JAPAN INTERNATIONAL
COOPERATION AGENCY

MINISTRY OF PLANNING AND INVESTMENT
THE SOCIALIST REPUBLIC OF VIET NAM

THE ECONOMIC DEVELOPMENT POLICY IN THE TRANSITION TOWARD A MARKET-ORIENTED ECONOMY IN THE SOCIALIST REPUBLIC OF VIET NAM

FINAL REPORT

SUMMARY

June 1996

DAIWA INSTITUTE OF RESEARCH LTD.
THE JAPAN ECONOMIC RESEARCH INSTITUTE
PACIFIC CONSULTANTS INTERNATIONAL CO. LTD.

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CURRENCY EQUIVALENTS

March 1996	Currency Equivalent
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	102.88 円 / USD 1.00

Preface

In response to a request from the Government of the Socialist Republic of Viet Nam, the Government of Japan decided to conduct the study of the Economic Development Policy in the Transition Toward a Market-Oriented Economy in the Socialist Republic of Viet Nam and entrusted the study to the Japan International Cooperation Agency (JICA).

JICA sent to the Socialist Republic of Viet Nam a study team headed by Mr. Hirohiko Sekiya, composed of members of Daiwa Institute of Research Ltd., the Japan Economic Research Institute and Pacific Consultants International Co.Ltd., from December 1995 to March 1996.

The team held discussions with the officials concerned of the Government of Viet Nam and conducted field surveys in the study area. After the team returned to Japan, further studies were made and the present report was prepared.

I hope that this report will contribute to the promotion of socio-economic development of Viet Nam through the successful introduction of market mechanisms and to the enhancement of friendly relations between our two countries.

I wish to express my sincere appreciation to the officials concerned of the Government of Viet Nam for their close cooperation extended to the team.

June 1996

Kimio Fujita
President
Japan International Cooperation Agency

Letter of Transmittal

June 1996

Mr. Kimio Fujita
President
Japan International Cooperation Agency

Dear Mr. Fujita,

It is my great pleasure to submit herewith the Final Report for the Development Study on the Economic Development Policy in the Transition Toward a Market-Oriented Economy in the Socialist Republic of Viet Nam ("the Study").

The report is the result of studies carried out by Daiwa Institute of Research, the Japan Economic Research Institute and Pacific Consultants International as per the contract with the Japan International Cooperation Agency (JICA). The Study was conducted between December 1995 and June 1996.

Based on the actual socio-economic situation in Viet Nam, a comprehensive development study was implemented covering four areas: the macroeconomy, fiscal and monetary policies, industrial policy and agricultural and rural development.

On behalf of the study team, let me express my heartfelt thanks to the Government of Viet Nam especially the Ministry of Planning and Investment for the generous cooperation, assistance and warm hospitality extended to them during their stay in Viet Nam.

Our thanks are also due to the Japanese International Cooperation Agency, the Ministry of Foreign Affairs, the Japanese Embassy in Viet Nam and the JICA Vietnamese Office for their valuable advice and support during the Study and preparation of this report.

Yours faithfully,

関屋宏彦

Hirohiko Sekiya
Leader of the Japanese Study Team
(Senior Consultant,
Daiwa Institute of Research Ltd.)

Abbreviation

AFTA	ASEAN Free Trade Area
APEC	Asia-Pacific Economic Cooperation
ASEAN	Association of Southeast Asian Nations
BIDV	The Bank for Investment and Development in Viet Nam
CMEA	Council for Mutual Economic Assistance
CPI	Consumer Price Index
DOSTE	Department of Science, Technology and Environment
EIA	Environment Impact Assessment
FDI	Foreign Direct Investment
GSO	General Statistic Office
ICOR	Incremental Capital Output Ratio
IMF	International Monetary Fund
ILO	International Labor Organization
MOF	Ministry of Finance
MOSTE	Ministry of Science, Technology and Environment
MPI	Ministry of Planning and Investment
MPS	Material Product System
ODA	Official Development Assistance
RCA	Revealed Comparative Advantage
SBV	State Bank of Viet Nam
SMEs	Small and Medium Enterprises
SNA	System of National Accounts
SOEs	State Owned Enterprises
TBI	Two-tier Banking Index
UN	United Nations
VAT	Value Added Tax
WTO	World Trading Organization

Table of Contents

1. Introduction

This is a summary of the final report on the study on the Economic Development Policy in the Transition toward a Market-Oriented Economy in the Socialist Republic of Viet Nam (hereinafter referred to as the "Study".)

1-1 Background of the Study

The Vietnamese economy has made remarkable progress since the start of the Doi Moi (renovation) policy declared at the Sixth Party Congress in December 1986. The Government of Viet Nam has successfully introduced a wide range of market mechanisms in the context of "a market economy under State management" in the last ten years.

In the last five years (1991 to 1995) since the Seventh Party Congress held in June 1991, Viet Nam has been accelerating the pace of socio-economic development, and for the first time exceeds many key target figures of the five year plan.

The Vietnamese economy, however, is still in a process of transition and has many difficulties to overcome in order to promote further "industrialization and modernization" and prepare for long-term sustainable growth under the new framework of a global and regional economy.

1-2 Outline of the Study

(1) Objectives

The Study intends to present our research and recommendations on the main issues concerned with the Five-year Socio-Economic Development Plan of Viet Nam for 1996-2000 based on an analysis of the current situation and existing development policies in order to achieve long-term sustainable economic development of the country.

(2) Components and Scope of Work

The Study covers the following four areas:

1) Macro Economy
2) Fiscal and Monetary Policies
3) Industrial Policy
4) Agricultural and Rural Development

In each area, the Study has put special focus on the key issues agreed upon in the December 1, 1995 Meeting on the Research Plan for the Study between Prof. Shigeru Ishikawa, Chairman of the Japanese Research Group and Mr. Nguyen Thai Nguyen, Head of the Vietnamese Delegation for the study. The agreement is based on the Scope of Work for the Study signed on August 28, 1995 between Councilor Mr. Hattori of Japan's Ministry of Foreign Affairs and Vice Minister Mr. Vo Hong Phuc of Viet Nam's Ministry of Planning and Investment.

(3) Organization of the Study

In order to implement the Study effectively, a Japanese Research Group, headed by Prof. Ishikawa, composed of academicians and experts from the Ministry of Finance, the Ministry of Trade and Industry and the Japan International Cooperation Association, was organized in July 1995.

A Japanese Consultant Group was nominated in December 1995 as a part of the Research Group under the program of social development studies of JICA.

At the same time, it was agreed that the Study was to be conducted as joint research between Japan and Viet Nam on August 1995. A Vietnamese project team, composed of four study groups, was also formed headed by Dr. Nguyen Quang Thai, Deputy President of the Development Strategy Institute of Ministry of Planning and Investment. The Research Groups of the two sides have been in close communication during the course of the Study. Meanwhile, workshops were held in Tokyo (January) and Hanoi (March) after the completion of Interim Report and Draft Final Report of the Study, respectively. The workshops provided the opportunity to exchange opinions among those concerned.

1-3 Viewpoint

Our viewpoint on the Study is mainly based on the preceding JICA research, "Country Study for Japan's Official Development Assistance to the Socialist Republic of Viet Nam."

Firstly, while Viet Nam is an economy in transition, it is also a low-income developing country with underdeveloped market mechanisms.

Therefore, secondary, we put emphasis on long-term development including cultivation of market driven economic activity, in addition to macroeconomic stabilization and structural adjustment.

Thirdly, we emphasize a firm commitment to renovation of the real economy as well as the monetary economy in connection with long-term development in a low-income developing economy. For example, we attach great importance to agricultural and rural development because breakthroughs in productivity in the agricultural sector (which employs 80 per cent of total population) is a pre-condition for sustainable growth of Viet Nam without relying heavily on external debt.

Fourthly, we attach importance to long-term sustainable growth with proper consideration of the balance between economic growth and stability or economic development and social development such as improving environmental problems and income inequality issues.

2. Conclusions

2-1 Macroeconomy

Viet Nam's recent macroeconomic performance has been impressive. This is attributable to appropriate government policies as well as favorable circumstances. A reasonably successful reduction of the rate of inflation seems to be due largely to a reduction of the fiscal deficit and the termination of its central bank financing.

Based on our simulations, with the use of data consistent with the proposed five-year plan, the following can be regarded as important for the balance between growth and stability: the maintenance of high investment efficiency, a raising of domestic savings, attraction of direct investment, an appropriate money supply policy, and a flexible fiscal policy.

The foreign exchange rate policy, which is implicitly assumed in the proposed plan, seems to be generally reasonable. There are views that the assumed rate of depreciation of the dong may be too low in view of the still relatively high rate of inflation in Viet Nam. However, the government needs to consider many other factors including money supply and price stability as well.

