recently as 2000. This is a remarkable performance, based largely on the supply of low margin, relatively simple manufactures to the US market. With forty percent of exports destined for the US, China ran a trade surplus with the US of $232.5 billion in 2006, a number that was probably exceeded in 2007. Chinese industrial wages in 2005 were just five percent of the EU15 average. Yet the shallowness of China's

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[27] "Missing the Barefoot Doctors," *The Economist*, October 13, 2007, . 27.
[28] Cited in Peter Nolan, *China at the Crossroads*, Cambridge: Polity Press, 2004.
[29] Will Hutton (2007) *The Writing on the Wall: China and the West in the 21st Century*, London: Little, Brown.

industrialization is revealed in the dominance of foreign companies in exports and the import intensive nature of export production. According to the OECD, 55 percent of exports are produced by foreign-owned plants, and foreigners produce 80 percent of telecoms and electronics exports.[30] China's largest single exporter is Hon Hai Precision Industries, a Taiwanese contract manufacturer for the likes of Hewlett Packard, Sony and Motorola. China's dependence on imported intermediate goods accounts for the country's trade deficits with Japan, Korea and Taiwan and the rest of the East Asia region, which amounted $87.5 billion in 2006.

Despite three decades of growth at breakneck speeds, China's industrialization remains shallow. China has only two genuine multinational companies of its own (Lenovo and Huawei), no companies in the global top 250 by research and development spending, and no companies on the Morgan Stanley 250 global competitive edge list. China has 22 companies in Fortune's Global 500, but nearly all are large state firms oriented to the domestic market (oil, the state grid, railways, telecommunications, banking and insurance) and which profit from monopolies. The country ranks 74th in UNCTAD's most recent "Innovation Capability Index" (2001), behind Tajikistan.[31] China's private firms are mostly micro or small enterprises, and their average lifespan is less than three years. This is a very different pattern from other East Asian success stories and even from India.

Part of China's problem lies in the aforementioned incentive structures facing local authorities, which view state-owned companies within their regions as assets to be preserved. State enterprises also inherited a legacy of fragmentation from the central planning period, during which firms built up a vast array of small scale (yet more profitable) ancillary activities around their core businesses. The resulting fragmentation has blocked rationalization of entire industries despite the efforts of national planners to set up large scale business groups on the Korean *chaebol* model. This hs also led to poor integration of domestic markets and in various years many provinces have traded more internationally than they have domestically. The process has also been excessively investment intensive. The share of investment in GDP has remained in excess of 35 percent for nearly thirty years, and in some years in excess of forty percent. It is worth noting in this context that foreign direct investment, which produces more than half of exports, absorbs only ten percent of net investment.

Yet the obstacles to industrial deepening are not just domestic. The global business environment had changed radically since the 1960s to 1980s when Taiwan, Korea, Hong Kong and Singapore broke into global manufacturing as Asia's Newly Industrialized Countries (NICs). Two decades of global mergers and acquisitions at historically rapid rates have transformed global production of manufactures and increasingly services. Production is now increasingly dominated by a small number of global companies that achieve massive economies of scale through global, integrated supply chains. Digital technology has facilitated the "modularization" of production, as product specifications can be cheaply and quickly shared between the apex firms and numerous suppliers and contract manufacturers. While modularization creates opportunities for low cost manufacturers like China, it has also generated obstacles to technological upgrading and learning that were not present forty years ago.[32] China must also confront these obstacles with less trade protection than was available to the NICs, including restrictions on the use of classic East Asian industrial upgrading tools such as transfer of technology of local content requirements. Japan, Taiwan and Korea also made full use of the more lax intellectual property rights regime of the 20th century.

Despite its massive exports, its historic rates of capital accumulation and mounting financial clout, China's comparative advantage in manufacturing is still largely confined to low wages, concentrating on assembly operations and other low-tech, low value added businesses. Although China has, unlike Korea and Taiwan, not yet succeeded in developing its technological capacity to the point at which it

[30] By way of contrast, only 29 percent of Indonesia's exports were produced by foreign firms in 2005.
[31] UNCTAD (2005) *World Investment Report*, Geneva.
[32] Edward S. Steinfeld (2004) "China's Shallow Integration: Networked Production and the New Challenges for Late Industrialization," *World Development*, 32:11, 1971-1987.

can compete with the apex firms of today's globalized marketplace, China is steadily moving up the technology and value added ladder; today machinery and transport equipment account for 40 percent of its exports. Economic growth still relies heavily on excessively high rates of investment, which reduces the amount of resources available to raise consumption levels among the poor (either through higher wages or social programs).

In the end the limits of China's current growth path are more likely to be political rather than economic. Rising levels of inequality, deteriorating public services, mounting rural unrest, rising levels of urban unemployment, an unresponsive bureaucracy and endemic corruption are dissolving the political consensus and social cohesion that have sustained China's remarkable growth over the past three decades. Although the government has shown signs of reorienting its strategy away from "growth at any price" and towards a stronger commitment to fairness and equity, its efforts thus far have yet to achieve real change on the ground. The problem facing China's leaders is that the longer it takes them to address these problems, the less likely it is that their ultimate resolution will be under their control.

PART THREE. **VIETNAM: EAST OR SOUTHEAST ASIAN?**

III. Vietnam's Current Policies

This section assesses Vietnam's performance in addressing the six key policy areas that have separated East from Southeast Asia.

1. Education

Vietnam's education system is in crisis. While its primary and secondary enrollment ratios are good, there are serious concerns about quality. The high failure rates recorded in the most recent national high school graduation exam reveals that many students are not acquiring the basic level of knowledge the Vietnamese government has determined that its citizens require.

Vietnam's universities are moribund. Too few Vietnamese people have university degrees, and the number of new graduates is growing too slowly. In 2000, the ratio of university educated workers to population in Vietnam was about 2 percent, compared to 5 percent in China and 8 percent in India. The 2005 enrollment ratio of university students was 16 percent in Vietnam compared to 17-19 percent in China and Indonesia – and 43 percent in Thailand. On top of this, the quality of Vietnamese universities and education are sub-standard. Professors and lecturers at Vietnam's best universities publish few articles in international, peer-reviewed journals. Indeed, comparisons even with Southeast Asia's unremarkable universities can only be described as embarrassing.[33] Half of university graduates in a hot job market were reported to be without a job related to their main area of study only one year after graduation. There has been a huge expansion in student numbers since 1990 but only a modest growth in faculty, with the result that system is under increasing stress. Both foreign and domestic firms report that recent university graduates have virtually no economically relevant skills.

The unsatisfactory results achieved by the existing system are not due to a lack of money. In fact, as a percentage of GDP, Vietnam spends more on education than most countries in the region.[34] The problem is how these resources are used, and in particular the governance structures of educational institutions at all levels. The current educational expenditure system is opaque and wasteful. As one Vietnamese commentator recently noted, if official figures regarding spending on teacher salaries are to be believed, then average salaries would be almost double their current actual levels.[35] Where has the money gone? The answer, it seems, is that it has been swallowed up the "system." (co che) The inefficiency of the current system is the reason why simply increasing spending through current institutional structures is unlikely to improve quality or access.[36] In higher education, universities need more autonomy to enable them to specialize and compete on the basis of quality, relevance and

[33] In 2006, the 2,830 faculty members at Thailand's Chulalongkorn University published 744 articles in international scientific journals. During the same period the 3,360 faculty members at Vietnam National University in Hanoi and Ho Chi Minh City published 36 articles. Source: Scientific Citation Index Expanded, Web of Science, Thomson Corporation.

[34] Vietnam is said to spend $1 billion a year on overseas education, much of it financed by families. This is one indication of the level of popular dissatisfaction with the domestic university system. While foreign graduate education is arguably a good investment, overseas undergraduate education is expensive and better quality programs in Vietnam would reduce the need for going abroad.

[35] See "Questions surrounding the financial report of the Ministry of Education and Training." http://www.tuoitre.com.vn/Tianyon/Index.aspx?ArticleID=230489&ChannelID=13

[36] Most recently, the government is considering a plan to allocate one billion dollars to the Ho Chi Minh Communist Youth League for vocational training and job creation. Although this initiative stems from a laudable desire, its success is far from assured. Training is not the Youth League's primary institutional focus or core competency; moreover, it is unlikely that the Youth League possesses a sophisticated understanding of the needs of employers and workers in the labor market.

graduates' job prospects. Personnel systems must shift from seniority to performance as the main criterion on which recruitment, remuneration and promotion decisions are made. University funding should make use of the full range of potential sources including tuition and fees, contracted research, private donations and government subsidies.[37]

As noted above, the East Asian countries emphasized the development of national technological capabilities. By any objective measurement, Vietnamese science and technology are a failure, and a major constraint on economic growth. In 2002, Vietnamese in Vietnam filed for a total of two patents with the World International Property Organization. Figure 2 provides further evidence of the extent to which the Vietnamese economy is technology deficient. The track record of Vietnam's research institutes is as shameful as its universities: in 2006, researchers at the Vietnamese Academy of Science and Technology (VAST) published 41 articles in international journals. By contrast, faculty at a single Chinese university, Fudan University in Shanghai, published 2,286 articles during the same period.[38] Despite VAST's poor performance to date, the Vietnamese government has announced plans to make VAST researchers the nucleus of a new science and technology university. Is it responsible to entrust the education of Vietnam's next generation of scientists and engineers to an institution that so clearly lacks capacity to conduct scientific research? This is yet another example of an attempt to impose a state-centric solution to education while avoiding the core weaknesses in Vietnamese higher education. A better option would be to relax controls on research institutes and universities, and allow them to compete for students and research grants on the basis of their performance.

In order to improve the quality of higher education and science, Vietnamese institutions must be able to offer attractive incentives to attract top-talent. Today, elite Chinese universities are competing in the global market for scientific talent; their internationally competitive salaries and generous research support are beginning to lure leading Chinese scientists resident abroad from the US and elsewhere. Vietnam, by contrast, has yet to adopt incentives that are attractive to young, foreign educated scientists and scholars from Vietnam.[39] Indeed, there appears to be some reluctance to accept the need to reward a select cohort with special incentives to which others are not entitled. The market for scientific talent is international, and the best young Vietnamese scientists have many career options. It is unlikely that more than a handful will be willing to accept the professional conditions now existing in Vietnamese universities. Few will find appeals to their patriotism sufficient incentive.[40]

University quality is related to economic performance: rich and rising countries have good universities, poor countries do not. Today Vietnamese universities are by far the worst among larger developing countries of Southeast Asia. Reform is urgently needed if Vietnam is to achieve its stated goals of modernization and industrialization over the medium term.

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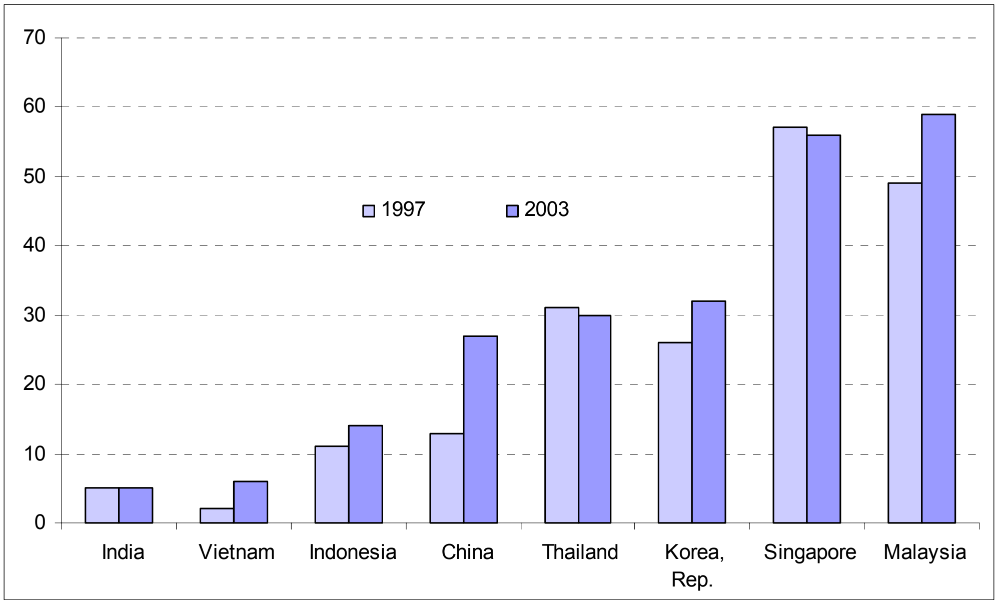
[37] Professor Hoang Tuy argues persuasively that governance, not material resources, is the root cause of the failure of Vietnamese higher education and science. See "New Year, Old Story." Available at http://www.tiasang.com.vn/print?id=1307. One dramatic example of Vietnamese universities' lack of autonomy is their inability to promote faculty to the rank of assistant or full professor. China granted its universities this authority more than a decade ago.

[38] Source: Scientific Citation Index Expanded, Web of Science, Thomson Corporation. Ignorance of the English language has been offered as an explanation for this abysmal performance. If Vietnamese researchers indeed lack English proficiency it is further evidence of the failure of Vietnamese science. Modern scientific research is a global enterprise, and English is its common language. Scientists unable to connect to global trends in their fields are almost certainly not engaged in relevant research.

[39] A Vietnamese scientist with research and teaching experience overseas was recently asked to consider returning to a university in Hanoi—he was offered a salary of 800,000 VND per month. This is not an isolated incident. For another example, see Hoang Tuy, "Education and Science Before the Challenge of Integration." Available at http://www.saigontimes.com.vn/tbktsg/detail.asp?muc=3&sobao=880&sott=8.

[40] See http://vietnamnet.vn/giaoduc/2007/01/649367/

Figure 2. High-Tech as a Percentage of Manufactured Exports[41]



2. Infrastructure and Urbanization

2.1. Electricity and Transport

The powerful economies of East Asia recognized that keeping the lights on and the trucks moving was key to their survival. In Vietnam, however, blackouts and traffic jams are an all too frequent occurrence. Infrastructure is the second most important constraint to Vietnam's development. Here too, the current situation is extremely worrisome.