As Viet Nam makes the transition to a market economy, its statistical system is also in the transition, e.g. National Accounts from MPS to SNA. There remain many problems in the system, for example: the discontinuity of time series data mainly due to changes in methodology; insufficient coverage such as non-state sector and underground economy and incomplete classification of sectors, commodities etc. The system should be changed in accordance with international standards.

To maintain stable growth from the long-run point of view, it is important for Viet Nam to deal with issues related to the environment at an early stage. The sooner Viet Nam deals with them, the lower the associated cost is likely to be.

The poverty situation in Viet Nam is widespread and more serious than in other Asian countries. Higher poverty incidence is recognized particularly in rural areas, ethnic minorities, and female headed families. There are indications that the recent economic reforms, while provided vast economic opportunities, had adverse effects on the poor. The following policy implications are presented for effective poverty alleviation: (1) need for rapid and broad-based economic growth; (2) need for targeted interventions; and (3) need for social welfare programs and provision of a social safety net for the rural poor.

2-2 Fiscal and Monetary Policies

Viet Nam needs substantial amounts of investment and development funds to industrialize and modernize its economy. The capital accumulation mechanism has shifted from physical planning to fiscal and monetary measures with the adoption of a market economy mechanism. The present capital formation is implemented in a two-tier system of public investment and private investment (including commercially viable investment by state-owned enterprises). Public investment funds are expected to be raised relatively smoothly, however the funds system for private investment has not developed fully nor functioned properly.

Tax and fee revenue, the major source of public investment funds, has grown to 24% of GDP in 1994, which is above the target figure in the 5-year plan for 1996-2000. Thus the issue now is to structurally reform the tax system to secure tax revenues in the long-term rather than to increase the tax amount per se. It is imperative to reduce the heavy tax burden on the business sector, which is due mainly to turnover tax and has discouraged business expansion through investment. Then the government has to develop special consumption tax and personal income tax as new sources. These will be needed to compensate the tariff rate reduction that is required for AFTA participation.

As to the relationship between central and local government, both wealthy and poor districts have little incentive to raise taxes because of the current fiscal system in which local revenue increase is not tied with local expenditure increase. Therefore local governments do not raise the tax revenue that could be raised with proper incentive. It is important to give local governments this incentive by clarifying the rules for sharing tax revenue between the central and local government.

Medium- to long-term funds are indispensable for developing industries with international competitive advantages. Not only is there a demand for investment funds to build plants and purchase machinery but also for long-term working capital needs in emerging labor-intensive manufacturing industries such as textiles and footwear. Foreign companies also have demand for domestic currency funds as a hedge against exchange rate risk. The ratio of domestic credit outstanding to GDP shows the extremely low level of financial intermediation in Viet Nam. The need to establish a direct finance market is understandable, but accounting, audit and related legal systems have just started to be developed in Viet Nam. The priority at present must be given to developing the functions of the indirect finance market, the banking system.

Bank deposits are increasing. However depositors are only those who seek high interest rates. Banks are not willing to accept deposits at such high interest rates because they cannot find enough borrowers to compensate these rates. The majority of the public still do not trust the banking system. There is still a large fear of inflation and in 1990 many credit unions went bankrupt. In order to regain the public trust, improved banking services and macroeconomic stability are indispensable. Banks must provide basic services such as the opening of deposit accounts without delay, the withdrawal of deposits with neither inquiries nor delay and the observance of client privacy.

Bank credits for the private sector are increasing, but they are mostly in the short term and with high interest rates. Banks must analyze the credit standing of the clients' business instead of relying on collateral lending. Financial institutions for medium- and long-term funds, needed for industrial growth, have not been developed. Banks must acquire credit analysis ability in order to provide medium- and long-term funds for investment projects. However, it is neither plausible nor economically efficient for every financial institution to attain this ability. Accordingly a special financial institution for medium- and long-term funds may need to be established.

Foreign savings complement the scarcity of domestic savings. FDI on a contract base has grown to the level equivalent with GDP, and FDI is expected to keep growing. FDI is by nature, cost sensitive and volatile. It must be noted that there would be FDI flight if domestic reform began to be neglected.

The Vietnamese government is conscious about the possibility that the high dong, caused by the foreign currency inflow accompanying FDI, could hinder export competitiveness and accordingly enlarge the trade deficit. It is probable that the dong's real effective exchange rate, which is the weighted average of currencies of all trading partners by trade volume, has not appreciated as much as its exchange rate against the dollar. Gradual appreciation of the real effective exchange rate would promote not only rationalization of export industries but also conversion of domestic dollars into dong. Dollar purchasing operations to prevent excessive appreciation is proper policy but the dong must be sterilized.

2-3 Industrial Policy

Viet Nam's most promising path toward more developed industrial mix is to fully pursue the potential of labor intensive industries, both simple and high-tech. This is based on the experiences of other Asian countries, current international environment (availability of FDI and high-tech machines), views of foreign investors, and Vietnamese advantage in human resources.

Viet Nam will eventually need domestic heavy and chemical industries, but the feasibility and timing of each project must be carefully examined. In addition to the requirement of huge initial capital for investment, the price of their products fluctuates by international supply and demand, and can be lower than the production cost. Further, small difference of production cost can divide the winner and the loser. There are cases of trouble in ASEAN countries.

Foreign Direct Investment (FDI) is the key to industrialization. Streamlined policies and a standard set of procedures on FDI must be established, be administratively implemented, and be widely known inside and outside to secure consistency and reliability. FDI can even provide the opportunity to reform state-owned enterprises.

Small and medium enterprises, and rural industries are important for balanced regional development, but they face various difficulties. The first step for the Government is to create consensus for their promotion with active policies of assistance and to put some institution in charge of all the administrative affairs on them to secure an effective administration.

Viet Nam should strive to maximize the benefits of participation in AFTA, then in APEC, and eventually in WTO. Viet Nam still have some flexibility regarding the timing, speed, and content of measures in the arena of trade and investment deregulation. The prime expectation by others to Viet Nam is that Viet Nam demonstrates a long-term commitment to the liberalization process.

2-4 Agricultural and Rural Development

Vietnamese agriculture has undergone various changes owing to the evolution of the political and economic environments. The Doi Moi policy and the subsequent renovation process aimed at transforming the economic system from a planned to a market-oriented economy. The economic incentives farmers gained through the renovation process have enhanced agricultural production. In fact, during the five years from 1991 to 1995, gross domestic product in the agricultural sector achieved average annual growth of 4.5%.

Rice production in paddy equivalent has increased from 19.2 million tons in 1990 to 24 million tons in 1994. This rapid growth has been achieved by an increase in the sown area and a shift in crop seasons from lower yielding winter paddy to higher yielding spring and autumn paddies, and to a lesser degree, the overall yield increase per unit of sown land. At the same time this increase should be regarded as the integrated result of the intensification process to which such factors as introduction of high yielding varieties, higher fertilizer application and more intensive pest/disease control contributed. Above all, the investment in irrigation and drainage was most instrumental to the production increase, since the spring and autumn paddies are grown during the dry season and thus require irrigation.

Equally important was the institutional framework established since the renovation. At the same time, however, there is a concern that these economic incentives offered to farmers may not be enduring.

Diversification of agriculture, together with intensification of production, are regarded as the strategic direction of the development of Vietnamese agriculture, since geographical expansion of agricultural land is limited. Agricultural diversification, supported by the changing pattern of food consumption and the brisk expansion of exports of some agricultural products, has been taking place both at the farm and national levels. At the national level, specified production zones of certain crops and livestock are being created. This Report reviews the markets of four exporting crops - coffee, rubber, tea and vegetables - and gives the respective market prospects and required action for promoting exports.

Following renovation, few agricultural cooperatives and production groups have successfully adapted to the new conditions and provided services to individual farm households. The roles and advantages of cooperatives in a market-oriented economy, in spite of the high expectations, are yet to be fully exploited.

The rural credit system was restructured and re-established in 1990. The current system in general is functioning well, and a few financing institutions are complementing each other. As a result, short-term loans are meeting a large part of the requirements, at least for the relatively better-off farmers.

Future sustainable development of Vietnamese agriculture should be achieved through intensification, diversification and strengthened economic incentives. Sustainable production calls for: (a) increased investment in agriculture centering on infrastructure such as irrigation, drainage, land consolidation, rural roads and rural electrification; (b) strengthening research and development for continuous technology improvements and breakthroughs; (c) further streamlining of institutional arrangements including, among others, extension of improved technologies, accelerated issuing of certificates of land tenure, and credit provision. To this end, discussions should be initiated regarding the extent and magnitude of investment in agriculture in order to secure a stable supply of food for the changing pattern of consumption and demand.

In view of the continuing importance of rice as a staple food, and in the farm and national economies, it may be opportune to review the policies and measures to stabilize rice prices, with reference to the experiences of other ASEAN countries in this area.

Regarding farmer organizations, the government already recognizes their importance in a market-oriented economy and the need of reconstruction of agricultural cooperatives. Although public support is necessary, at least at the inception stage of reconstruction, it must be carefully implemented lest it discourage the autonomy and initiatives of cooperatives and voluntary participation of rural people.

As the rural credit system has been re-established, and the current system is in general functioning well, the pending tasks are therefore to fill in the existing gaps and to rectify shortcomings such as the shortage of medium and long-term loans, coordination and merging between credit cooperatives and the People's Credit Funds, and improvement of lending conditions so as to enhance their accessibility by farmers, while maintaining the viability and sustainability of financing institutions.

Given that investment and other measures are effectively carried out, it will not be very difficult to achieve the targets for food production set in the next phase of five year plan 1996 - 2000. With the continuing fast growth of the economy, Vietnamese agriculture will face new issues and challenges and is expected to respond to them. The next five years will be crucial to build the base for the sustainable agricultural development beyond the year 2000.

3. Macroeconomy

3-1 Growth and Stability

(1) Macroeconomic Conditions

Viet Nam's recent macroeconomic performance is truly remarkable. The country's economic growth rate has averaged more than 8 percent over the past five years, and is estimated to have reached 9.5 percent in 1995, in spite of the diverse difficulties that have accompanied the transition to a market economy. Inflation, which briefly reached triple digits in the latter half of the 1980s, has remained generally tame since 1992. Viet Nam's trade and current account deficits, however, have substantially expanded since 1993, and last year the current account deficit is estimated to have reached 8.0 percent of the country's GDP. Nevertheless, the country's net capital inflows are more than adequate to cover this deficit, and for the past few years the dong's exchange rate has actually been experiencing upward pressure. Viet Nam's foreign exchange reserves have also been growing. In addition, it appears that U.S. dollars, which have been in plentiful supply and widely circulating in Viet Nam, are increasingly being converted to dong.

It is largely factors related to the country's resurgence that have made possible comparatively high economic growth in spite of low savings and investment rates. Incentives that had been suppressed under the old economic system were liberalized, use was made of excess production capacity, and investments were made in more needed areas. The result of this was greater investment efficiency. The collapse of the CMEA had a relatively weak impact because Viet Nam had a comparatively small volume of trade with the other member nations, the Vietnamese economy is fundamentally an agriculture-centered one, and Viet Nam was not highly integrated into its international division of production. The use of gold and dollars as mediums of exchange may have helped to stabilize the economy during this turbulent period. Now the country is about to be tested as to whether or not it can sustain high growth as it moves from a period of resurgence to one of rebuilding.

The most important factor behind the taming of inflation in Viet Nam was the termination, beginning in 1992, of the policy of monetizing the country's fiscal deficit (financing the deficit with central bank credit). This is a fundamental difference between Viet Nam, on the one hand, and Russia and the countries of Latin America, where rabid inflation went unchecked, on the other. The cessation of lending by the central bank to state enterprises also helped to tame inflation. These changes were made possible by the country's success in reducing its budget deficit. The budget deficit fell to 2.4 percent of GDP in 1994, in part because of increased government revenues from oil. Indeed, without oil revenues the budget deficit would have averaged 8.4 percent of GDP annually from 1989 to 1994, but with these revenues it was only 5.7 percent. Government borrowings from abroad averaged 1.6 percent of GDP over this same period, and this is thought to have also helped the country circumvent monetization of its deficit. These circumstances differ from those in Eastern Europe and Russia. There is no telling what the future may hold, however, as it is possible that monetization of the budget could be reinitiated if, for example, a raise in wages in the public sector were to cause the fiscal deficit to grow at a time when there were limitations on the issue of government bonds.

The collapse of the CMEA certainly had an impact on Vietnamese trade, but the country was successful in finding new trading partners in a short period of time and mitigating the negative impact. This success can be partly ascribed to the fact that the majority of Viet Nam's principal exports are primary products, such as crude oil, rice, and marine products, which it was able to sell with comparative ease on world markets. In addition, further progress in liberalization of the country's principal export markets, including Japan, over the same period also helped to boost Viet Nam's exports. With the dong's real exchange rate (the actual exchange rate adjusted for differing rates of inflation) rising against the dollar, however, attention will now turn to whether or not Viet Nam is able to maintain high growth in exports of higher value-added products.

Net capital inflows are rising, and they now surpass the current account deficit (the deficit on the trade account and the invisible trade account). Inflows in the form of direct investment are particularly large. The outstanding amount of direct investment in Viet Nam (on a contract basis) is reported to have reached $20 billion, nearly equivalent in size to the country's GDP. This is partly attributable to Vietnamese efforts to attract foreign capital and the Vietnamese economy's excellent performance. It is also attributable, moreover, to a boom of investing in developing countries among industrialized nations and some middle-income nations. The recommencement of official development assistance to Viet Nam by many countries has also contributed to the expansion of capital inflows. The rescheduling and reduction of past foreign debt, which have already been partially agreed to by the country's creditor nations, have made it easier for Viet Nam to finance the deficit in its international balance of payments. In order to achieve stable economic performance from here on, it is important that Viet Nam promote the mobilization of domestic savings and not rely too heavily on foreign savings.

A trend in conversion of dollars into dong can be inferred from the fact that dong currency and dong-based deposits have both been on the rise while dollar-based deposits have not risen at all since 1991. The fundamental factors behind this are high interest rates on dong deposits, real interest rates (nominal interest rates minus the expected rate of inflation) that are positive, and the stabilization of the dong's exchange rate against the dollar. As long as large amounts of gold and dollars are used as stores of value and mediums of exchange, it will be difficult for the central bank to control domestic liquidity and to mobilize domestic savings as investment capital. If the conversion of gold and dollars into dong is to be promoted, it will be necessary to maintain positive real interest rates and a stable exchange rate. Price stability is an important factor in the achievement of these goals.

(2) Examination of the Draft Five-year Plan[1]

1) Econometric Model of Viet Nam

The draft five-year plan covering the years from 1996 to 2000 calls for an average annual growth rate of 9 to 10 percent and an inflation rate (in consumer prices) of less than 10 percent. These macroeconomic targets are premised upon a variety of plans and assumptions. Seeking high growth through overly ambitious investment plans can send prices surging upward and adversely affect a country's balance of payments, thereby undermining the foundations for sustainable growth. On the other hand, however, excessively restrained economic plans can cause a country's economic growth potential to go unrealized.

Assuming that the plan's growth and inflation targets are appropriate, what conditions must be met in order to achieve those targets? And what effects would changes in these conditions have? By analyzing these effects it is possible to determine what is important in the effort to achieve stable growth. In the consideration of such questions it is often useful to construct an economic model expressed in mathematical formulas and examine the aptness of the figures in the model. At the same time, it is helpful to examine how a change in one variable (investment, for example) changes other variables (growth rate, inflation rate, balance of payments, etc.). Economic variables are inextricably interrelated, and an econometric model is useful in consistently assessing the changes variables have on each other.

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[1] This section is jointly written by Prof. Watanabe, a member of the academic group and Mr. Minami, a member of consultant group.