Electricity is the oxygen of the modern economy. Without sufficient, reasonably priced supply, economic life will suffocate. Although it is no secret that electricity is an essential input, Vietnam's energy policy is severely flawed. By over-investing in hydroelectricity, Vietnam now faces potentially crippling power shortages during the dry season, when reservoir levels are low. This situation was predictable—that warnings were ignored suggests a lack of long-term strategic vision or the undue influence of special interest groups. Vietnam's inability to control water flow upstream heightens the risk of over-reliance on hydro power. Electricity shortages are not only a phenomenon of the dry season. By mid-December 2007, Ho Chi Minh City was already experiencing unannounced, rolling black outs. The government's decision to reject EVN's proposal to establish a for-profit power trading company was correct, and it appears increasingly that EVN's priorities are misplaced. In addition to its over-investment in hydroelectricity, EVN's expansion into telecommunications, financial services, and real estate development cannot help but divert its limited human and financial resources from its core responsibility, to "play the principal role in supplying stable, safe electricity for socioeconomic development, execute investments to develop integrated electrical grid to increase efficiency of investment, [and] invest in power generation projects as assigned."[42] A regulated monopoly such as EVN should work best not if it is large and complicated with many side businesses, but if it focuses on its main task and does it effectively and profitably at a reasonable cost.

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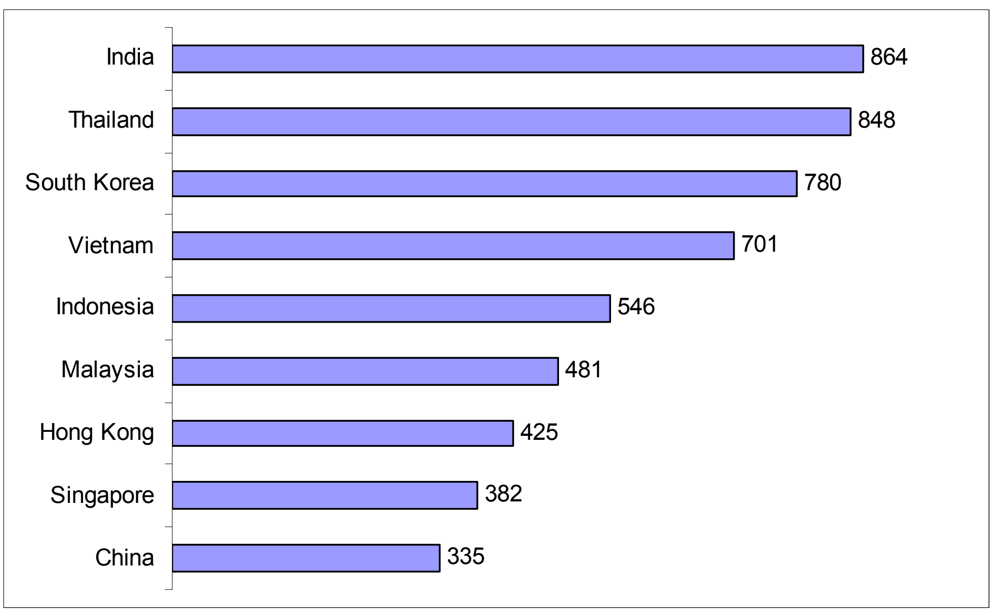
[41] Source: World Development Indicators.
[42] "Electricity shortages not only EVN's fault?"
http://www.tuoitre.com.vn/Tianyon/Index.aspx?ArticleID=234125&ChannelID=3

According to the government's energy strategy for the period 2006-2015, Vietnam must increase electricity supply by 17-20 percent per year. Many existing projects have fallen seriously behind schedule, just when they are needed most. Of the five projects tasked to EVN in 2007, only one has come online.[43] This trend strongly suggests that EVN is not capable of providing Vietnam with the energy it will surely need to maintain a high rate of economic growth. The government must improve the regulatory regime in order to provide sufficient incentives and conditions for private and foreign participation in generation, while EVN focuses on transmission and distribution.[44]

Infrastructure investments are often wasteful and riddled with corruption. Even urgently needed projects often lag far behind schedule. The waste, corruption and delays that plague infrastructure development are well documented by the Vietnamese press and require no explication here. In general, Vietnam has sought to achieve regional equity by investing heavily in underdeveloped areas. This is an understandable objective. However, too often these initiatives have proven wasteful and unproductive. Provinces with slow population growth receive "gold plated" infrastructure—broad high speed roads and bridges—while infrastructure in the Southeast focal economic zone is stretched to the breaking point. Initiatives such as the "Million Ton Sugar Program," the off-shore fishing program, and the "movement" to construct industrial zones in rural areas have produced few benefits for the people whose livelihoods they were intended to improve. Other problems include pollution emanating from industrial zones that is now having a negative impact on surrounding populations. While resources are being wasted on projects like these, underinvestment in urban infrastructure is reaching crisis levels. This trend is harmful and short-sighted: should infrastructure bottlenecks lead to an economic slowdown in the Southeast region, the repercussions for the national economy and to workers from central and northern Vietnam migrating to the Southeast could be severe.

Figure 3. Costs to Export[45]



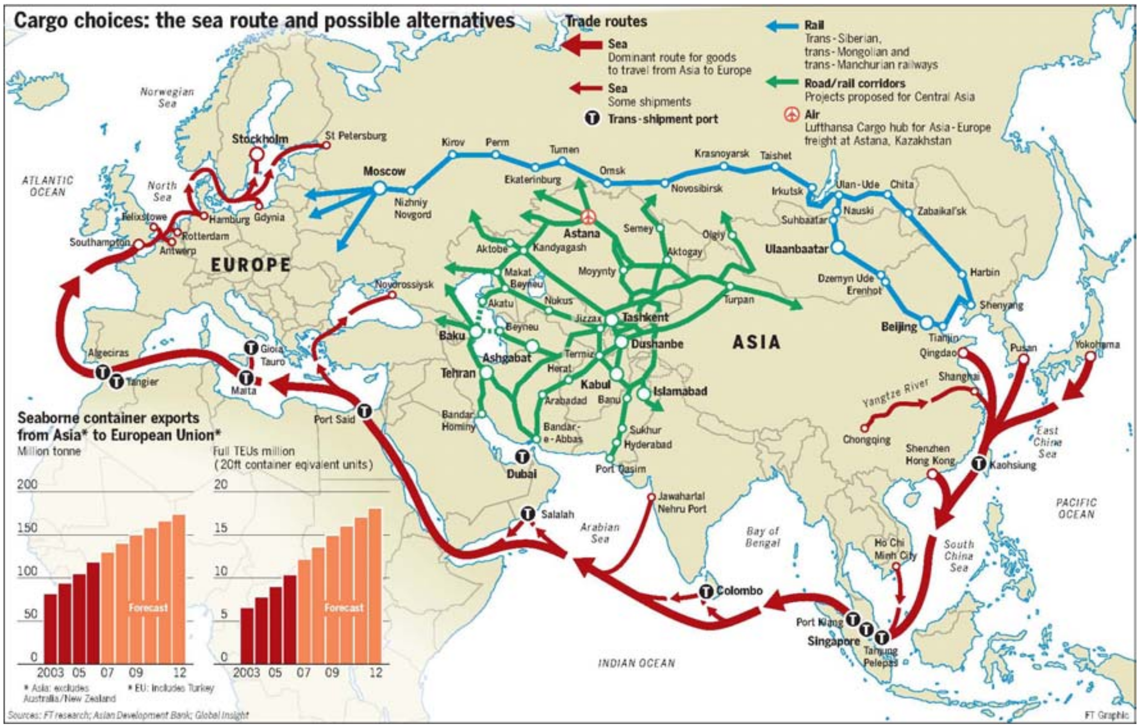
Wasteful and costly infrastructure usually lead to inefficient and costly services. According to the World Bank, and as illustrated in Figure 3, exporters have to pay US$701 including costs of documents, administrative fees, terminal handling and inland transport costs to ship a 20-foot

[43] Ibid.
[44] It has been reported that EVN has been unable to reach agreements with some domestic power companies, while it purchases more expensive electricity from China.
[45] Source: Doing Business 2007, World Bank.

container from Vietnam , while it only costs Chinese exporters US$335 and Singaporeans US$382. In light of this serious lack of competitiveness, current trends in port development are alarming. The Southeast region desperately needs a modern deepwater port to sustain its rapid economic growth. At present Vietnamese exports are not shipped directly to North America and Europe, but instead are shipped to transshipment ports in Hong Kong and Singapore, where they are loaded on larger "mother ships" for transport to the final destination. Of course, this adds to shipping costs. It is likely that within a few years, however, the "mother ships" that carry goods to Europe and North American will begin to call on Ho Chi Minh City. As can be seen in Figure 4, the Southeast is very well positioned to take advantage of the major international shipping routes. In fact, it has been put on the map by major shipping lines. A new port complex at Cai Mep/Thi Vai in Ba Ria Vung Tau is planned and foreign investors have expressed interest. *Development of new port facilities for the Southeast should be a national priority, yet, inexplicably, construction has yet to begin.* At the same time ambitious plans have been announced to build "deepwater ports" in no fewer than six central provinces: Khanh Hoa, Binh Dinh, Quang Ngai, Quang Nam, Danang, and Thua Thien Hue. There is no valid economic rationale for these plans. Because modern port facilities are highly automated, they cannot be expected to create many jobs. A country of Vietnam's size needs at most three ports, one each in the north, center, and south; a modern rail system would arguably obviate the need for a major port in central Vietnam. The entire west coast of the United States (more than 1900 kilometers long) features three major international ports. [46] Decisions regarding expensive infrastructure projects like ports must be informed by an understanding of the flows of international commerce. Ho Chi Minh City is the only port in Vietnam that is likely to attract "mother ships" in the foreseeable future. Investing in world class port facilities for the Southeast, while upgrading road and rail links to the center and north is a far more intelligent strategy than that being followed at present.[47]

[46] An earlier draft of this paper criticized the serious degradation of the Dong Nai Bridge and the delay in improving infrastructure of this critical economic artery. In a decision that should be applauded, the Ministry of Transport has announced plans to build a new bridge in January 2008. See:
[47] A standard width and normal speed rail link is all that is needed. Such a link costs little more than a few million dollars per kilometer to construct. It would link the poor central provinces to the world economy more efficiently and effectively than deep water ports spread along the coast.

Figure 4. Strategic Trade Routes: Asia to Europe[48]



2.2. Land and Urbanization

A related challenge concerns urbanization, especially housing and transportation. Unless land use and transportation issues are dealt with quickly and efficiently, there will be a rapid increase in congestion, pollution and crowding in major cities. Growth will slow drastically if policies are not improved. In some urban and periurban areas land prices in Vietnam are as high as comparable locations in Japan, a crowded island with fifty times the per capita income of Vietnam. As shown in Table 1, absurdly high land prices extend far beyond central Hanoi and Ho Chi Minh City. Land in a new urban development project near the provincial town center of Binh Duong province is currently selling for 26 million VND per square meter.[49] This means that a 100 square meter housing plot costs more than US$160,000.[50] Prices like these in areas absorbing significant population growth means that many Vietnamese will be unable to own a house or even be able to rent decent housing. It seems likely that local officials and wealthy speculators are primarily responsible for this situation. In some provinces, thousands of hectares have been seized for industrial zones that remain vacant or undeveloped. Farmers often get little compensation for land they do not wish to sell and many have poor prospects after losing their land. These unfortunate practices cause social discontent among farmers and in urban areas. Change is needed quickly to rationalize land use policies as the process of urbanization is accelerating and the cities are becoming unmanageable.

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48 Source: *Financial Times* (10/12/2007).

49 Chanh Nghia Urban Area in Thu Dau Mot Binh Duong. Source: Phap Luat News Papaper, "Nha dat 2008 se sot cao", 18 December 2007.

50 This land has infrastructure costing perhaps $20 per square meter, but no house. A 50 square meter house built to modest standards would cost an additional 100 million dong. Few Vietnamese families make as much as $5000 a year, yet a small, basic home would cost nearly $170,000 or over thirty years of income.

Table 1. Land Prices, New Urban Areas in the Southeast Region [51]

Locality	December 2006	December 2007	% Change
Ho Chi Minh City			
Phu My – Van Phat Hung, District 7	11.0	27.0	145%
Thai Son, Nha Be District	5.5	16.0	191%
Nam Nam Saigon, Hồng Lĩnh, Binh Chanh District	4.3	13.0	202%
Thach My Loi – Huy Hoang, in District 2	16.0	26.5	66%
Gia Hoa, District 9	5.5	14.0	155%
Surrounding Provinces			
Long Tho – HUD, Nhon Trach, Dong Nai	1.0	2.5	150%
Long Hau, Long An	3.2 (June, 2007)	6.5	103%
Chanh Nghia, Thu Dau Mot, Binh Duong	6.7	26.0	288%

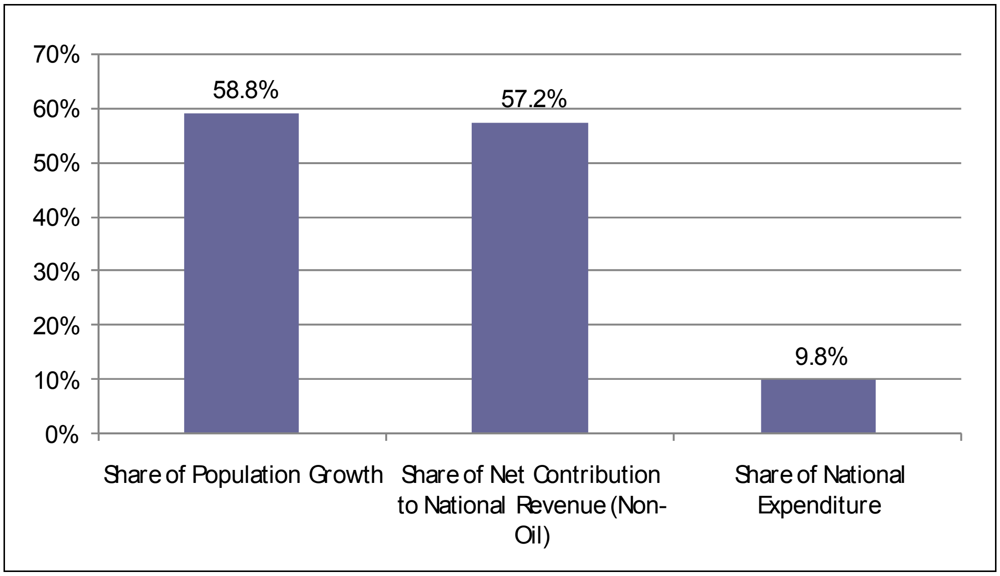
Given the pace of growth in industry and (mainly urban) services, it is likely that the rate of urban population growth will be faster in the next few years than the last few. So long as formal sector job growth continues from its ever-larger level, it is all but certain that the share of the population in urban areas will increase and the absolute number of people living in the countryside will fall.[52] Just as China began to lose rural population to urban growth over the last two decades, so Vietnam is likely to do so soon. If urban population were defined more on the basis of objective criteria than legal boundaries, it is likely that the effective urban population would be higher and faster growing than as now measured. The Vietnam Household Living Standard Survey underestimates the urban population because it uses administrative criteria to differentiate rural from urban areas. Many of the communes listed as rural are in fact already highly urbanized by any objective criteria.