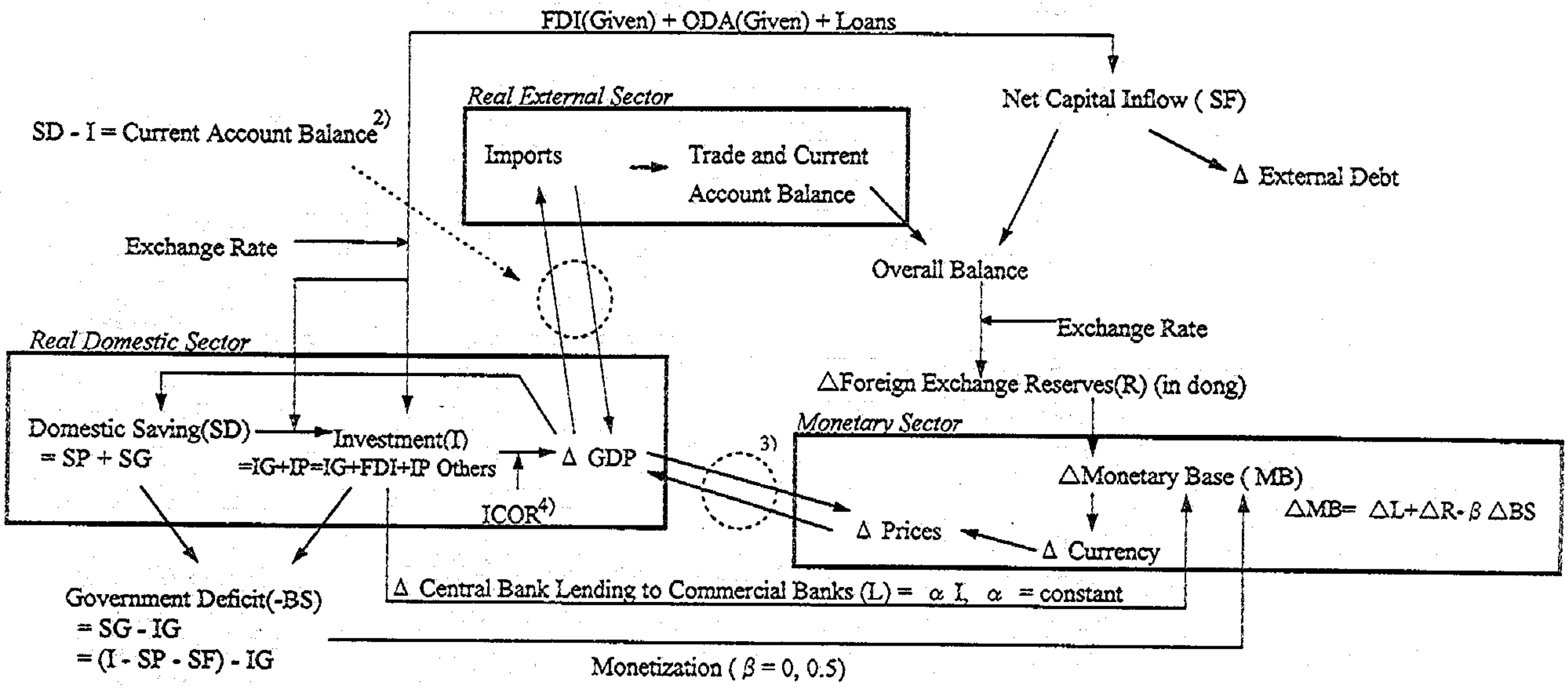
In Viet Nam's case, however, there are major limitations on the construction of such a model. Specifically, Viet Nam's economic system is in the midst of substantial change, which presents the following problems: economic data relevant to a market economy are lacking; what data are available are not very reliable because they are changing in both content and meaning (several different figures often exist for one variable); and, the relationships among economic variables are not necessarily stable. For these reasons, we had to be satisfied with constructing a simple model.

We constructed a simple macroeconometric model in order to assess the appropriateness of the goals of the new five-year plan. The basic assumptions of this model were that gross domestic products (GDP) are determined by investment and the incremental capital output ratio, and that investment not covered by domestic savings and foreign direct investment (FDI) or official development assistance (ODA) is borrowed from other countries. Initially, we considered the balance between economic growth, fiscal balance, and the international balance of payments by examining the relationship between investment and savings using a real model without introducing monetary sector, a model assuming the rate of price increase as constant.

We then incorporated into the model a real import function and a real currency balance function derived through an assumption that the import volume and the real currency balance (currency outstanding divided by the price level) are determined by real GDP. We further postulated that increases in the monetary base (currency plus bank reserves) occur in three ways: increases in foreign exchange reserves, financing of the fiscal deficit by the central bank (monetization of the deficit), and supply of credit by the central bank to commercial banks. Also, we assumed a fixed ratio of currency to bank reserves. In this way, we expanded the model to include the monetary sector. With this model, which includes the monetary sector, it is possible to observe what impact changing various assumptions has on the rate of inflation.

Further, in order to maintain consistency among macroeconomic variables, we adjusted for the difference between the domestic savings and investment balance (IS gap) and the (negative) current account balance (trade gap) by changing imports (or, more accurately, the constant in the import function). With regarded to the exchange rate, we considered two cases: one in which the dong's exchange rate against the dollar is lowered from 3 to 4 percent per annum and another in which the dong's real exchange rate against the dollar is maintained. (With regard to the structure of the model, see an attached figure "Macroeconometric Model of the Vietnamese Economy.")

Macroeconometric Model of the Vietnamese Economy [1)]



1) P stands for the private sector and G for the government. Δindicates changes.
2) Real imports or the import volume is considered to be determined by real GDP, but, in case of need, imports are further adjusted to make the domestic savings and investment balance and the current account balance equal.
3) Real currency balances (currency outstanding divided by the price level) are considered to be determined by real GDP. The price level and real GDP are determined so as to ensure both the equilibrium of the real sector and that of the monetary sector.
4) ICOR is the incremental capital output ratio which is defined as the ratio of an increase in real capital stock to an increase in real GDP. In actual calculation, real investment is used in place of the increase in real capital stock. The lower ICOR, the more efficient is investment.

2) Major Findings of the Simulation

In our simulations (using our model) we adopted the data and structural parameters (which express the relationships between economic variables) used in the draft five-year plan. There are some inconsistencies in the economic variables, but these are thought to be similar in nature to the inconsistencies that frequently appear in the formulation of economic plans by countries around the world. Namely, after targets have been set, diverse input from various quarters causes the targets to be modified, which results in inconsistencies in the interim. In our work, however, these types of inconsistencies were not regarded as significant problems insofar as our objective was to perform simulations to observe the relationship between high economic growth and economic stability. The following points outline the main findings of our simulation.

A. If investment, particularly private investment, continues to follow the recent high-growth trend and high investment efficiency is sustained, the economic growth rate may exceed the targeted range. At the same time, however, Viet Nam's international balance of payments situation may worsen and foreign debt rise. That is to say, if the given public investment plan is adopted, and private investment increases more than envisaged in the plan, the economic growth rate could exceed 10 percent. In this case, unless domestic savings rise considerably or foreign direct investment surpasses the plan's forecasts, borrowings from abroad will increase more than estimated in the plan and the country will take on considerable foreign debt. This, in turn, could become a constraint on future stable growth.

In the above case, if Viet Nam were unable to borrow more funds from abroad than envisaged in the plan, the growth rate could even fall below 9 percent during the five-year period covered by the plan.

If foreign debt mounts substantially or sufficient foreign borrowings cannot be secured, and private investment expands more than envisaged, measures might be needed to reduce fiscal spending, including a downward revision of public investment plans.

B. If investment or consumption expands more than envisaged in the plan, the inflation rate will be more likely to rise. If either investment increases or domestic savings decline (because of increased consumption), the domestic savings-investment balance will deteriorate. And, as a result, the fiscal deficit may grow. If the fiscal deficit is financed by the central bank, the rate of inflation could exceed 10 percent.

The inflation rate would also rise if foreign exchange reserves grow, for whatever reason, leading to an increase in the money supply. In this context, it is important whether or not the central bank intervenes in the foreign exchange market and takes sterilization measures (the central bank itself absorbs dong liquidity that had been supplied through central bank dollar-buying intervention).

C. The inflation rate is affected by many variables and economic policies. A high growth rate does not necessarily lead to a higher rate of inflation. In our examination, the factors seen as bringing about the highest inflation rate were an expansion of government consumption and a consequent financing of the fiscal deficit by the central bank. These factors were not seen as leading to a higher economic growth rate. In contrast, an increase in public investment produced a relatively low inflation rate and a high growth rate in the simulation.

D. The above simulation findings have several implications. The first one is the importance of sustaining high investment efficiency. To achieve this, technological levels must be heightened through direct investment and the introduction into Viet Nam of technology from abroad, and appropriate investments should be made possible through deregulation and financial system reform. The second implication is the importance of boosting domestic savings. This has the effect of reducing the country's dependence on foreign capital. The third implication is that although foreign borrowing is necessary as a last resort, direct investment is obviously more desirable than borrowing as a source of foreign capital. The fourth implication is that fiscal spending may need to be reduced in order to promote stable growth, and to this end it would be desirable for the government to examine spending priorities in advance. The fifth implication is that it is very important to maintain the recent central bank policy of not linking increases in the fiscal deficit and foreign exchange reserves with an excessive money supply. The sixth implication is that if fiscal spending is increased, growth in investment is preferable to growth in consumption expenditures in terms of both prices and economic growth.

(Box 3-1) **What is Wrong with Inflation?**

Inflation can produce an unfair distribution of income and wealth. People anticipate inflation, attempt to protect themselves from inflation, and try to gain from inflation, with the result being the waste of economic resources (human resources, goods, and capital). An important aspect of inflation is that it robs people of the hope that their lives will be enriched through steady work.

When the inflation rate is high, the forecasted range of future fluctuations in the rate widens, making it difficult for people and businesses to make future plans and diminishing their inclination to save and invest.