Poorly planned urbanization is a potential source of social and political instability as the recent experiences of Thailand, the Philippines, and Indonesia make clear. People need decent housing, reasonably clean and livable surroundings, and quality health and education services for their families. Proactive policies and efficient and timely public investments are necessary to avoid overcrowding and unhealthy urbanization, which can become a constraint on the growth process. With the very high price of urban real estate in Vietnam, most people face an unpalatable choice between moving outside of cities and enduring long commuting times and living in the city in difficult and crowded conditions. High rents in city centers mean that centrally-located apartments are beyond the means of most households.

[51] Source: Authors' estimation based on interviews with real estate agents.

[52] If actual urban/total population in Vietnam were 32 percent instead of the official 27 percent, then a 4 percent urban growth rate would absorb all of Vietnam's population growth. In China in 2002, the official urban/total population ratio was 27 percent based on household registrations, but found to be 39 percent in household surveys. In Vietnam the 2004 Vietnam Household Living Standard Survey found 45 percent working in nonfarm jobs with over 70 percent in the Southeast. If three-fourths of nonfarm jobs were in urban or near-urban areas, the urban and near-urban ratio would be 34 percent.

Figure 5. Share of population growth versus expenditure, Greater Ho Chi Minh City (2005)[53]



Vietnam lacks experience in dealing with this emerging problem. Even in 2002, most *registered* urban families owned their own residence. Only 8 percent did not own their living quarters, and most of those rented from the government.[54] But the new wave of migrants will be different.[55] Often not even counted as living in the city, their incomes will not be large enough to buy even tiny properties, and if they do not have wealthy or landed relatives they will have no option but to live in crowded accommodations in periurban areas. If the urban population grows by over one million a year, it will be a huge task to provide sufficient housing, infrastructure and schools for them (it is possible that urban growth is now over one million a year, if properly measured). The government's recent decision to make it easier for migrants to acquire household registration in cities should be applauded. However, to the extent that it creates stronger incentives for rural dwellers to migrate to urban areas, it is likely to place even greater pressure on urban services.

Land policy is a difficult issue in both urban and rural areas. But it is in urban areas that land taking, zoning and development have driven up the price of land to a level that is far above any price that most Vietnamese can afford. Land has become a way to invest and speculate more than a physical input for housing or industry. Moreover, because of the immense profits that can be made through land speculation, a significant share of Vietnam's economic resources is being shifted away from more productive activities. An integrated set of policies to promote sensible urban development would include the provision of public transportation, local property and building taxes to finance infrastructure development and urban services, and better, more equitably distributed services. Long-term financing for construction and purchase of apartments would allow more newcomers to buy their own homes, although the poorest residents will require additional assistance. Here too comparative

[53] Includes Ho Chi Minh City, Ba Ria-Vung Tau, Dong Nai, and Binh Duong. Statistics from the Ministry of Finance.

[54] *Results of the Survey on Households Living Standards 2002,* Tables 115 and 116. (GSO, Hanoi, 2004) Of those renting in cities, 74 percent had the government as a landlord. In 1999, 86 percent in cities owned their home.

[55] According to statistics, during the first eight months of 2007, 280,316 motorcycles were registered in Ho Chi Minh City, a rate of approximately 35,000 cycles per month. If this trend continues, roughly 420,000 new motorcycles will be added to the city's streets this year, not including the large number of motorcycles registered in other provinces brought in to the city by migrants. Based on this data, a conservative calculation suggests that Ho Chi Minh City's population is growing by 400-500,000 people every year.

experience may prove valuable. Hong Kong and Singapore both built public housing for low income residents during the 1950s.

In the first section, this paper argued that Southeast Asian countries have failed to meet the immense challenges presented by rapid urbanization. Southeast Asian cities are unable to provide urban residents with basic social services like healthcare, education, and sanitation. Ho Chi Minh City looks more and more like a Southeast Asian city. The symptoms are well-documented by the Vietnamese press, including congestion, flooding, a shortage of classrooms, low or unenforced food safety standards, overcrowded hospitals, inadequate fire protection, and so forth. Figure 5 above suggests one reason why conditions in the city continue to deteriorate. Although the Southeast focal economic zone is absorbing a majority of Vietnam's population growth and provides a majority share of national revenue, in return the region receives less than ten percent of national investment. To be sure, increased investment is not a panacea for the region's challenges (especially in light of Vietnam's poor track record in the development of public infrastructure). Ho Chi Minh City urgently needs a more centralized, effective municipal government; indeed, without much improved governance increased investment may make the situation worse. For this reason, the proposal to implement a "municipal government" model should be prioritized.

3. Competitiveness of Firms

3.1. The Formation of Conglomerates, 2006

In the early 1990s, the lagging performance of state owned industrial enterprises led the government to try to find a way to make this sector more dynamic. The general approach to this objective beginning in 1994 has been to try to consolidate many of these enterprises into larger firms, referred to as general corporations – precursor of the conglomerates. The idea was that these larger firms could develop their own recognizable brand names, would enjoy greater economies of scale, and other advantages. The model or ultimate goal of this exercise was based on the Japanese keiretsu (Mitsubishi, Mitsui, etc.) and the South Korean chaebol (Samsung, Daewoo, Kumho, etc.). All of the chaebol were expected to become internationally competitive within a few years and then to export a substantial share of their output. They were heavily subsidized at the outset, but the subsidies began to disappear after a few years. The Vietnamese general corporations, in contrast, were built more on an import substitution model that received protection from foreign imports and other subsidies on a continuing basis. In short, the general corporation was in many respects simply a new form of government bureau overseeing its subordinate enterprises. The underlying model was closer to the previous centrally planned command system where enterprises had almost no autonomy than it was to a genuinely independent conglomerate.

By 2006 and 2007, the government was certainly aware that the general corporations had not achieved what had been hoped for. The major initiative to deal with the weak performance of the general corporation was to form these corporations and various other enterprises into 19 large conglomerates that effectively have a near monopoly over many of the heavy industry sectors. A more important explanation for pursuing the creation of large conglomerates at this time has to do with the fact that the agreements connected with Vietnam's entrance into the World Trade Organization are now coming into effect. There is a very real fear among many of the state owned industrial enterprises that they will not be able to compete under the new rules. Most of the earlier methods of supporting local industries (high tariffs, local content requirements, various other government subsidies) are no longer allowed under the WTO rules.

What does not seem likely to us is that these conglomerates as currently organized are going to be able to transform themselves into internationally competitive companies. The central reason why we feel this is the case is because the current structure of these conglomerates is very much like the previous general corporations and these corporations had a dozen years to show that they could improve performance and, for the most part, they have not done so. There is little evidence anywhere in the world, with the possible exception of Singapore, where state owned enterprises have ever been the primary vehicle for the creation of strong international corporations, and Vietnam, for a variety of reasons, is not likely to be able to duplicate Singapore's performance.

But even when state enterprises are not involved, there are reasons to be skeptical about whether forming 19 diversified conglomerates out of existing not very dynamic enterprises is the way to create strong companies. To an important degree, those who advocate this approach are misreading the experience with conglomerates elsewhere. For example, forming large conglomerates is not a universal formula for industrial enterprise success anywhere in the world, especially when these decisions are not made by the private corporations themselves and handled according to laws that are enforced by independent courts.

To conclude, seen as a combination of a control and a defensive mechanism, the formation of 19 conglomerates of the kind now being created will not give Vietnam a strong and internationally competitive heavy industry sector. For a time the dynamism of the private and FDI sectors may keep Vietnamese industry growing rapidly, but some time in the not too distant future, Vietnam will also have to have a dynamic heavy industry sector and the current strategy is not likely to be the vehicle to get the country there.

3.2. Conglomerates and the Rise of Crony Capitalism

There is a basic contradiction in Vietnamese economic policy: although the private and foreign invested sectors are the most dynamic, the state sector continues to receive the lion's share of investment and other privileges. While the Enterprise Law was a fence-breaking innovation, it is not clear that this momentum has been or can be sustained. Surveys suggest that although the business environment in Vietnam has improved in certain respects, Vietnam's competitors are improving faster. Rankings of international competitiveness tell a similar story. Access to land and capital may be improving, but many barriers remain, including lack of skilled workers and middle to senior level managers, effective business associations and easy procedures to set up and close down businesses.

The Vietnamese economy appears increasingly dominated by state owned "economic conglomerates." While Party policy pronouncements have stated that the conglomerates should focus on strategic sectors, they are in fact expanding rapidly into a wide range of sectors, including real estate, financial services, tourism and even mobile phone distribution.[56] Almost without exception, these firms are not taking advantage of Vietnam's WTO membership to tap foreign markets. To the contrary, they are attempting to create domestic monopolies as a barrier to foreign competition. A recent survey of Vietnam's 200 largest firms by the United Nations Development Program reveals a worrying trend. Many Vietnamese companies, including conglomerates, equitized state firms, and private firms, are not focusing on becoming internationally competitive in their core businesses or competing on foreign markets. Instead, they are seeking quick returns in real estate and the financial sector. Examples include REE, a refrigeration company, and Gemadept, a shipping firm, both of which are investing heavily in real estate projects.[57]

Similarly, a number of conglomerates, including PetroVietnam, Vinashin, and EVN, have founded or acquired controlling stakes in banks, a classic feature of the now discredited Japanese *keiretsu* system and a practice that gave rise to endemic insider lending in Southeast Asia in the 1990s. In the absence of robust controls, conglomerates will use their banks to finance intra-group expansion plans. In

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[56] This observation was made by former Prime Minister Vo Van Kiet in his recent article "Caution Regarding the Establishment of Economic Conglomerates." See http://www.saigontimes.com.vn/tbktsg/detail.asp?muc=216&sobao=867&sott=5. See also, "Vietnam Pushes State Owned Firms to Diversify," in the *Asian Wall Street Journal* (19/12/2007).
[57] See http://www1.thanhnien.com.vn/Kinhte/2007/8/29/206709.tno

effect, group owned banks will be able to use central bank credits like an ATM machine, which will drive them to over-invest in risky projects and thus socialize risk. Conglomerates are also taking advantage of implicit or explicit state guarantees to borrow large amounts of foreign capital on fickle international capital markets. The rise of conglomerates in Southeast Asia was financed by the same mechanisms, and in pursuing these methods created the conditions for the regional financial crisis in 1997.

A new class of firms appears to be emerging that does not fit neatly into the orthodox categorization of state, private and foreign invested companies. There is a real risk that these firms are serving as vehicles though which politically powerful people enrich themselves at the expense of the state. This is not a privatization process that sells state assets at market value to entrepreneurs who believe that they can generate higher returns than state-owned enterprises. Instead, this process is more accurately described as "state asset stripping."

The following scenario appears increasingly common. A state-owned conglomerate establishes a subsidiary. Shares in the subsidiary are owned by the new firm's executives and by executives in the parent conglomerate. Assets, such as land, are transferred to the new company. When shares in the new company are listed on the over the counter (OTC) market or the stock exchange, existing shareholders can earn substantial profits on the difference between the price at which they bought the shares and the market price after listing. As a result of this process, a small group benefits from the sale of an asset that was, in theory, "owned by the people." By undervaluing assets, equitization can also provide a vehicle for this process; examples include the equitizaton of the Phu Gia Hotel and Intimex. In this murky world of insider dealings, classification by ownership is difficult. A private firm that succeeds in securing access to "golden lots" in Ho Chi Minh City or Hanoi almost certainly enjoys strong connections to a government official. Is such a firm really "private"? This is not unlike state asset stripping in Russia in the early 1990s, although perhaps not as rapid, nor as concentrated in as few hands.

Some subsidiaries of conglomerates are engaged in legitimate economic activity, although they certainly benefit from the power of the parent company. Worryingly, however, some subsidiaries appear to have no assets or value other than the "brand" of the conglomerate to which it belongs. When these firms are listed on the exchange, the share price is bid up by uninformed retail investors. Those individuals and entities that acquired shares at par value are able to earn large profits. This is, in essence, a transfer of wealth from minority shareholders to wealthy insiders.[58] The practice is clearly not sustainable, and raises the risk of a major correction on the equity markets when retail investors at home and abroad lose faith in the corporate governance of Vietnamese firms.

Vietnam's General Corporations (CGs) were created to reaffirm the state's leadership in the industrialization process, but at the same time to remove control of state-owned enterprises from line ministries and localities and re-assign this authority to ostensibly non-political entities. Yet the CGs lack authority to restructure and reinvigorate their fragmented and out-dated industries. They have not hired professional managers or dismissed the economic bureaucrats of the central planning period. They continue to rely heavily on arbitrary output targets. They have not adopted strictly commercial criteria in making decisions on mergers, acquisitions, new investments and plant closures.

In fact the CGs exist as loose affiliations of small-scale operations applying outdated technologies, often in slow-growth industries oriented to the domestic market. Vietnam's highly protected steel industry deploys hundreds of micro-mills producing low quality steel at high cost. Similarly, the cement industry uses old, environmentally unsound technologies in under-scale plants. Productivity in the paper sector is less than one-fifth of average productivity in Japan.[59]

[58] The recent floatation of the PetroVietnam Finance Corporation (PVFC) appears to be one of these transactions.
[59] These data were collected by Nguyen Thi Thanh Nga, UNDP National Economist.

Equitization will not necessarily reverse improve this situation. Although some subsidiaries of the GCs have made an effort to break free from bureaucratic control to acquire new technologies and attack new markets, even these 'pioneer' companies find it difficult to achieve efficient scale, shed money-losing small units and bring in managerial talent. Moreover, inefficient equitized firms continue to receive favors from government in the form of easy access to credit, free land, trade protection and other subsidies.