A high rate of inflation implants inflation expectations in people's minds, and people then try to adapt to continued inflation (for example, by raising wages and prices to match inflation). Thus, inflation expectations themselves beget inflation.

When inflation forecasts are not lowered, there is no decline in the retention of gold and dollars as mediums of saving and exchange, making it difficult to control domestic liquidity and mobilize investment capital.

It is difficult to lower interest rates when inflation is high, and high interest rates discourage investment, especially long-term investment. Lowering interest rates when inflation is high causes a decline in savings and a consequent decline in investment.

High inflation in Viet Nam brings with it expectations of a decline in the dong's exchange rate against the dollar, which impede the conversion of dollars into dong.

With the dong's exchange rate against the dollar stable as it has been recently, if Viet Nam's inflation rate were higher than that of other Asian countries, exporters would lose their price competitiveness. With one or two exceptions, other Asian countries have inflation rates of less than 10 percent.

(3) Exchange Rate Policy

Of chief importance to the question of whether or not Viet Nam will be able to sustain stable economic growth from here on is whether the government's investment plans or, more broadly speaking, its economic plans are appropriate or not. Along with this, monetary and fiscal policy will become increasingly important as the means of macroeconomic control. In this report, however, we are not dealing directly with Viet Nam's monetary and fiscal policy from that vantage point nor with the problem of creating an appropriate environment for formulating monetary and fiscal policy. Instead, we have taken up the single issue of exchange rate policy, which is, however, related to a wide range of other issues, including trade and capital balances, interest and money supply policies, and the handling of gold and dollar economies.

Capital inflows, mainly in the form of direct investment, have been on the rise in recent years. This, together with a shift from dollar to dong deposits within Viet Nam, has exerted upward pressure on the exchange rate. This situation is not unique to Viet Nam, but is one that has been experienced by many developing countries since the beginning of the decade.

1) Upward Pressure on Exchange Rate and its Policy

Reference to responses formulated by other Asian and Latin American countries that confronted similar upward pressure on their currency suggests that monetary authorities in

Viet Nam must consider the following factors in their consideration of exchange rate policy:(1) the size of foreign exchange reserves; (2) the degree of change in the dong's real, effective exchange rate; (3) a phasing out of gold and dollars as stores of value and mediums of exchange; (4) the need to use the exchange rate as a nominal anchor to promote price stability; (5) the relationship between exchange rate policy and interest rate policy; (6) the extent to which central bank intervention in the foreign exchange market or sterilization measures (the central bank itself absorbing dong liquidity that had been supplied through central bank dollar-buying intervention) can be implemented without causing difficult problems; (7) preparedness for taking stringent fiscal measures; (8) the feasibility of imposing capital inflow restrictions and liberalizing capital outflows; and, (9) the relationship between a fall in the dong's exchange rate and the country's foreign debt burden.

2) The Size of Foreign Exchange Reserves

The exchange rate of the dong comes under upward pressure when net capital inflows and the conversion of dollars into dong inside Viet Nam (both result in net dollar selling, dong buying) exceed the country's current account deficit (net dollar buying, dong selling). To suppress this upward pressure, Vietnamese monetary authorities have to intervene in the foreign exchange market and buy dollars, thereby boosting the country's foreign exchange reserves. Viet Nam's foreign exchange reserves are thought to be less than the IMF target of three months' worth of imports, and therefore a further increase in these reserves can be regarded as necessary and desirable. Doing so is also desirable as a buffer against a sudden decline in capital inflows.

3) The Degree of Change in the Dongs Real, Effective Exchange Rate

The dong's exchange rate against the dollar has been stable since 1992, but because inflation is higher in Viet Nam than in the United States its real exchange rate against the dollar has been rising. Similarly, the real exchange rates of many of Viet Nam's principal trading partners' currencies have also been trending upward against the dollar over the same period. Because of this, the dong's real, effective exchange rate - the weighted average of its real exchange rate against principal trading partners' currencies - has not risen as much as its real exchange rate has against the dollar. Still, there is no denying that it has risen, which brings with it concern of a possible decline in exporters' price competitiveness. There is no doubt that a rising exchange rate means a country's businesses face stiffer competition in trade. On the other hand, however, it causes people and businesses to step up their rationalization efforts, which ultimately boosts productivity, increases real wages, and enhances living standards.

4) Phasing Out of Gold and Dollars as Stores of Value and Mediums of Exchange

There have been recent signs that the conversion of dollars into dong is accelerating, which is fundamentally attributable to high interest rates on dong deposits and stabilization of the dong's exchange rate against the dollar. If a stable supply of dong liquidity is to be achieved and savings held in gold and dollars are to be used as investment capital, it is important that stability be maintained in the dong exchange rate.

5) The Need to Use the Exchange Rate as a Nominal Anchor to Promote Price Stability

When a country has a high inflation rate and its exchange rate falls, exporters in other countries try to raise their prices in that country's currency. This causes the prices of imports into that country, along with general price levels, to rise. This, in turn, causes the exchange rate to fall still further. To break this vicious circle, the exchange rate is sometimes used as an anchor to stabilize prices by pegging it to another currency, for example, the U.S. dollar. Because the country's rate of inflation will not immediately fall to a level comparable to that in the U.S., the real exchange rate against the dollar will rise during the interim period. The rise in the real exchange rate can be thought of as the cost of stabilizing prices in a country that had a high rate of inflation in the past.

6) The Relationship between Exchange Rate Policy and Interest Rate Policy

Once prices and the exchange rate stabilize, interest rates can be lowered. If the actual inflation rate declines, the expected inflation rate will also decline over time. Hence, nominal interest rates, which are a combination of real interest rates and the expected inflation rate, would fall in tandem with a decline in the expected inflation rate. This would stimulate investment, especially long-term investment. It would also makes it possible to promote the conversion of savings held in gold and dollars into dong deposits with lower interest rates.

7) Central Bank Intervention and Sterilization Measures

The central bank can intervene in the foreign exchange market by buying dollars to the extent that doing so does not create difficult problems. When the Vietnamese central bank buys dollars, it is also supplying an equivalent amount of dong. It appears, however, that the money supply has not been affected by foreign exchange market intervention because the central bank has not altered its credit supply targets, previously determined on the basis of the prospective economic growth rate, the rate of price increases, and other factors. Success in this area can also be ascribed to the fact that the scale of intervention has not yet reached an extreme level.

The Vietnamese central bank has been buying dollars primarily from the Foreign Trade Bank of Viet Nam, and the central bank's credit has been supplied primarily through that bank. To that extent, only a limited amount of central bank credit has been supplied through other commercial banks. Recently, however, dong deposits have been substantially growing, leaving commercial banks with surplus funds, and the central bank has been selling state bank bills in order to absorb these surplus funds. Given this situation, unevenness in distribution, vis-à-vis commercial banks, and instability in the central bank's supply of credit may not surface as major problems. If conditions change, however, they will likely develop into problems. Many countries attempt to implement a policy of full sterilization in order to prevent intervention in foreign exchange markets from disrupting money supply policies. It would probably be advisable for Viet Nam, also, to consider ways of sterilizing the central bank credit supplied through intervention. It would be desirable for the central bank to diversify the parties from which it buys dollars as much as possible. At the same time, it would be desirable if a short-term money market were developed so that the central bank could engage in open-market selling operations whenever necessary, selling short-term securities through the market (and thereby absorbing dong liquidity). There is a risk, of course, that security prices could fall, and interest rates rise, if the scale of open-market selling operations were to grow too large.

There is no doubt that recent central bank dollar-buying intervention has served to expand sales of state bank bills. This is one type of sterilization, but it is a type of operation that carries with it a large burden for the central bank. Given that the dong's exchange rate is stable against the dollar, even if the central bank deposits overseas the dollars it has purchased, the interest it will receive on such deposits is significantly lower than the interest paid on state bank bills. In certain Latin American countries the spread between this interest received and interest paid has widened to an almost unbearable degree.

8) Preparedness for Taking Stringent Fiscal Measures

Assuming that there are limitations on solely monetary responses to the problems related to intervention and sterilization, consideration should perhaps be given to fiscal responses. Namely, in the event that the money supply were to grow excessively because dong liquidity supplied through intervention could not be completely absorbed through sterilization, cutting fiscal spending might alleviate upward pressure on prices and interest rates.

9) The Feasibility of Imposing Capital Inflow Restrictions

Consideration should perhaps be given as well to the possibility of regulating capital inflows. In an extreme situation, it would be conceivable to control the timing with which foreign direct investment is implemented and/or set ceilings on foreign borrowings.