3.2. The Business Environment

The policy environment largely determines a country's international competitiveness. According to the World Economic Forum's annual national competitiveness rankings, Vietnam lags far behind most East and Southeast Asian countries. While league tables such as Table 2 must be treated with a healthy degree of skepticism, they are a valuable tool for assessing the relative speed of Vietnam's reforms in comparison with its principal competitors. Furthermore, foreign investors take rankings of competitiveness and policy environment into account when making investment decisions. Movement in the right direction matters little if other countries move quicker. Movement in the right direction matters little if other countries move quicker. Speed, as Sun Tzu cautioned, is an essential component of victory.

Table 2. World Economic Forum Global Competitiveness Index, 2006-2007[60]

	2007 (among 2006 countries)	**2006**
Singapore	7	8
Korea	11	23
Hong Kong	12	10
Taiwan	14	13
Malaysia	21	19
Thailand	28	28
China	34	35
Indonesia	51	54
Vietnam	**64**	**64**
Philippines	67	75

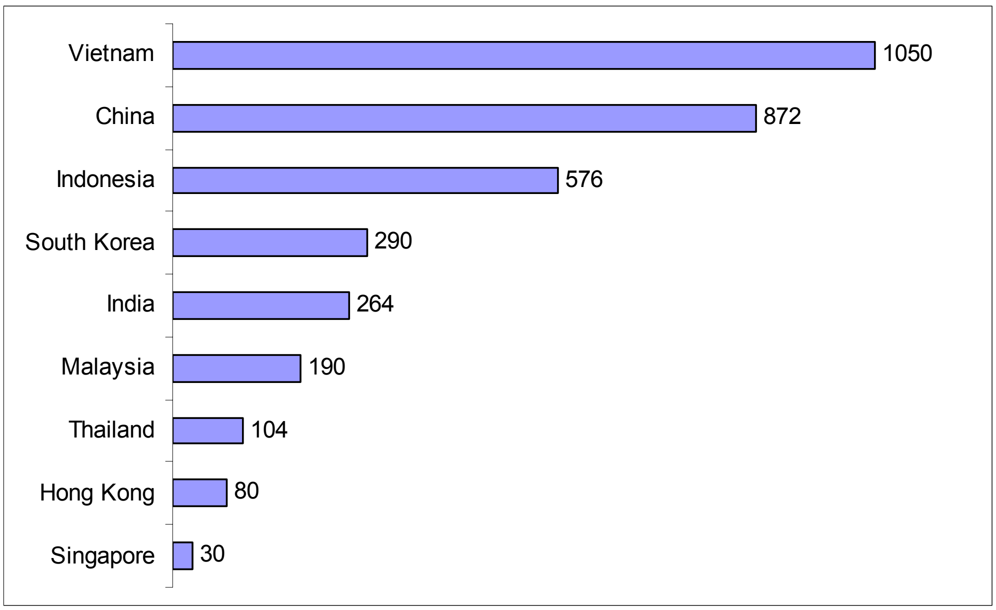
Foreign-direct investment will play a critical role in Vietnam's continued development. However, to take full advantage of the benefits of FDI, these investments must be embedded within the local economy. This in turn requires a vibrant private sector with the capacity to adopt technology and management practices and integrate into larger supply networks. Yet surveys of the Vietnamese business environment identify a number of barriers to the emergence of larger, competitive Vietnamese private firms. The most important constraints—human resources and infrastructure—have already been mentioned, but recent studies illustrate that firms are also hampered by an inefficient and extractive bureaucracy (see Figure 6 below). Firms report particular difficulties with

[60] Source: World Economic Forum; http://www.weforum.org.

tax and customs officials. Since most exporters are foreign invested or private, this amounts to another de facto tax on these sectors.

Today the areas in which Vietnam is most competitive—commodities like coffee, rubber, rice, and labor-intensive products like garments and shoes—are typified by wafer thin margins and low rates of value added. These are also income inelastic commodities, which means that people do not buy more of them when their incomes rise. The secret of success of the East Asian economies was to focus on products with high income elasticities like consumer electronics, because these markets grow much more quickly.[61] Vietnam is now very competitive in slow growth, low-return industries. The challenge for the future is to remain competitive in these industries while progressively breaking into knowledge-intensive, higher value added and fast-growing products and services.

Figure 6. Comparison of the number of hours firms spend finalizing taxes[62]



Moreover, even basic industries are excessively dependent on imported inputs. Garment producers realy on imports for 80 percent of their textiles; steel companies import more than 60 percent of billet (semi-finished) steel despite the country's massive iron ore reserves; and paper manufactures import 65 percent of pulp used in production. While Taiwan used its state enterprises to achieve industrial deepening, Vietnam's state enterprises compete with downstream processors. Most firms spend nothing on research and development, and very little on training and skills development.

4. Financial System

4.1. Inflation Returns

Since overcoming the hyperinflation of the mid-1980s, Vietnam has succeeded in maintaining a high rate of economic growth and macroeconomic stability. As the Vietnamese economy becomes increasingly complex and integrated into the international economy, maintaining a sound macroeconomic environment has become much more difficult. The government's decision to cut tariffs in as a response to the acceleration of price inflation is illustrative of the low level of technical

[61] Yuichiro Uchida and Paul Cook, "The Transformation of Competitive Advantage in East Asia: An Analysis of Technological and Trade Specialization," *World Development*, 33:5, 701-728, 2005.
[62] Source: Doing Business 2007, World Bank.

preparedness of Vietnam's macroeconomic policymakers. Although Vietnam possesses many highly trained economists, the absence of critical and informed debate and the dismal state of the country's research institutions and universities are real obstacles to the use of existing technical capacity in economic policymaking. As a result, the gap between the demand for more sophisticated policies and the capacity of policymakers has grown rapidly as Vietnam has integrated into the world economy.

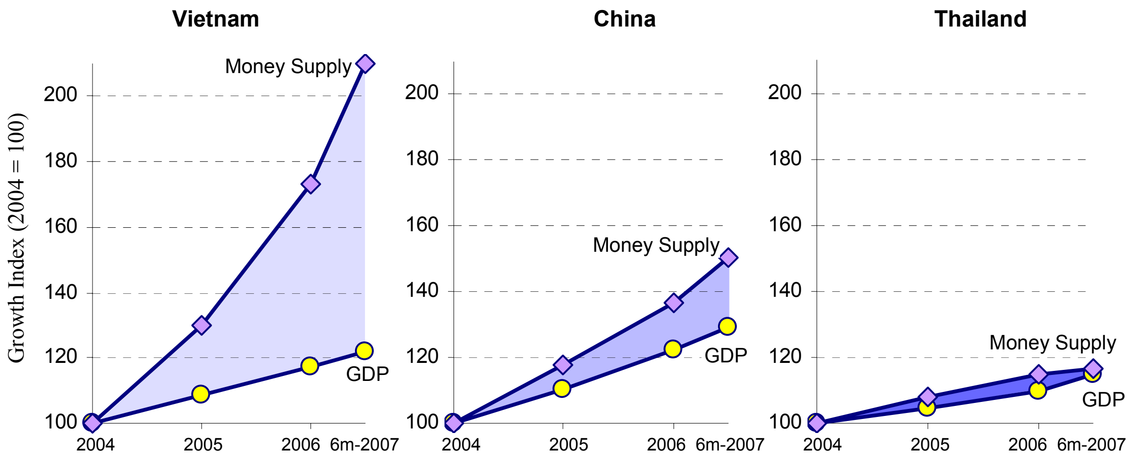
Inflation has emerged as an area of concern, in part because the real rate of inflation is most likely much higher than the official numbers suggest. Domestic spending has increased rapidly as oil revenues, foreign borrowing, official development assistance, FDI inflows and remittances have fueled inflows of capital. Since 2003, nominal retail spending has risen over 20 percent a year, and investment has risen faster still, while real supply (real output plus the real trade deficit) has risen less than ten percent a year. If spending is up over 20 percent and real supply up less than half as much, the difference must be inflation.[63] Even though the consumer price index suggests that price inflation is still in the high single digits, inflation is in fact much higher and has been for several years.

This should not be surprising. Money supply has posted average growth rates of over 25 percent per year since 2003, and private credit has grown over 35 percent. While imports have jumped to respond, some goods can only be supplied locally and they are in short supply. Everything from electricity to hotel rooms to skilled labor is being bid up and/or is not available. But why should growth of only 7-8 percent a year cause such problems if investment is so high – about 35 percent of GDP? Recall that Taiwan grew at 10 percent a year for 18 years with its investment averaging only about a quarter of GDP.

Prolonged, high rates of growth require a commensurate increase in the money supply in circulation. However, when the imbalance between increase in money supply and increase in GDP becomes too large, inflationary pressure arises. As Figure 7 illustrates, during 2005 and 2006, Vietnam's GDP increased 17 percent, while broad money supply (M2), increased 73 percent. By contrast, during the same period, China's GDP increased 22 percent, but broad money supply only increased 36 percent. The imbalance between GDP growth and money supply increase in Thailand is even lower. Vietnam's economic growth is lower than China's but money supply growth is higher. One result is that while the CPI in China only grew 6.5 percent in the twelve month period ending in December 2007, in Vietnam the CPI increased 10 percent.

[63] The 2002 and 2004 Living Standards Surveys suggest each household's consumption rose by 17-18 percent a year. Since supply in this period rose by 8.5 percent a year, the implied inflation is 9 percent, However, investment rose more than consumption, the number of households increased, and spending picked up after 2004, so double digit inflation is still likely. Some of the discrepancy is also due to unrecorded supply—in other words, smuggling.

Figure 7. Money supply and GDP growth differential, 2004-2007[64]



Why does money supply rise so fast? One major reason is the pace of government spending growth. Total expenditure in 2006 was 321.4 trillion dong, an increase from 221.8 trillion in 2004 – a 45 percent increase or 20.3 percent a year compounded. (Retail sales went up by the same amount.) Now non-oil tax and fee revenues offset spending, as money is taken out of one pocket (the public's) and put into another (the government's) and then spent, with little net impact. But an increasing amount of revenue comes from oil and grants and loans, not from domestic revenues. Domestic revenues in 2004 were 119 trillion and in 2006 were 190 trillion, an increase of 71 trillion. But spending went from 190 to 321 trillion, an increase of 131 trillion, or nearly twice as much. If government spending is going up a lot faster than non-oil taxes, even if it comes from grants and oil, it will add to demand pressure. If the public investment is poorly chosen and adds little to output, it will be even more inflationary.

Some government officials have sought to blame inflation on "objective factors" such as the cost of specific items like food and fuel. Global supply shocks are one source of inflation in Vietnam. Vietnamese consumers benefited from relatively low rice prices until 2004. Low rice prices have also helped the poor, since rice represents about half of their spending. However, rice prices have risen with rising demand in Asia and oil prices (reflecting the price of nitrogen fertilizer), and are now equal to peak prices in the 1990s. But these same global shocks are being felt in other Asian economies and they mostly have much lower rates of inflation. While these price increases are visible, they are not the root causes of inflation. If the money supply was rising less rapidly, so would total spending. If fuel prices rose, that would take more out of the budget of a household and they would spend less on other things (to the extent they cannot cut back on the quantity of fuel purchases) and other things would fall in price. The fact that Thailand has low single digit inflation while Vietnam is much higher is evidence of this. Thailand, after all, uses fuel more intensively than Vietnam. As Figure 8 illustrates, Vietnam and China are the countries most affected in the region.[65] Even troubled Thailand expects 2007 inflation of 2-3 percent and has averaged under 3 percent inflation a year in the last five years.

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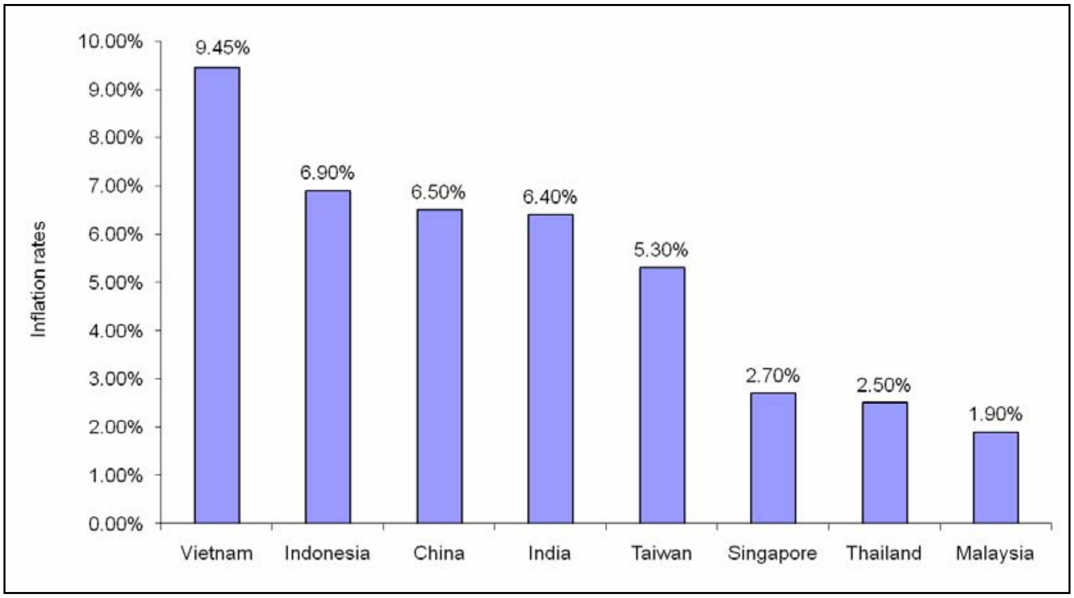
[64] Money supply is measured by M2 which includes cash in circulation and demand, savings, and time deposits. Source: IMF, International Financial Statistics, except for GDP growth rates in the first 6 months of 2007 which are taken from the Economist Intelligent Unit.

[65] While inflation was and remains low in Thailand, Malaysia and the Philippines, it was just over 10 percent in 2005-06 in Indonesia, which faced significant decontrol of petroleum prices and an unstable exchange rate, but inflation is expected to be 5-7 percent in 2007. It was officially 5 percent in Vietnam just from January to June.