10) The Relationship between the Exchange Rate and the Country's Foreign Debt Burden

Viet Nam is a country with considerable foreign debt. A drop in the dong's exchange rate increases the country's debt burden in dong terms. If the dong's exchange rate falls, a borrower with debt denominated in a foreign currency needs additional dong, in direct proportion to the extent of the drop, to repay its debt. Because the borrower's income is usually in dong, this means a heavier repayment burden.

There are desirable aspects - or perhaps unavoidable aspects given the present state of the Vietnamese economy - to a rise in the dong's real exchange rate against the dollar, or its real, effective exchange rate. Even if a rise were permitted, however, there are naturally limitations on the extent of such a rise. Assuming an inflation rate of 10 percent in Viet Nam and 3 percent in the U.S., and assuming for a moment that the real exchange rates against the dollar of Viet Nam's principal trading partners' currencies were stable, it would be desirable for the drop in the dong's nominal exchange rate against the dollar to be less than 7 percent. And if a drop of between 1 and 2 percent were deemed to be appropriate, it would perhaps be better to keep the dong's nominal exchange rate against the dollar stable for the sake of simplicity. In any case, however, it is possible that rises in the dong's real exchange rate against the dollar and its real, effective exchange rate could accrue over time. Given these factors, consideration must be given to the necessity of devaluing the dong's nominal exchange rate in response to changing conditions.

(Box 3-2) **The Real, Effective Exchange Rate**

The dong's real exchange rate (index) against the dollar is the actual exchange rate adjusted for differing rates of price increases in Viet Nam and the U.S. For example, let us assume prices are rising at rates of 10 percent and 3 percent per annum in Viet Nam and the U.S., respectively. If, over the course of a year, the dong's nominal exchange rate against the dollar were to go unchanged, the real exchange rate would have risen by 7 percent, and if the dong's nominal exchange rate against the dollar were to fall by 3 percent, the real exchange rate would have risen by 4 percent.

The dong's real exchange rate (index) is calculated not only against the dollar, but against the currencies of Viet Nam's principal trading partners as well. These various rates are trade weighted to produce the dong's real, effective exchange rate (index).

Further, (relative) purchasing power parity (index) is a theoretical exchange rate (index) that eliminates any price advantage/disadvantage in a country's trade, even if its rate of price increases is different from that of its trading partners. Using the above example, the dong's purchasing power parity falls 7 percent in order to offset the different rates of price increases. In this sense, the dong's real exchange rate against the dollar expresses the divergence of the actual exchange rate from purchasing power parity. Further, the dong's real, effective exchange rate is a weighted average based on this divergence that expresses the extent of Viet Nam's price advantage/disadvantage in trade.

(4) Present State of Economic Statistics in Viet Nam

1) The Current Situation of Economic Statistics

Economic statistics are essential for all kinds of macro-economic studies and management. In Viet Nam, where economic reforms have been undertaken in the past decade, its statistical system is in the process of transition.

A. National Account Statistics

As for National Account Statistics, the General Statistics Office (GSO) is in the process of implementing the UN System of National Accounts (SNA). GSO started to consider adopting SNA in 1990, and in 1992 it was decided to replace the Material Product System (MPS) with SNA. GDP figures before 1989 or 1990 are not officially available. The capital stock data for SOEs are published by GSO, and capital stock data excluding SOEs is held by Ministry of Finance, but not published.

B. Price Indices

The system of compiling Consumer Price Index (CPI) has been also changed in recent years. Under the new system introduced in 1996, price data for around 300 items are collected by a retail price survey while CPI from 1990 to 1995 was calculated with 175 items and fixed weights. Between 1980 to 1988, the Retail Price Index was compiled in such a way that the General Price Index was calculated as a weighted sum of the Official Price Index and the Free Market Price Index. The Export/Import price index is calculated based on the report on FOB/CIF prices of major items from trading companies through the Ministry of Trade. The Producer Price Index is compiled from survey results for around 600 items, which come from different ministries.

C. Monetary and Fiscal Data

The aggregate amount of cash currency is available from 1986, and the amounts of demand deposits and bank reserves from 1989. Attempts to estimate the amount of US dollars in circulation are so far not satisfactory, since the government is equipped with little means to gauge the amount remitted by Vietnamese living abroad and the amount brought into the country by tourists. The figures for the rediscount rate are available from 1992, and the government deficit is calculated by the Ministry of Finance (MOF) on the basis of estimation.

D. Balance of Payments

Regarding balance of payments, trade statistics are compiled based on the report of the Ministry of Trade, which combines reports of companies and local governments. Other parts of international balance of payments are shared by the Ministry of Trade, the State Bank of Viet Nam and MOF.

E. Employment Situation

Employment and unemployment are surveyed by GSO. Data on working hours are collected by the Ministry of Labor from enterprises and local governments. Wages are gauged by GSO with reports from ministries and local governments. The statistical definition of "wage" corresponds to wages and income in the public sector. For the private sector, "income" is surveyed.

2) Some Points to Notice Using Economic Statistics

Since the statistical system in Viet Nam is in transition, one should be cautious when using its macro-economic statistics.

A. National Account Statistics

As for National Account Statistics, three points have to be born in mind. First, it is not acceptable to use the series of annual GDP figures as usual time series data. Although some GDP figures were estimated on the basis of experimental computation, GDP figures are officially not available until 1989 or 1990. Even after 1991, GDP does not necessary represent the same object because of insufficient coverage and methodological changes. Secondly, there remain some discrepancies between the system of calculating GDP in Viet Nam and SNA standards. For example, nominal GDP is not equal to, probably not equivalent to nominal GDE. The gap between the figures is substantial. This is probably because the GDP indicators are compiled not from the harmonized system of national accounts, but from the limited basis of production accounts without coordination with other accounts. Thirdly, the reliability of the estimates suffers form insufficient coverage. The scope of calculation does not yet cover all industrial and economic sectors. For example, it admittedly fails to collect a complete set of data from non-state economic sector activities, export and import activities through unofficial channels. The lack of such information may significantly distort the aggregate and lower their reliability and validity. Besides the above points, there are shortcomings in the breakdown of GDP and in the calculation of local GDP. Currently GDP is not broken down by institutional sector, and the breakdown by industrial sector is not completed. Every province and city calculates GDP for its own locality, which is often invented due to methodological problems and the intention of proving economic achievement.

B. Price Indices

As for the inflation indicator, first, validity of CPI figures are not assured due to limited coverage and changes of methodology. Secondly, the economic meaning of price, not statistical definition of the price, comes into question when one sees the series for the 1980's. Thirdly, the present CPI is based on retail prices which may be different from actual consumer prices in Viet Nam.

C. Trade Statistics

Regarding trade statistics, figures for both exports and imports are unreliable. It is difficult for the authority to cover all the dispersed organizations engaged in international trade. A large amount of goods are smuggled, but such unofficial activities are not reflected in the present statistics.

D. Employment Situation

With respect to labor statistics, there is a concern that the unemployment rate does not necessarily show the real situation of the labor market due to its definition problem. Currently, employment is defined as people who have stable jobs for six months or longer while unemployment as people of working age who have no stable job and want to work. Since there is no unemployment allowance in Viet Nam, everyone has to make his/her own living by any means, including sharing a portion of work which could be handled by only one adult.

3) The Improvement of Economic Statistics

Considering the present status and problems with regard to macro-economic statistics, the following areas require further efforts for improvement. There is a need for the total coordination of government statistics. Basic classification systems of industry sectors, commodities, etc. should be immediately set up for common use in government statistics. The management of all statistical activities undertaken by GSO and other governmental organizations has to be strengthened to avoid overlaps or gaps of surveys and statistical reports which are necessary for economic management.

Fundamental statistics such as GDP have to be generated with a firm basis in the scope of SNA. An Input-Output table would be helpful to summarize the entire economic activities of the country. How to deal with the existence of the underground economy is one of the most difficult issues.

For macro-economic and econometric studies, time series data are essential. To make any analysis meaningful, it is necessary to document and publish, if possible, the transition of concepts and methodology, based on the latest framework.

International comparability should be secured in the process of development of statistical systems. It would be desirable to arrange within the government a system of statistical standards according to the recommendations of international organizations such as UN, IMF, ILO etc. It is also recommended to fully participate in international activities such as the International Comparison Program organized by the UN.