Figure 8. Regional comparison of inflation rates



4.2. Investment efficiency

A central theme of this paper is that allocation of resources is a critical determinant of economic performance, and social development more broadly. One problem common to Vietnam and China is the reliance on extremely high levels of investment to sustain growth. But much of what is categorized as investment in these two countries is actually disguised consumption. Corruption and waste in public investment projects and state-owned enterprises redirects capital away from investment and towards personal consumption. Poorly planned public projects generate low rates of return. If investment is financed from domestic savings, these inefficiencies represent a lost opportunity. Projects financed by foreign borrowing create claims on future exports of oil, rice, rubber and other commodities. These projects must stimulate production and exports if they are to be self-liquidating. If they are not, they can in the end become a drag on future growth. This is a characteristic of Southeast Asian economies. Very high investment rates were needed to sustain modest rates of growth.

Table 3. ICOR Comparison[66]

	Period	GDP Growth (%/year)	Gross Investment/ GDP (%/year)	ICOR
South Korea	1961-80	7.9	23.3	3.0
Taiwan	1961-80	9.7	26.2	2.7
Indonesia	1981-95	6.9	25.7	3.7
Malaysia	1981-95	7.2	32.9	4.6
Thailand	1981-95	8.1	33.3	4.1
China	2001-06	9.7	38.8	4.0
Vietnam	2001-06	7.6	33.5	4.4

Some argue that a high ICOR is unavoidable because Vietnam is a rapidly developing but still poor country with a massive need for investment in infrastructure, technology, etc. According to this position, the fact that Vietnam's ICOR is similar to China's—another rapidly growing but still poor country—is evidence that Vietnam's high investment to growth ratio is not abnormal. This reasoning is flawed in several respects. First, it ignores the fact that when other East Asian countries were at similar levels of development, their investment was much more efficient (see Table 3 above). In the 1970s, when Korea undertook a major drive to develop heavy and chemical industries and shipbuilding, which require large investments, its ICOR was 3. The China comparison is also problematic. As countries get richer, their ICOR increases. In per capita terms China is at least twice as rich as Vietnam, and as a continental country, has infrastructure needs that dwarf Vietnam's, yet Vietnam's ICOR is higher. Moreover, as we have seen, China's use of investment capital could not reasonably be described as good practice.

Is Vietnam at risk of a major financial crisis? In the short term, probably not. However, many of the underlying weaknesses that contributed to the 1997 financial crisis are present in Vietnam today.

First, although the stock market has developed rapidly, the domestic financial system is still dominated by inadequately supervised banks with sizable volumes of non-performing loans.

Second, excessive investment, approaching 40 percent of GDP and an ICOR of 4.4 (meaning that 4.4 units of investment are needed to produce one unit of growth) is very high in comparison with other countries in the region at similar levels of development (the regional average is about 3).

Third, a significant amount of money, from corruption, laundering, and overseas investors is flowing into real estate and the stock market, creating asset bubbles.

Fourth, a steadily increasing trade deficit, and abnormal exchange rate fluctuations (largely a result of weak economic management) signify underlying risks. The fiscal deficit is also rising, which reduces the scope for corrective action on the demand side should external conditions deteriorate. Vietnam is also building up significant amounts of unhedged foreign currency debt, although unlike Thailand in 1997 this is mostly in the public sector. What are lacking, at present are triggers, such as a big

[66] Source: World Bank, World Development Indicators and Taiwan Statistical Data Book, 1992.

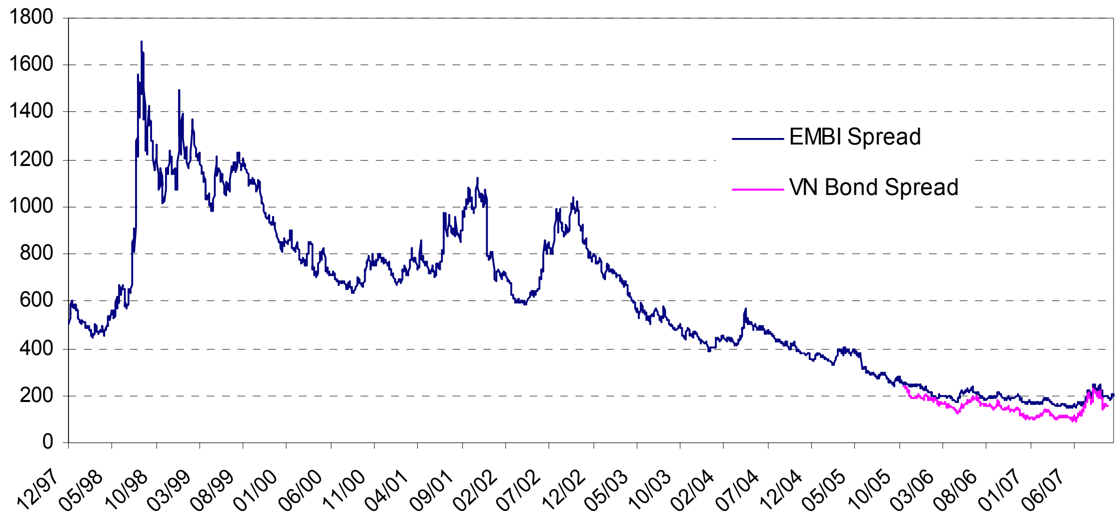
external shock or a domestic bank run caused by a sudden drop in share or property prices. In the medium to long-term, Vietnam's financial system could be at considerable risk.

Table 4. Repeating History? Causes of the 1997 Financial Crisis

Symptoms	Vietnam in 2007
Current account deficit	√
Asset bubbles	√
Unhedged foreign borrowing	√
High invest/growth ratio	√
Inefficient public investment	√
Inadequate bank supervision	√
High volume of NPLs	√
Intra-group lending	√
Short-term foreign borrowing	**X**
Open capital account	**X**

Vietnam is attempting to build a modern financial system at a time when international capital markets, especially in Asia, are exceptionally liquid. JP Morgan's EMBI+ index, a measure of the spread between interest rates on US Treasury bonds and emerging market bonds, has reached historic lows this year (see Figure 9). Despite the recent market turbulence surrounding the collapse the sub-prime mortgage market in the US, spreads have remained exceptional low through the end of October. The spread for Vietnam's first-ever sovereign bond, which was issued in October 2005 and expected to be used as a benchmark for state-owned conglomerations seeking to borrow internationally, has always been below the EMBI average. This means that a developing country like Vietnam can continue borrowing money from international capital markets at very low rates. The availability of unlimited amounts of relatively inexpensive foreign savings represents an economic opportunity for Vietnam, if overseas financing is used judiciously. However, there is a danger that the government and domestic firms may be tempted to rely heavily on foreign financing rather than make the hard choices necessary to sort out the domestic financial system. As the analysis in Part Four demonstrates, state-owned firms are not using their capital efficiently; if they do not become more efficient, and are allowed to tap international capital markets, there is a real risk that Vietnam will have paid a high price for very little value. In addition, the government must take care to keep debt obligations under control during the boom in order to prepare for the inevitability of external shocks in the future. This suggests that fiscal policy should err on the side of caution, with small deficits or even primary surpluses in most years. The government needs to resist the temptation to tap into cheap foreign financing of the fiscal deficit. The main reason is that although financing may be cheap now, there is no guarantee that it will remain so.

Figure 9. Emerging Market and Vietnam Bond Spreads: JP Morgan's EMBI+ Index 1998-2007



5. State Effectiveness

East Asian countries possessed the long-term strategic vision and political will to anticipate and respond to development challenges before they could disrupt growth. They also dealt reasonably well with unexpected crises. Time and again, however, Vietnam has failed to respond adequately to problems that were recognized years in advance. Over-reliance on hydroelectric power generation, noted above, is one example. The traffic gridlock that threatens to clog Hanoi and Ho Chi Minh City was foreseen by city planners more than a decade ago, yet to date very little has been done. Indeed, Ho Chi Minh City and Hanoi stand out among Southeast Asian cities for their lack of effective public transport. Today Ho Chi Minh City's planners pin their hopes on a subway system that, in reality, is at least two decades away. The widespread flooding that now afflicts Ho Chi Minh City during the rainy season, a by-product of filling in of wetlands and building over of canals, was also predicted, but again, the city's response has been singularly ineffective. Many cities in developing countries have addressed these problems and "best practices" are well known. This situation raises the question: if the Vietnamese government cannot respond effectively to predictable challenges, how will it react in the face of an unforeseen crisis?

In the World Bank's latest governance study, countries were evaluated according to six criteria: voice and accountability, political stability, government effectiveness, regulatory quality, rule of law, and corruption.[67] With the exception of political stability, Vietnam scored lower than all East and Southeast Asian countries but Indonesia. It should be emphasized that these indices are comparative. The fact that Vietnam's ranking in the category of "governance effectiveness" declined between 1996 and 2006 does not mean that Vietnam declined in this area; rather, although Vietnam made important progress during this period, other countries in the region improved even more quickly.

While streamlining the bureaucratic apparatus (such as by reducing the number of line ministries or adopting "one door" administrative processes) may produce certain efficiency gains, ultimately more will be gained by restricting the scope of state functions and focusing on core areas that only the state can address. In recent years the donor community has spent large sums in pursuit of "public administration reform." This effort is widely regarded as a failure because it poured money into the

[67] *Governance Matters VI: Aggregate and Individual Governance Indicators 1996–2006*. Daniel Kaufmann, Aart Kraay, Massimo Mastruzzi World Bank Policy Research Working Paper 4280, July 2007

existing administrative apparatus without fundamentally changing what it does. The Vietnamese government's own reform efforts have proven much more successful—the Enterprise Law is a shining example—and the high priority it is now attaching to continued reform of the state sector is laudable. Today Vietnam faces a new round of challenges that require much more sophisticated solutions. Improving education and healthcare, addressing the infrastructure crisis, and meeting the challenges of urbanization and environmental degradation will require better government, not just less government.

6. Equity

In the all important area of human development, Vietnam has enjoyed impressive success over the past two decades. According to many key development indices, Vietnam scores better than much wealthier countries. The infant mortality rate is lower in Vietnam than in Thailand or China, two considerably wealthier countries. Vietnam will exceed most of the Millennium Development Goal targets well ahead of schedule. Poverty in Vietnam has also fallen at historic rates. These are all impressive achievements. However, as with economic development, in human development, past achievements are not guarantors of further advancement. In particular, the fight against poverty will be protracted. Even as Vietnam approaches "lower middle income" status, it must be recognized that a majority of the population does not enjoy a standard of living that can be regarded as acceptable by international standards. The precise level of the poverty line is less significant than the fact that most Vietnamese live either just below or just above it. Rising food prices, out of pocket costs for health and education and soaring urban rents threatened to reverse some of the gains achieved in recent years.

If Vietnam is to maintain social stability over the next five to ten years, more must be done to ensure that the bottom 30% of the population retains a stake in the country's development. There are three key areas: education, healthcare, and social safety nets. This paper has already addressed higher education, but primary, secondary and vocational training are also critical. Healthcare is an essential prerequisite for living a productive life. While Vietnam's basic indicators are strong in comparison to other countries at similar GDP per capita levels, more can and should be done. A growing percentage of healthcare costs have been shifted to the public. The healthcare system in rural areas is particularly troubled, which means that a majority of Vietnamese do not have convenient access to even basic quality care. Multiple studies have shown that health crises are a leading cause of landlessness, as families have no choice but to sell their only valuable asset in order to pay for the care of a loved one. Finally, all successful countries provide some form of social safety net for their citizens.

If nonfarm incomes continue to grow rapidly, an increasing number of families will live in urban areas, often not even owning their homes. These families will need a social safety net, as the village and community networks that would help them will be much weaker. The state must find a way to create affordable insurance and other kinds of assistance for these urban citizens. A combination of better social safety nets funded by taxes on new sources of wealth and policies aimed at making home ownership more realistic will create the new social contract that will ensure stability in the future. This kind of equity is not just a nice add-on to growth, but a prerequisite to sustaining rapid growth. A divided society, as seen in most of Southeast Asia and China, creates series economic, social, and political problems that take a long time to solve. It is much better to address them during the growth process than later.

Some readers, lulled into complacency by years of upbeat donor reports, may be surprised by this conclusion. Yet the evidence is already present for those willing to look for it. A recent UNDP report found that the gini coefficient in 2004 was already 0.41 if one excludes "imputed rents" from income calculations.[68] The employment elasticity of growth in Vietnam is 0.4, far less than Korea and Taiwan

[68] Martin Evans, Ian Gough, Susan Harkness, Andrew McKay, Dao Thanh Huyen and Do Le Thu Ngoc, "How Progressive is Social Security in Vietnam," Hanoi, UNDP Policy Dialogue Paper, 2006. Imputed rent is a sum

during their rapid industrialization and even lower than China. Vietnamese households rely more on private spending for health care than any country in the region including China.[69] Meanwhile, the public social security system favors upper income earners over the poor.

If Vietnam is to maintain social stability over the next five to ten years, more must be done to ensure that the bottom forty percent of the population retains a stake in the country's development. The East Asian experience has shown that job creation is the key to equity. At present, Vietnam's job creation track record is fairly strong, although, as we will show in Part Four, job creation is coming overwhelmingly from the private and foreign sectors, despite the fact that the state sector continues to receive the lion's share of investment. Also, Vietnam's employment elasticity of growth, .4, is much lower than either Taiwan of Korea's during their periods of rapid growth. Sustaining such job growth requires certain favorable conditions. A failure of public services and a social safety net, unfair taxation, land concentration and haphazard urbanization have led to more inequality in Southeast Asia than in Japan, Korea or Taiwan. These failings do not just mean that income is a little lower than it might be for some families. They mean that the societies are less fair and are perceived to be tilted towards those who are well off. These problems reduce growth, create insecurity and diminish hope for a better future.

On a fundamental level, the equity challenge facing Vietnam is to impart meaning to Vietnamese citizenship in a way that creates a sense of shared destiny and promotes social cohesion. The East Asian experience has shown that job creation and access to quality health and education services are central to this vision. Fairness and transparency in the public and private sectors are of equal importance. Citizenship is not worth much if some citizens can cash in on political connections when others are subject to constant and increasingly arbitrary demands for official and unofficial payments. Vietnam must also abandon the household registration system, which no longer serves a viable economic or social function and which now exists solely as a mechanism to deny migrants access to public services.