3-2 Socioeconomic Development with Particular Emphasis on the Environment

(1) Industrialization and Environment in Viet Nam

1) Current Environmental Situation in Viet Nam

Viet Nam is presently faced with serious environmental problems such as deforestation, soil erosion, over-exploitation of natural resources, threats to ecosystems and industrial pollution. Industry, transportation and domestic wastes are identified as three major sources of pollution. In comparison with other Asian countries, the Vietnamese industry is still not developed. Most of the existing industrial plants were constructed over twenty years ago, and the production technology is backward and productivity is low. Besides, most of the existing plants do not have effective pollution control facilities, and they are located in or nearby residential areas. Thus, industrial pollution in Viet Nam is serious in some areas. Similarly, air pollution caused by transportation means in urban areas is serious because of outdated technologies adopted in the cars and trucks. In Mekong Delta, the waterway transport is very common. Ten-thousands engine-boats are the main oil and grease pollution sources in rivers and canals in the region. Domestic wastes are another major pollution source in Viet Nam since there is a shortage of proper facilities for domestic waste control.

Air pollution, water pollution and the solid waste treatment and disposal are already serious in Viet Nam. Air pollution is particularly serious in the big cities and industrial zones due to the following causes: (1) dense population in urban areas; (2) location of industrial units in or nearby residential areas; (3) low vegetation coverage in urban areas; and (4) old transport means. While air pollution mainly occurs in urban areas, water pollution is observed in almost all regions of the country. The major causes of water pollution is discharge of untreated domestic and industrial water into canals, rivers, ponds and lakes. Solid waste treatment and disposal is a great problem in Viet Nam. The capacity of solid waste collection in Hanoi is less than 50% and about 90% in Ho Chi Minh City. The remaining waste is mainly dumped into canals, rivers or lakes. Collected solid waste is mainly transported to landfills, but since the landfills are made without any sanitation measures, air, soil and ground water pollution is observed.

The industry in Viet Nam has rapidly developed in recent years. Currently six industries are identified as major sources of industrial pollution in Viet Nam. These are energy industry, metal industry, mining industry, chemical industry, construction material industry and light industry. Although the way they affect the environment differ from each other, they face common problem in relation to environment degradation. One of these problems is that the technologies and facilities adopted in those industries are old and outdated, and therefore, a large amount of industrial waste is generated. Another problem is that some of them are facing severe competition and resource constraints, and thus cannot afford to adopt appropriate pollution prevention technologies. Consequently, these industries have given severe impact on the ecological environment and also on the living conditions of people, which require adequate measures in the near future.

2) Efforts to Protect Environment by Vietnamese Government

Concerned with the deteriorating situation of the environment, the Government of Viet Nam has made efforts to protect the environment and prevent its further degradation. In terms of environmental administration, the Ministry of Science, Technology and Environment (MOSTE), which is responsible for environmental management at the central level, was established in 1992. At provincial level, the Department of Science, Technology and Environment (DOSTE) in the Provincial People's Committee is responsible for the environment administration.

Various law and regulations were also promulgated. Among them, the Law on Environmental Protection is most important, which was promulgated in 1993 and enacted in 1994. The Law comprises of the following seven chapters: (1) general provision; (2) prevention and combat against environmental degradation, environmental pollution and environment incidents; (3) remedy of environmental degradation, environmental pollution and environmental incidents; (4) state management of environmental protection; (5) international relations with respect to environmental protection; (6) rewards and dealing with breaches; and (7) implementation provisions

As for the environmental regulations for the new project investment, the regulation for foreign investment, the regulation on industrial zones and the regulation on special export processing zones are important. The regulation on formation, evaluation and implementation of foreign direct investment projects was promulgated in 1994, which stipulates the content of the evaluation of investment projects. It also states the responsibility of investors for complying the Law on Environment Protection, and the role of MOSTE in setting standard on environmental protection, in monitoring and examination of the said standards and in providing guidance and supervision. The regulation on industrial zone was also promulgated in 1994, which stipulates the responsibilities of the enterprises in the Industrial Zones for taking measures to ensure labor safety, industrial hygiene, environmental protection and fire and explosion prevention. Promulgated in 1991, the regulation on special export processing zones includes the requirement for investment in the zones for not causing pollution to the environment.

In recent years, the Government of Viet Nam has also issued a number of guidelines related to Environment Impact Assessment (EIA). A guideline was issued in 1993 on the contents of EIA reports, which should include both impact of environment of social activities and measures to mitigate the impact and suggestions on the alternatives. The Law on Environment Protection stipulates the procedures for preparation, submission and follow-up of EIA for the existing and new social activities. Furthermore, to strengthen implementation of the Law on Environment Protection, a Guidance for the Implementation of the Law of Environment Protection was issued in 1994, which describes the EIA procedures in more details. Accordingly, as long as new projects are concerned, a detailed feasibility study report and a EIA report are submitted to the Ministry of Planning and Investment (MPI), which is responsible for reviewing and providing investment licenses. EIA reports are reviewed and approved by the National Environment Agency of MOSTE for projects with high investment cost or having special problems. EIA reports of remaining projects are reviewed by DOSTE. Based on evaluation of the reviewing committees, which are composed of various experts form different fields, MOSTE and DOSTE draw conclusions on the environmental problems of the project and reply to MPI for project approval.

3) Importance of Countermeasure in Early Stage

In spite of the government recent efforts for the environment protection, it is expected that the industrial pollution will be widely prevailing and worsened along with rapid industrialization unless some effective measures are taken at the early stage. The Japanese experience in rapid industrialization and the consequent industrial pollution indicates the following lessons: (1) the cost and time for curing the damage or injury due to industrial pollution is much more than those of the cases when effective measures are taken beforehand to control industrial pollution; and (2) since the pollution impact expands as time elapses, short-term measures must be immediately taken, followed by long-term programs. It could be concluded that the earlier the pollution preventative and control measures are taken, the less expensive to tackle the problems of industrial pollution.

(2) Poverty Alleviation in Viet Nam

1) The Current Situation of Poverty in Viet Name

In Viet Nam, poverty alleviation is high on the development agenda along with rapid and sustainable economic growth. Estimates on both poverty incidence and nutrition data suggest that the poverty situation in Viet Nam is prevailing and more serious than in other Asian countries. According to the Viet Nam Living Standard Survey (VNLSS), the poverty incidence in 1993 was estimated at 51%[1]. Based on three different estimates, between 20 to 30 % of the total population are considered to be the food poor, who cannot meet their daily basic calorie requirement, even if they were to spend all of their income on the basic food basket. Nutrition data such as caloric intake and prevalence of malnutrition among children under five also indicate the existence of relatively large population who are facing household food insecurity.

In terms of distribution of poverty, the following features are identified: poverty incidence is much higher in rural areas than in urban areas; the poverty situation is more widely spread and severe in Northern Mountainous Region, in North Central Coast and Central Highlands; higher poverty incidence is recognized particularly among the rural population whose income and livelihood totally rely on agriculture, among ethnic minorities living in midlands and highlands, and among those de-facto female headed families which are composed of only women and children. It is also believed that the poverty situation becomes acute just before the harvest, when the stock of rice from the previous harvest is depleted.

In the past twenty years, Asia has experienced rapid poverty reduction. Recent studies on such Asian experiences derived the following lessons. On one hand, high and broad-based (defined as leading to raising standards of living at all socio-economic levels) economic growth is essential. On the other hand, some mechanisms, such as provision of basic social services and targeted interventions for the poor, are necessary to enable more-broad-based distribution of the benefits of the economic growth. As for the first lesson, the World Bank simulations indicate that the higher the economic growth rate is, the faster the poverty reduction would be in the case of Viet Nam. Moreover, they show that poverty reduction will be quicker if regional growth is more evenly distributed. The lesson on the importance of targeted interventions requires identification of problems which

[1] According to the similar definition of poverty line, the poverty incidence in other East Asian countries in 1990 are estimated as follows: 9% in China, 15% in Indonesia, 5% in Korea, 2% in the Philippines and 16% in Thailand.

the poor households are facing in Viet Nam. Some of the major problems include (1) vulnerability to changes in climate and natural conditions; (2) limited assets and capital, lack of assets, lack of access to credit at or below market interest rate; (3) lack of job opportunities; (4) isolation, lack of access to knowledge, skills and market; and (5) low education level and physical weakness. The poor households often face multiple problems mentioned above simultaneously.

Viet Nam is in the process of transition from the centrally planned economy to the market-oriented economy. The recent economic reforms have provided vast economic opportunities. However, there are indications that they have adverse effects on the poor, particularly on the rural poor in the process of recent decollectivization, which have made their livelihood more insecure and vulnerable. For example, the drop-out rates of children in primary and lower secondary schools have increased, and there are indications that utilization of health services by the poor has declined. Anecdotal evidence reckons loss of assets of the poor due to indebtedness. It is most likely that so-called poverty ratchet effects are emerging in certain localities, which tend to further impoverish the poor households.