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added to household income when families live in owner-occupied dwellings to impart a value to home ownership. Since many rural households live in owner-occupied dwellings this practice tends to boost the recorded incomes of the poor.

[69] Alberto Gabriele, "Social Services Policies in a Developing Market Economy Oriented Towards Socialism: The Case of Health System Reforms in Vietnam," *Review of International Political Economy*, 13:2, 258-289, 2006.

PART FOUR. **SUSTAINING EQUITIBLE GROWTH**

IV. Dualism: The Structure of the Vietnamese Economy

If Vietnam is to achieve its ambitious development objectives, the Vietnamese economy must continue to deliver high rate of equitable growth for the next several decades. This has proven to be an exceptionally difficult feat that only a handful of countries in East Asia have achieved. As Figure 1 illustrates, Southeast Asian countries, and indeed most middle income countries around the world, began to slow down and plateau when they reached a level of development such as Vietnam will attain soon. Vietnamese leaders must therefore ask themselves the following question: how can the Vietnam sustain its robust growth far into the future?

It should be clear that the only way to achieve a sustained high rate of economic growth for several decades more is to identify the sectors with the most growth potential and provide them with the environment and inputs needed to thrive. This section will show that the private and the foreign invested sectors are the twin-dynamos of the Vietnamese economy. These sectors are most likely to provide the prolonged economic growth on which Vietnam's future depends. However, the Vietnamese government is not providing these sectors, and especially the private sector, with the conditions needed to ensure their continued success. Instead, as this section will show, in critical ways government industrial policy remains skewed in favor of the sector that objective analysis reveals is the least competitive, generates the fewest jobs, and delivers the lowest growth rate. Set against the need to sustain a high rate of growth for the next 20-30 years, this is no different from a soccer coach who starts his weakest players in the championship match.

For the past twenty years, the defining feature of the Vietnamese economy has been dualism, a "one country two systems" strategy that sought to retain the dominance of the state sector while opening to foreign investment and permitting the emergence of a vibrant private sector. Dualism may have been necessary to ensure political support for the transition to a market economy. If so, it has been remarkably effective: today the private and foreign invested sectors account for nearly 90 percent of Vietnam's industrial growth and virtually all job creation.

1. Sources of Growth

Which sectors are generating Vietnam's economic growth? The leading sectors are manufacturing, utilities, construction and some services which together account for nearly 75 percent of recent growth. Since 2000, manufacturing, utilities and construction have contributed 45 percent of real growth, while agriculture and mining account for less than a sixth of GDP growth. Trade, transport, finance, education and health are also recent contributors, and together they account for 26 percent of output growth. Most of these fast-growing sectors are using skilled workers and, often, foreign capital and technology.

Simply because a sector grows slowly does not make it unimportant. If agricultural growth can be sustained, it will help slow urbanization and create a more balanced growth path with more regional equity than one centered only in and around major cities. Less rapid rural to urban migration takes pressure off cities and leads to more social stability.[70] Agriculture is also an important source of exports and hence foreign exchange. However, the faster-growing sectors will contribute most to GDP growth. For the sake of clarity, this paper will analyze the economy by ownership: state, private, and foreign invested. As will be argued below, these distinctions are not clear-cut, and increasingly the economy appears to consist of two general categories: firms (state and private) that depend on special treatment from government and those that do not.

[70] There is some evidence from research that urban population growth is greater than officially measured. It is likely that most current population growth, perhaps all of it, is in cities or close to them now.

2. Key Trends

There is little doubt that FDI has helped to boost growth. As Table 1 shows, foreign enterprises reported turnover growing at 30 percent a year from 2001 to 2005 at current dong prices.[71] Foreign non-oil exports have also grown 26 percent a year in US dollars since 2000. Only private enterprises, which quadrupled output over five years at current prices, did better with a 34 percent annual growth rate. State-owned firms also did fairly well, with a 16 percent annual rate of turnover growth at current prices. Inflation as measured averaged 5 to 7 percent per year.

Can the fast growing sectors keep going or will they "run out of gas"? The answer is different for each ownership type. The foreign sector has been using up Vietnam's supplies of skilled labor and also its raw materials. Just as oil output is now falling, if skilled labor supplies are exhausted and not replenished fast enough, it is likely that output growth from FDI will slow. Of course, it is possible to bring in foreign labor but that is more expensive.[72] An additional drawback to that is if the economy did slow down and the contracts of foreign workers terminated, Vietnam would lose access to the accumulated experience and knowledge that these workers had brought with them and that they had acquired in Vietnam. This is precisely what happened in Thailand in the 1990's. Training local labor is possible but takes time, and trained workers are often lost to other firms, which raises the cost of training to individual companies. Thus, government support is needed to raise the overall skill level of the labor force. While the current FDI boom seems to indicate that foreign interest in Vietnam is deep and fast-growing, similar booms ended elsewhere in Southeast Asia. Vietnam has to be alert to the conditions that sustain such investment, including competitive cost structures and providing adequate infrastructure and supplies of skilled workers. It is also important to remember that while cheap labor provides a temporary advantage to firms in Vietnam, labor on average represents only 3 percent of production costs of manufactures from developing countries, and less than 1 percent of retail prices of all manufactured goods sold in OECD markets. Betting on cheap labor is a losing strategy.

The private (non-state) sector faces different issues. It lacks scale, sophistication and access to important technical and commercial information. In addition, land and finance are still problems for many, in spite of very rapid private credit growth. Private firms complain that they can get access to short term credits but that banks are unwilling to extend credit over longer terms. Unless these problems can be addressed, it is likely that the high growth rate since 2000 will begin to slow down as small firms crowd into hypercompetitive domestic markets (petty trade and services and simple processing industries) and few firms grow into larger enterprises that are able to adopt more advanced technologies and achieve economies of scale. Crucial to the success of private companies will be their relationship with foreign firms in Vietnam. Supplying foreign firms enables local companies to link into global supply chains and learn to work to international standards of quality and price. The presence of dense networks of local suppliers would also make Vietnam more attractive as a destination for foreign investment. However, foreign firms in Vietnam still complain that domestic private firms are too small and technologically unsophisticated to play this vital role.

Another aspect of private investment is that it tends to be distributed more widely and evenly than state-owned or foreign investment. Private firms respond more quickly to local opportunities than either state or foreign firms, both because local people are more familiar with opportunities in their own towns and villages, and because many of these opportunities are too small to interest larger foreign and state enterprises. The growth of private firms is therefore an important component of rural

[71] The turnover data comes from the Enterprise surveys, which break out foreign-owned and non-state from state owned firms. The FDI export data comes from online tables in *Vietnam Business Briefs* and the *Statistics Yearbook.*
[72] This assumes that the 3 percent foreign worker ratio now set by the Ministry of Labor is not enforced too rigidly or is repealed. Rather than restrict foreign workers, it would be better to improve the quality and quantity of Vietnamese experts. Firms prefer to hire local workers if they are cheaper and available.

development. Numerous opportunities exist for private firms to take the lead in input supply and marketing and processing of farm production. In linking farmers to urban and foreign markets, local companies can play an important role in helping them to upgrade quality and diversity into new product lines. Job creation in rural areas is essential if Vietnam is to close the growing rural-urban income gap or at least stop it from growing much larger over the coming years.

The state sector has grown but only with the help of large amounts of capital per worker and per firm.[73] State enterprises in 2005 had triple the capital per worker of private firms; but generated only 44 percent more turnover per worker. State firms had two-thirds more capital per worker than foreign firms, but achieved the same level of sales per worker. In addition, state-sector workers tended to have more skills, but productivity (output per worker per day) does not reflect this double advantage of capital and skills. If state firms are to contribute to growth rather than simply siphon off precious capital and talent from more efficient projects, they will have to learn how to compete on a more equal basis. Now, many state enterprises prefer to shelter in the protection of cheap capital and land and/or quasi-monopoly or noncompetitive contracts. This is one way to start up, but if continued, a certain way to fail over the long period.

Table 5. Capital, Turnover and Workers in Vietnamese Enterprises in 2005 by Ownership[74]

	State	Non-State	Foreign	Total
Employees (thousand)	2041	2982	1221	6244
Capital (Trillion Dong)	1451	705	528	2684
Turnover (Trillion Dong)	838	853	502	2159
Capital/worker*	711	236	432	430
Turnover/worker*	411	286	411	346
Turnover/Capital	0.58	1.21	0.95	0.80
Annual Growth, 2001-05:				
Employees	-1%	22.4%	25.7%	12.2%
Capital	15.3%	44.4%	18.5%	21.0%
Turnover	16.2%	34.5%	29.7%	24.5%

Table 5 shows that the growth of formal sector jobs has been exceptionally rapid in private and foreign firms. Only 1.1 million are added to the labor force each year and there were 4.2 million in the non-state and FDI sectors at the end of 2005. This means that from 2006 to 2008-2009, if the recent job growth rate continues, more than 100 percent of labor force growth would be absorbed by formal enterprises – and this is prior to the large increase in realized FDI in 2006-2007. Since many urban jobs are not in the formal sector, this will pull many workers in from rural areas where they are now employed at low wages or incomes and accelerate urbanization to a significant degree. The cities need

[73] The state sector declined slightly in terms of workers, both because there were fewer firms by 2005 and because they probably started in 2001 with some over-staffing, which was reduced. Capital per worker grew at about the same rate in state and non-state sectors.

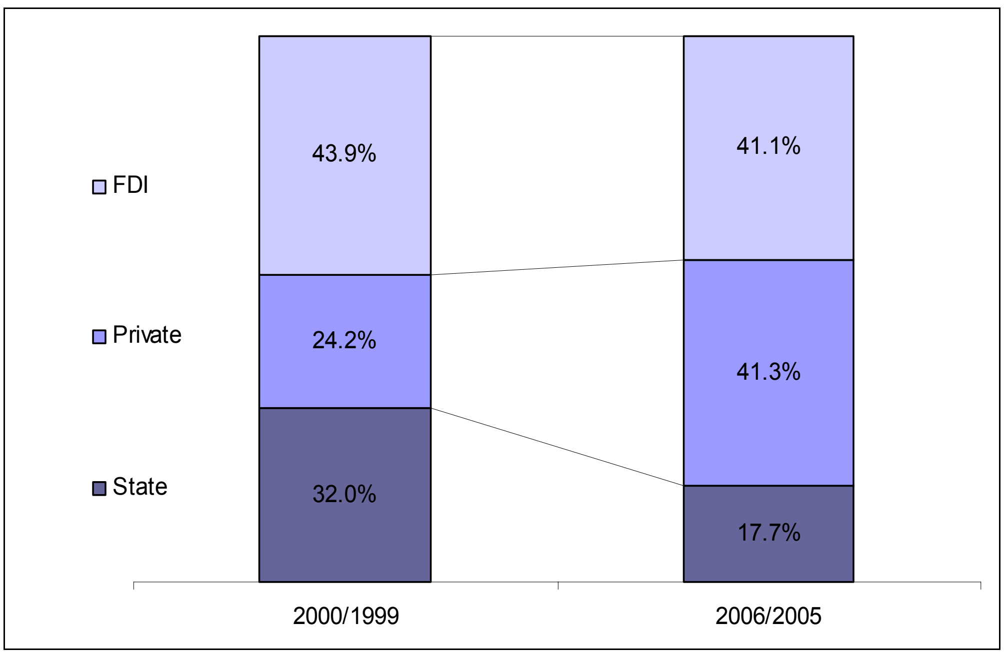
[74] Source: 2003 and 2005 Enterprise Surveys. * Capital and turnover per worker are in million dong per worker. The number of state enterprises in the survey has dropped from 5355 on 12/31/2001 to 4086 on 12/31/2005.

to be ready for this movement of millions of people in the next few years. As will be discussed below, urban institutions and investment plans are not ready for this.[75]

3. The State's Commanding Heights Strategy

The objective of Vietnam's industrial policy should be to support the emergence of large, competitive, technology savvy firms that are capable of competing in the international economy and create quality jobs and socially beneficial innovation. In theory, it does not matter whether these firms are state or privately owned; every firm should be evaluated according to how well it achieves the objectives described above. As in the East Asian countries, performance rather than ownership should be the main criteria on which firms are evaluated. While the Vietnamese government has repeatedly asserted its policy of promoting the development of all ownership sectors (state, private, and foreign-invested), a majority of investment and credit is allocated to the state sector. Statistics suggest that the state-owned sector is not performing at a level that justifies the massive support that it is receiving. Figure 10 shows that in fact the state's share of industrial growth was about one-eighth in 2006, a year in which the state sector accounted for less than one quarter of industrial output. As recently as 2001, the state industrial sector accounted for nearly one-third of both industrial output and growth.

Figure 10. Share of Real Industrial Growth by Ownership in Vietnam[76]



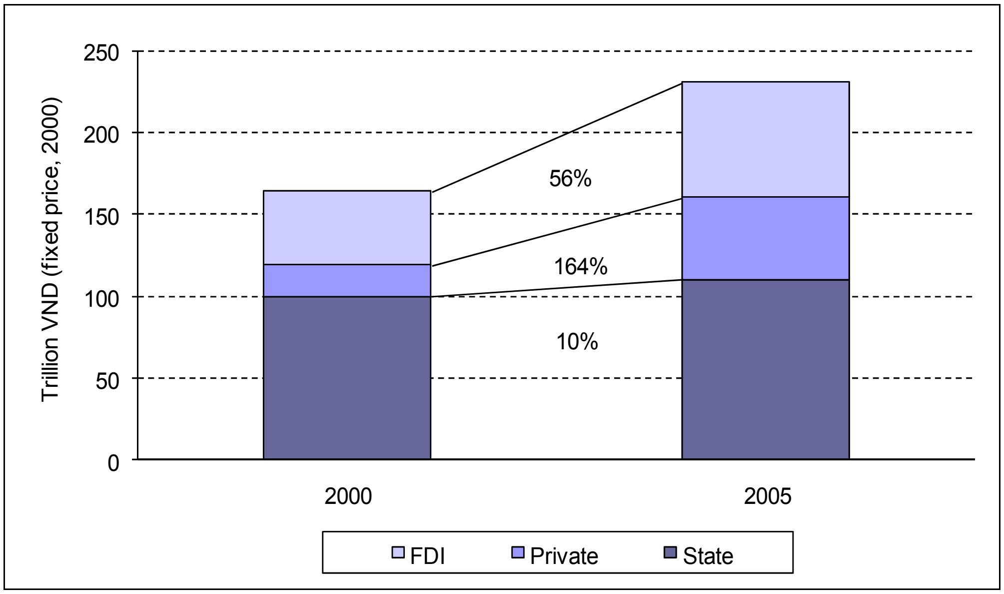
As noted above, there is almost no job creation within the state-owned sector. With few exceptions, state firms do not export manufactured products; those that do receive such generous subsidies that it is difficult to determine whether they are in fact competitive or simply transferring resources from domestic tax payers to foreign consumers. Figure 11 below shows that value-added in the state sector is increasing very slowly, in dramatic contrast to the private and foreign sectors. Taken together, all of these numbers suggest that the faster growing private and foreign sectors are in fact the core of the

[75] In a 2007 report, the United Nations Population Fund projected an annual gain in Vietnam's urban population of 700,000 people from 2005 to 2010, yet the government's official growth from 2002 to 2005 was 800,000 per year—and the official data are likely to be understated, due to under- counting of migrants and urban sprawl. Total population in Vietnam grows by 1.1 million a year.

[76] Source: Vietnam Statistical Yearbook, 2006.

Vietnamese economy, and that the state-owned sector is failing to achieve Vietnam's stated economic objectives. Whether it is in Vietnam's long-term economic interest to continue showering the state sector with resources is one of the central questions confronting the Vietnamese leadership.

Figure 11. Value-added by Sector



The government has adopted a policy to promote the creation of horizontally diversified, state-owned "economic conglomerates." This is an effort in part to achieve economies of scale and rationalize management structures. Another justification offered for the policy is that it will enable Vietnam to retain economic "independence and autonomy.[77] The conglomerates have been exhorted to "control the domestic market."[78] These statements are unclear, but suggest a lack of understanding of the 21st century global economy. The world economy is growing increasingly interconnected, with companies in multiple countries contributing inputs to supply chains. Participating in these global supply chains is not a threat to autonomy and independence, but the only way to become a modern, knowledge-based economy. Given that almost every product, from shoes to computers, consists of components made in multiple countries, what does it mean to "control the domestic market"? Old models of import substitution have been thoroughly discredited, and, as noted above, WTO rules prevent most forms of industrial protectionism. Again, while in theory state ownership does not preclude a firm from becoming efficient and competitive, the strongest economies in the region (with the possible exception of Singapore) do not have a large state sector, yet would anyone accuse Korea or Japan of lacking "autonomy and independence"?

The focus on domestic-oriented economic conglomerates suggests a Southeast Asian industrial strategy, in which domestic state and private conglomerates accumulate capital through their domination of domestic (and often highly protected) markets, or through various subsidies such as lucrative contracts or cheap inputs. While Indonesian, Malaysian, Thai and Philippines conglomerates did grow in size and scope, few of them succeeded in penetrating export markets for technologically advanced, income elastic products. They remained heavily dependent on domestic markets for low

[77] See the economic policy statement adopted at the Tenth Party Congress in 2006. http://www.cpv.org.vn/print_preview.asp?id=BT160635244
[78] See "The economic conglomerates must have sufficient strength to control the domestic market." Available at http://www.cpv.org.vn/tiengviet/kinhte/details.asp?topic=5&subtopic=10&leader_topic=84&id=BT17100761088.

value added goods and on speculation and financial engineering. The conglomerate structure also created domestic vested interests that eventually became a serious obstacle to industrialization and national competitiveness. Vietnam is now replicating this strategy.

The East Asian countries pursued a different strategy. Access to domestic markets was not granted based on ownership but rather on performance. Conglomerates did develop in Korea, but the government consistently applied the test of competitiveness in export markets as the main success criteria. As a result, Korean firms did not become complacent, and did not use their political muscle to block productivity-enhancing policies and public investment. In Taiwan state-owned enterprises dominated upstream industries such as chemicals, synthetic fibers, and mining and metalworking industries. But they did not compete with private firms and in fact were established to provide inputs to the growing private sector at competitive prices. They were set up to stimulate exports and increase national competitiveness, not (as in Southeast Asia) to accumulate capital on the basis of preferred access to the domestic market.

4. Meeting the China Challenge

One question that inevitably arises in any discussion of Vietnamese economy is its ability to "compete with China." The short, and only, answer is that no country can compete with China in the area of mass produced consumer goods. China's economies of scale are simply too great. Vietnam must be faster and smarter than China—this is synonymous with moving up the value chains described at the outset of this paper. Currently Vietnamese firms are not embedding themselves in these global production processes. (Although to be fair, few private Chinese firms are either.) Vietnam's greatest advantage may be its ability to reform quicker. Leapfrogging China requires reversing many of the trends described in Parts II and III of this paper. It must be said that, as long as the quality gap between Vietnamese universities and their Chinese counterparts continues to be measured by orders of magnitude, Vietnam has very little hope of making this leap.

PART FIVE. **POLICY RECOMMENDATIONS**

V. Prerequisites: The Politics of Reform

The analysis above strongly suggests that Vietnam is behaving much more like a Southeast Asian than an East Asian country. Indeed, in certain respects Vietnam may be in danger of repeating the mistakes of both pre-1997 East *and* Southeast Asia and of China today. For the Vietnamese leadership, this should signal the need for real policy change. However, there is nothing inevitable about Vietnam's economic trajectory. Vietnam enjoys many advantages over Thailand, Indonesia, and the Philippines, among them a high degree of social cohesiveness and strong cultural traditions that include a reverence for learning. Vietnam is not riven by the ethnic and religious divisions that plague much of Southeast Asia. In light of these advantages, more than perhaps any other developing country, Vietnam is in control of its economic destiny.

One of the implications of this paper's analysis is that there is not much doubt about the specific policies that Vietnam must implement. Many countries have faced similar challenges. Vietnam is not so exceptional that these lessons cannot be applied, with appropriate adaptation to local conditions. In almost every major policy area, from education to urbanization, international "best practices" can be found. It is clear that the principal barrier to Vietnam's attainment of the East Asian development trajectory is in the main political, not technical. Land policy is a good example. A well-designed and rigorously enforced buildings and property tax is essential to discourage speculation and raise revenues. Yet the National Assembly has rejected various proposals on several occasions. (The question arises of whose interests the deputies are serving when it is apparent to all concerned that land market speculation is out of control and the government is starved of revenues.) In short, political will is the necessary catalyst for reform.

Vietnam has marshaled the political will to break with the status quo before. At the Sixth Party Congress in 1986 a consensus formed around the urgent need for economic reform. Nothing focuses the mind like economic crisis, and in 1986 the party recognized that its very survival was on the line. Since then, the threat of crisis has receded, and interest groups have formed that have objectives that are inconsistent with the national goals of rapid modernization and industrialization. The reform consensus of 1986 no longer exists. Forming a new pro-growth, pro-reform consensus will not be easy in the absence of a serious economic crisis. The government must articulate a compelling case for reform and show more willingness to counter the interests of anti-reform forces.

This is not to say that improving the technical capacity of government policymakers is unimportant. The simple reality is that improving the quality of government policy—and by extension Vietnam's national competitiveness—depends on the quality of the civil service. Today the government is facing a critical shortage of human capital. This situation is largely one of the government's own making: at present, loyalty, seniority, family background and other criteria unrelated to job performance too often factor in appointment and promotion decisions. It is well known that to secure state jobs it is often necessary to "run." Senior positions are rumored to be awarded on the basis of political connections or are simply purchased. The government seems reluctant to offer special incentives to attract top talent, on the grounds that this would be unfair. This lamentable situation has given rise to a widespread perception among Vietnamese young people that the public sector personnel system is not merit based. These phenomena are widespread in Southeast Asia and China where they have had disastrous consequences for socioeconomic development. They are unheard of in the most successful East Asian countries. These countries made sure that careers in the public sector remained an attractive option for top university graduates. These governments go to great lengths to recruit the most talented people, and legally reward the top echelons of the civil service at levels comparable to the private sector. Here too, however, political will is needed to break with the status quo.

Several influential commentators, including General Vo Nguyen Giap and Professor Hoang Tuy, have argued that the state system is in an advanced state of decay.[79] Both men believe that the organs of the Vietnamese state, political, administrative, and academic are increasingly co-opted by interest groups who use them for self-enrichment and aggrandizement. The recent admission of the State Inspector General that every inspection of a government project or agency uncovers malfeasance is further evidence of the decay in the state system.[80] The implication of this situation is that the greatest threat to the state is its own failings.

VI. Policy Recommendations

This paper argues that East Asia's rise is due in the main to its superior response in six key areas. Ensuring that Vietnam avoids the "Southeast Asia trap" while at the same time not repeating China's mistakes will require a coordinated policy response in each of these areas. All of these recommendations should be prioritized in Vietnam's next ten year socio-economic development plan, which is currently being drafted. If implemented effectively, take together these policies should succeed in maintaining social equity will delivering high rates of economic growth.

1. Education

1. *Make government expenditures on education more transparent.* The current crisis in education is not the result of underinvestment but it is partially the result of waste and inefficiency in education expenditure. Greatly increased transparency is an essential first step in improving the education system. First, if parents and the press have a better understanding of how public funds are being spent, they can provide much more effective oversight. The central government can in turn more easily hold local governments and school leaders accountable for their actions. Second, the government is likely to have greater success mobilizing funds from the private and philanthropic sectors if donors have more confidence that their contributions will be spent effectively.

2. *Revolutionize higher education.* The crisis in higher education is a fundamental barrier to Vietnam's continued growth and must be dealt with vigorously. In fact, the Vietnamese government knows how to respond. Decision 14, calling for a "comprehensive reform" of higher education, embraces the key reforms needed to breathe life into the system. However, the pace of implementation has been plodding. *These reforms must be implemented with great urgency; if not, Vietnam will find it difficult to attain the level of development enjoyed even by Southeast Asian countries.*

   Without improved higher education outcomes, Vietnam will be unable to reap the full benefits of foreign investment. Vietnam has succeeded in attracting a number of significant high-tech investments from global leaders including Intel, Canon, Nidec, and Foxconn. This is a golden opportunity to begin the transition out of low-value added products, but seizing the opportunity requires training knowledge workers in sufficient numbers to staff these investments and private supplier firms. If it fails to implement such steps, it could find itself like Malaysia – losing out to nations with more skills and lower costs. Already, fast-rising wages, shortages, and frequent job hopping are raising caution flags for future investors.

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[79] See Vo Nguyen Giap, "Assessing the PMU 18 case and the report for the Tenth Congress." Available at http://www.tuoitre.com.vn/Tianyon/Index.aspx?ArticleID=132423&ChannelID=3. See also Hoang Tuy, "New year, old story."

[80] See "Violations found at every agency." Available at http://www.tuoitre.com.vn/Tianyon/Index.aspx?ArticleID=226258&ChannelID=3.

2. Infrastructure and Urbanization

1. *Address Vietnam's energy shortage.* Ensuring that current electricity shortages do not get worse requires several urgent actions. First, there must be increased investment in non-hydroelectric power generation and improved distribution systems. EVN cannot be allowed to spend its scarce financial and human capital on speculative, non-core businesses like telecommunications and real estate (see recommendation 3.1 below). Second, private and foreign investment should also be encouraged, but doing so will require imposing a more transparent and effective regulatory environment that provides the necessary incentives and assurances that investors demand.

2. *Create an independent national project appraisal board.* Vietnam is wasting huge amounts of capital on inefficient public investment schemes. One reason why these schemes persist is that there is no truly independent review process and the agencies involved in making public investment decisions, including provincial governments and line ministries, almost always have vested interests in implementing a given project. As a result the Vietnamese leadership cannot be confident in the accuracy of the rationales provided to them in support of particular projects. The government should establish a special commission, accountable to the Prime Minister that is responsible for conducting a thorough and objective review of public investments above a certain value. The board's findings should be made public.

3. *Enact a buildings and property tax.* A tax on buildings and property is a necessary, although in itself not sufficient, response to the land situation. This tax must be progressive and significant enough to deter speculation and ensure that those who possess land use it productively. The argument that a land tax will impose a significant burden on the poor is not valid; the tax can be structured so as to ensure that the poor are not hurt. It must be rigorously enforced. It is likely that to be enforceable, the tax must be collected and retained by the local government. This will provide an incentive to local government to collect the tax and will provide localities with much-needed revenue free from interference from the central government. A capital gains tax is unlikely to curb speculation; indeed, in the absence of other attractive investments, it may create an incentive for speculators to hold on to their property. Only an annually assessed tax is likely to rationalize land markets.

4. *Adopt transparent land regulations.* Today the Vietnamese real estate market is regarded as among the least transparent in the world. The press has documented numerous examples of well-connected firms acquiring extremely valuable land at extremely low price from local government. The "asking and giving" mechanism must be dismantled, with land use rights awarded through a process of public bidding. The current discrepancy between the price of land set by the state and the market price is currently a source of corruption and must be abolished.

5. *Invest in cities.* Will Ho Chi Minh City be the next Manila, or the next Seoul? Certainly if current trends persist Vietnam's largest city is likely to suffer ills similar to those which have afflicted the other major urban areas of Southeast Asia. To avoid this fate, the Vietnamese government must permit Ho Chi Minh City to run its affairs like other modern cities, with power centralized in the hands of a powerful executive who can make decisions and be held accountable for them. Vietnam must also acknowledge that the continued stable and sustainable development of the southeast focal economic zone is not a regional concern but a national one, by allocating resources it needs, if used efficiently, to provide the people living there (who come from across the country) with the essentials of a fulfilling life.

3. Firm Competitiveness

1. *Disband the General Corporations.* The CGs were set up to achieve economies of scale and to reduce political control over state-owned enterprises. But they have failed to achieve these objectives. They continue to exist as loose collections of under-scale enterprises using outdated technology and oriented chiefly to the domestic market. Real reform will only come when these firms bring in new, entrepreneurial managers, when mergers and acquisitions are carried out on a commercial basis and when procedures are in place for orderly closures of uncompetitive firms. This will not be possible under the GC system, which leaves too much power in the hands of bureaucrats.

2. *Support the private sector.* This paper has demonstrated that although the Vietnamese government frequently voices its commitment to supporting the private sector, in fact the state sector continues to receive many advantages, including privileged access to land, and capital while the private sector continues to suffer from the harassment of government officials, especially in the area of taxation and customs. The Vietnamese government must redress these inequities by ensuring that resources are distributed to those who can use them most efficiently. All firms, public and private, large and small, must be required to publish annual accounts audited by independent and reputable accounting firms, and these accounts must be made available to the general public.

3. *Establish a National Innovation System.* High-tech parks and good universities are components of a national innovation system, but in themselves they are not enough. Vietnam should immediately establish a National Innovation Council consisting of national and international scholars, business leaders and government offficals (active and retired) to develop a national innovation plan and to begin its implementation.

4. Financial System

1. *Reduce inflation.* The implication of the analysis in this section is that inflation in Vietnam is a problem of the government's own making, being largely the result of poor macroeconomic management and inefficient investment decisions. The government must controlling inflation by regaining its grip on macroeconomic policy. Formulating policies appropriate for a complex economy requires a cohort of expert technocrats. Bluntly put, it is not clear if such a cohort currently exists within the government agencies tasked with formulating macroeconomic policy. If they do exist, their message seems not to be heard.

   Inflation is an economic and a political challenge. Like all governments, to a significant degree the Vietnamese government's popularity and legitimacy in the eyes of the people is determined by its ability to deliver rising prosperity and a stable macroeconomic environment. Persistence or worsening of the current situation is sure to drive popular dissatisfaction to higher levels.

2. *Transform SBV into a genuine central bank.* Vietnam has made progress in banking sector reform, but these gains are threatened by the absence of a genuine central bank with the authority and capacity to regulate and supervise the banking system, and the monetary instruments appropriate to a complex market economy. Lack of regulatory clarity and adequate enforcement of the rules under the present structure imposes unacceptable financial risks on the economy as a whole. SBV also lacks the instruments needed to intervene effectively in the money markets to achieve macroeconomic stability.

5. State Effectiveness

1. *Eliminate delusional policies.* Policy decisions in East Asia are informed by a sophisticated understanding of real social, economic and political conditions. One indication that Vietnam lacks this capacity is the worrying frequency with which Vietnamese policymakers attempt to address problems through "delusional policies." A delusional policy is one that exists on paper but has little or no positive impact or any realistic chance of becoming competitive. Delusional policies may fail because they are unfunded, infeasible, or simply wrongheaded. The policy of providing universal healthcare to children under six years of age is one example of a delusional policy. Although it is admirable in theory, the state has not provided sufficient funds to make it feasible. As a result, parents still have to pay extra fees at the hospital or clinic if they wish to receive timely and attentive care. Voluntary pension programs for rural dwellers are another delusional policy.

2. *Enhance technocratic competence.* The government must develop an elite cohort of policymakers and analysts by abandoning the existing personnel system in favor of one that is rigorously merit-based.

3. *Demand critical debate and analysis within government.* Vietnam's leaders cannot make correct decisions on policy matters unless they are provided with a comprehensive, objective analysis of the situation and possible responses. This kind of analysis can only emerge from constructively critical debate. Therefore, the government must actively encourage constructive criticism, and the sharing of alternative viewpoints.

4. *Promote external oversight.* The government will only realize its goal of promoting greater accountability within the system and of fighting corruption if the press is accorded greater space to engage in critical analysis of government policies and government officials.

5. *Hold donors accountable.* Vietnam's international development partners should be encouraged to play a more constructive role in the policy debate. As the largest multilateral donor, the World Bank has a particular responsibility to stop serving as an enabler of and apologist for delusional policies. The donor community is deeply complicit in the erosion of Vietnam's policy analysis capacity over the past decade. Foreign aid has created an environment in which research institutes adopt donor priorities as their own and securing the next project takes priority over crafting policy relevant analysis and recommendations for the government.

6. *Adopt an aggressively reform-oriented socioeconomic strategy for 2011-2020.* The Vietnamese government is preparing its next ten year socioeconomic strategy. A successful strategy must be laser-focused on adopting an East Asian development path. By doing what should and must be done to sustain growth and a degree of equity, the state will succeed in making Vietnam more "East Asian" and less "Southeast Asian". The needed changes are possible and within the grasp of the government, but change will not be easy. However, if the current opportunities are used to excuse inaction and drift, the future may hold fewer opportunities and a much less attractive society than the one that most in Vietnam now hope for and expect.

6. Equity

1. *Improve educational quality:* The failure of Vietnamese higher education (and even secondary education) is "solved" by sending the lucky few who can afford it, or get state support, overseas. But this is not a strategy for a country approaching 90 million people. For equity and for tapping its best talent, better domestic educational opportunities are needed.

While enrollments have grown hugely, this has often been at the expense of quality. Since the next cohorts of young people are not increasing in size, there is now a chance to improve quality. This will allow more ordinary young people to compete with the very limited number of overseas-trained workers, who get high salaries due to their scarcity.

2. *Improve health care:* Vietnamese people depend more on out of pocket payments for health care than any other large country in Asia. The entire health system has been subject to de facto privatization, under which practitioners make their living by prescribing unnecessary drugs and even surgery to their unwitting patients. Health care costs of family members and lost wages due to poor health are now the single largest causes of households falling back into poverty. "Voluntary" health insurance is neither fiscally sustainable nor attractive to the uninsured. The government must assign top priority to adequately staffing and financing local health centers for the provision of primary care. Hospitals and clinics must be monitored and regulated by a combination of government and professional associations. High standards of care upheld.

3. *Improve access to affordable housing in urban areas:* A solution must be found to the absurdly high prices of land and the growing congestion of cities. If urban migrants crowd into slums that are flooded, fetid and polluted, they will be sick and angry. Since almost all population growth will be in or near cities, equity demands that these people find opportunities to create a decent life.

4. *Subsidize retraining:* When workers lose their jobs through no fault of their own, but due to fluctuations in demand, the availability of retraining will help them adjust more quickly. By working with growing industries, workers with obsolete skills can shift to sectors where they are needed. This will act as a safety net to reduce the costs of unemployment. It will also give those with only a middle school education another chance to acquire skills.

5. *Continue to upgrade rural infrastructure:* Numerous studies have shown that the employment elasticity of the agriculture sector is closely associated with the coverage and quality of irrigation systems. Yet irrigation systems in Vietnam are in disrepair due to underspending on maintenance and repairs. While farm sizes will have to grow as marginal farmers leave for nonfarm jobs, the viability of the rural economy will depend on a better network of roads and services being developed. The rural economy will continue to hold many if not most Vietnamese for some time, and it must be given the infrastructure it needs to raise output and the value of its products. These upgrades do not include an industrial park or port in every province, but the transport, communications, storage and post-harvest processing capability to connect the rural areas with larger markets.

By giving all Vietnamese the public goods that only the state can provide, many more will find it possible to improve their skills and incomes without extra payments. There will always be some who are old, sick, disabled, in remote areas or isolated minorities who will need special attention. However, the overwhelming majority will benefit from these general steps suggested here.

Appendix 1. **Understanding Inflation**

When prices of food or fuel go up a lot, sometimes all prices also rise a lot. This leads many to think that rising prices of a particular good or group of goods causes inflation. Inflation is a sustained and general rise in the price of most goods and services. However, economists believe that inflation is caused by "too much money chasing too few goods." That is, if money supply grows a lot faster than real supply, then prices will rise. (Real supply is basically real GDP, with the trade deficit added in.) So, if real output can grow 10 percent a year and money supply rises by 15 percent a year, we would expect inflation to be about 5 percent a year. This is not an exact relationship, because the demand for money can change. If people want to hold more money per unit of income or spending, it is possible to have money supply grow faster than real output (or supply) without so much inflation.

The basic equation that captures this relationship is**: MV = PQ**. In that equation, M is the supply or demand for money. V is the velocity or rate of money turnover – how many times a year money is spent. P is the price level and Q is the quantity or real supply of goods and services. If V is constant, as it often is in the short term, then increases in M must show up either in more Q or more P.

From end of year 2004 to year-end 2006, money supply in Vietnam grew about 80 percent while real output grew only 17 percent[81]. If velocity were stable, prices should have risen by over 50 percent, but measured inflation was only 16 percent. Why such a big difference? There are several possibilities. One is that there was a huge increase in the desire of Vietnamese to hold cash or bank accounts for each unit of spending or production – that is, velocity declined a lot. This is not likely to be the case, because the interest rate, when adjusted even for measured inflation, was zero. If you get no return, or even a negative return in real terms, from holding money, it is not likely that you will want to hold a lot more of it.

Another possibility is that the price increase was higher than officially measured. This is possible. Many things are not in the price index but are part of spending. However, it would be unusual for inflation to be "off" by 100 percent or more, as is suggested by the difference. Official measures have inflation at 8 percent a year, while money supply growth is 32 percent a year and real supply growth is 8-9 percent a year. This implies an expected inflation from the equation of over 20 percent a year. Even a bad price index should be closer to reality.

A third possibility is that the excess money was used to bid up asset prices such as land and stocks as well as things not in the price index. (Tuition payments to teachers for special classes or side payments to doctors are examples.) With large increases in these prices, this is a distinct possibility. If asset prices get much more expensive than is reasonable, there is often a painful period of readjustment when they fall sharply or stay level for an extended period. This can lead to an economic slowdown and bad loans.

But why does real output rise by only 8-9 percent when demand is rising by more? One possibility is that some skills take time to learn, and some factories take time to build. So, rising demand cannot immediately be satisfied with increased output. But this "extra demand" should show up in increased imports. While imports have been rising (35 percent in real terms from 2004 to 2006), they have actually grown less rapidly than real exports. This suggests that a lot of the money supply growth is not going to buy capital equipment or even intermediate or consumer goods, but for asset accumulation. After all, if the official inflation data are correct, real money supply has grown by about 50 percent, much more than the real import growth.

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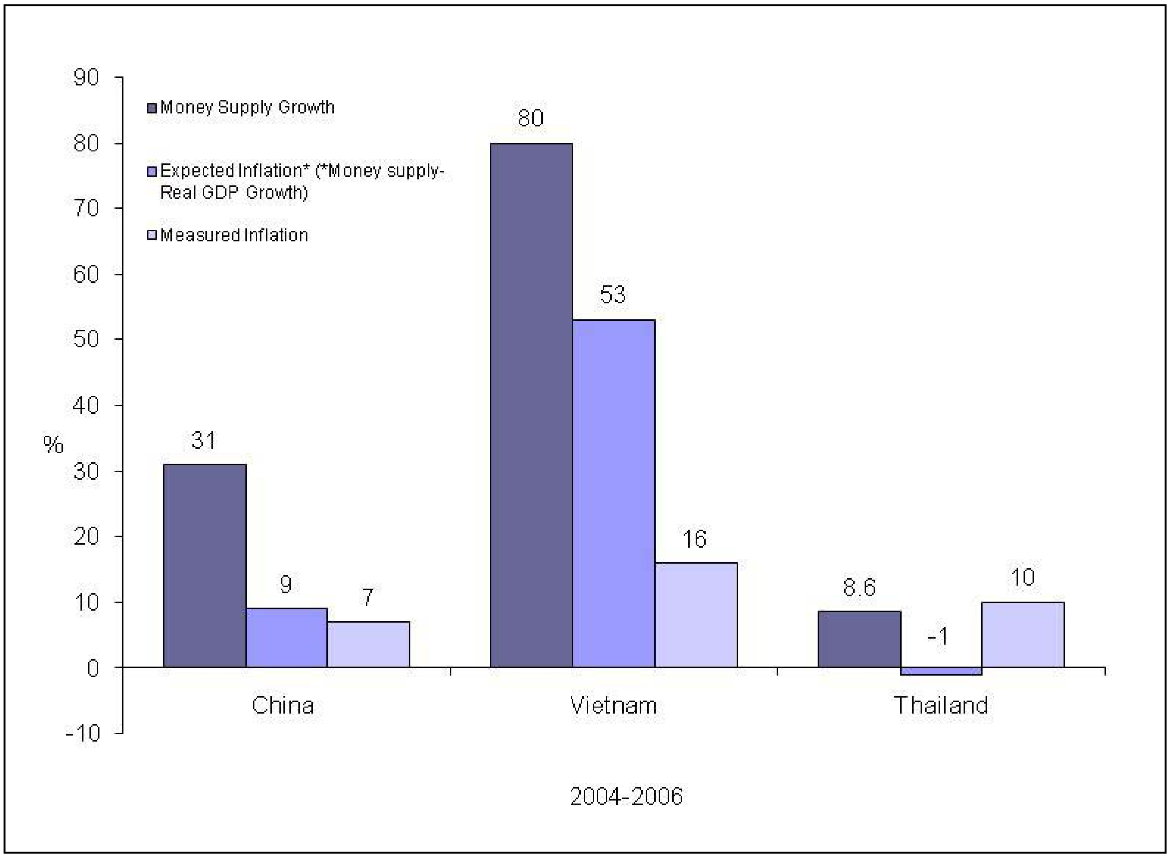
[81] M1, which includes cash and checking accounts grew by 79.5 percent while M2 which includes time and savings deposits as well as M1, grew by 73 percent in the two year period of 12/04-12/06. Real GDP growth was 17.3 percent in the same period, while the trade deficit actually shrank slightly. The ADB *Key Indicators 2007* is the source of all of this data. It is available at http://www.adb.org.

The implication is that much of the investment is not immediately productive. A lot of the money supply increase is used for large public investment projects. (Private loans tend to be for working capital or to have fairly quick payback.) The public projects are often chosen more for political or administrative than economic reasons. One way to avoid excessive increases in money supply is to be more selective with public investment. There would be less waste, less debt and less distortions that later cause pain. This is the key to slowing inflation in Vietnam. Administrative measures to control prices are not a fundamental solution, nor are fiscal measures such as cutting taxes.

Figure 12. Measured and expected inflation



It is interesting to note that in China, the expected and actual inflation levels were very close. In Thailand, the money supply and real GDP grew by about the same amount, but political uncertainties led to an inflation rate of about 5 percent a year as people decided to hold less local currency (Baht) per unit of output. In these cases, the MV=PQ equation worked quite well. It is not likely that it will be irrelevant to Vietnam over time, and sustained increases in money supply well in excess of real output growth will result in high levels of inflation or "bubbles" in asset prices that will be painful when they pop.