2) Policy Implications

Based on the findings discussed above, the following policy implications are presented for effective poverty alleviation: (1) need for rapid and broad-based economic growth; (2) need for targeted interventions; and (3) need for re-allocation of resources in social sector and provision of social safety net to the rural poor. Poverty is prevailing in Viet Nam, and thus, rapid economic growth is a prerequisite for rapid poverty reduction. Not only rapid but broad-based economic growth is essential. Regionally, this leads to the need for special efforts to induce such economic growth in the three regions, namely, the Northern Mountainous Region, the North Central Coast and the Central Highlands where the highest poverty incidence and slower economic growth is recognized. As for targeted interventions, the following should be considered. Included in the target groups are the rural poor, the ethnic minorities in the uplands and those de-facto female headed families who do not have adult male labor. Considering the problems of the poor, areas for interventions include (a) small-scale rural infrastructure building, (b) provision of credit for the poor, (c) dissemination of knowledge both in production and social sector, and (d) provision of seasonal employment opportunities through public work schemes. To prevent further impoverishment of the poor due to emerging poverty ratchet effects, a social safety net has to be provided to the poor to assure the stability and a minimum standard of living with access to basic social services. Given the government resource constraints, how to provide a kind of social safety net especially to the rural poor is one area which requires urgent investigations. In this connection, some efforts are required for re-allocation of resources in social sector which are currently not effectively and efficiently pro-poor.

3) Comment on the Poverty Alleviation Program

Three points were discussed on the new Poverty Alleviation Program for Viet Nam 1996-2000: (1) the need for re-consideration on the operational mode of the Viet Nam Bank for the Poor; (2) the need for increase in flexibility and improvement of quality of basic social services; and (3) the need for consideration of provision of seasonal employment opportunities through public work schemes. Provision of credit to the poor is one of the most effective means for alleviating poverty. However, the following points require reconsideration as for the mode of operation of the Bank for the Poor: (a) needs for provision of careful technical extension services; (b) needs for efforts to make the Bank closer to the potential beneficiaries, for example with regular and frequent visits by the field workers to the poor for collection of payments for the interest and the principle, formation of small liability groups among homogeneous members and introduction of saving schemes; and (c) needs for further discussion on the optimal interest rate to make the operation sustainable. The program pays attention to the provision of basic social services such as health and education. Availability and accessibility (cost factor) matters but does the quality of services in the decision of the poor on utilization of health care and educational services. Some efforts are required to make the service more accessible and useful to the poor by improving the quality of services and increasing flexibility in the way the services are provided. As already discussed, one of the biggest problems of the poor is a lack of job opportunities especially in slack seasons. Provision of seasonal job opportunities through public work schemes such as building rural roads and irrigation could be included as an effective means for alleviation poverty. This could increase the stability in income throughout the year and access to food, particularly when the activities are carried out through food for work schemes. The wage rate could be set low so as to attract only the poor, so the schemes can be self-targeting. This can avoid the complication and difficulties involved in targeting the right beneficiaries.

4. Fiscal and Monetary Policies

Enormous investments and development funds are required for economic industrialization and modernization being promoted by the Vietnamese government. The Fiscal and Monetary Group conducted a study on measures for mobilizing investments and development funds (mainly savings mobilization). The results of the study are summarized in Section 4-2 and Section 4-3 as the flows of public and private investments and funds. Section 4-1 briefly shows that in the transition an economic management system is transformed from fiscal policy driven one of a planned economy to monetary policy driven of a market economy, in accordance with the shift of capital accumulation mechanism from physical planning to market oriented allocation.

4-1 Role of Fiscal and Monetary Policies in Economic Development

(1) Investment and Saving Ratios in Viet Nam

The domestic savings ratio of Viet Nam increased slightly from 15% in 1990 to 17% in 1994. However, Viet Nam still has a low domestic savings ratio in comparison with neighboring countries where the domestic savings ratio exceeds 30%. The low ratio derives from the fact that the savings surplus in the whole economy is limited because of the low income level. Another factor contributing to the low savings ratio is that Viet Nam is changing to a market oriented economy. Under the planned economy, no bank system was available for common people. Common people were not expected to contribute to domestic savings. The people have not acquired the habit of bank deposits even now that a bank system has at least been formally established. Common people's access to banks is extremely low because of the service and credit problem. Worries over inflation are exerting a major influence on this trend. Gold and cash still have a larger share of the people's saving assets.

The income difference between the north and the south is another restrictive factor for investments and savings in the Vietnamese economy. Rapid economic growth inevitably brings about an income difference among regions. In Viet Nam, the differing initial conditions between the north and the south have widened the income difference. A policy giving high priority to correcting the income difference is often in conflict with the efficiency oriented mechanism of a market economy. The absence of self-help efforts deprives local governments of incentives for mobilizing savings.

(2) Fiscal and Monetary System under the Planned Economy

The state-owned enterprise (SOE) sector forms the nucleus of a planned-economy system. In accordance with the heavy industry promotion policy under the planned economy in Viet Nam, capital was accumulated by physical planning in which SOEs played a major role. The role of the fiscal system was to secure a flow of funds without disturbing the physical planning. National savings required for equipment investments were concentrated in governmental savings, mainly transfers of operating surplus of SOEs. The savings collected by this method were distributed to SOEs for their equipment investments through governmental budgets. There arose a problem of soft budget restriction. As long as SOEs operate according to governmental commands and plans, the government must provide assistance for their deficits.

The Bank for Investment and Development in Viet Nam (BIDV) played the role of a fund conduit for actual distribution of investment funds. The State Bank, which also functioned then as the only commercial bank, in addition to as a central bank, supplied operating funds. Both of these banks moved funds according to governmental commands without playing the role of a financial intermediator. Also, it should be noted that local governments in Viet Nam exerted major influence on bank's fund supply operations. Administrative divisions were the basis for setting up branch offices. Branch offices were placed subjected to a dual command structure, the main office and local governments. The latter exerted greater influence. This minimized the possibility of autonomy in the flow of bank funds.

(3) Fiscal and Monetary System under the Transition to a Market-Oriented Economy

The market oriented economy mechanism was officially introduced after the adoption of the Doi Moi policy in 1986. Let's summarize the changes from the viewpoint of the flow of investment funds. As a result of the financial system reform that started in 1988, the mono-bank system was changed to the two-tier banking system. The financial source of SOEs was changed from fiscal funds to bank loans. The Agricultural Bank and Bank for Industry and Commerce were established by separating the commercial banking function from the State Bank. Negative interest rates provided as subsidies were changed to positive interest rates. Market oriented restrictions were thus imposed on bank loans. Direct financing to SOEs by the Central Bank and fiscal deficit financing were discontinued because they caused inflation. As a result of the tax system reform in 1990, the source of fiscal revenues was changed from transfer of operating surplus of SOEs to taxes. Thus, Viet Nam roughly completed the formal introduction of the market economy system by 1992 - 1993.

After the introduction of the market economy mechanism, capital formation for industrialization has been implemented in two sectors, public investments and private investments. It is predicted that funds for public investments will be secured relatively smoothly in the future. Tax revenues, which are the source of public investments, are increasing steadily. The target of the 5-year plan, 21 - 22% of GDP, has almost been accomplished. Since Japan resumed ODA in the form of yen loans in 1992, the funds will keep increasing in the immediate future. The budget fund distribution function that was previously assigned to the BIDV was transferred to the General Department of Investment and Development that was newly established under the Ministry of Finance. Direct control by the MOF strengthens the control of budget funds. Profitability must be assured for obtaining loans which are provided on an assumption of repayment. The issue is how the government responsible for executing policies can ensure the profitability.

On the other hand, it cannot be said that the private investment system is functioning properly. Bank loans to the private sector are increasing, but short-term loans account for most of them and lending rates are high. The problem is that the private sector has few medium and long-term fund sources. Bank deposits are increasing, but they are enticed by high interest rates. Most deposits are short-term. Only speculative business can be profitable at such high interest rates. Although the industrial sector has funding needs for expanding business, high interest rates are suppressing their needs. Banks are unable to play the role of monetary intermediator because they have few borrowers. Meanwhile, the habit of holding bank deposits has not been disseminated widely among common people in spite of high interest rates. As a result, financial intermediation from the household sector to the enterprise and the government sector does not function well.

(4) Changes in Fund Flow

When the market economy mechanism was introduced, budget subsidies to SOEs and direct financing by the Central Bank were discontinued almost completely. SOEs had to obtain deposit-based loans from a commercial bank. As a result of the tax reform, transfers of operating surplus to the budget was replaced by taxes based on sales and profits. Thus, the budget restrictions for SOEs became hard. In fact, SOEs' share in the GDP is increasing, but bank loans to them show a decreasing trend. Also, the net transfer to the budget is increasing rapidly. It is suspected that SOEs are under severe fund restrictions. On the other hand, SOEs' bad debts held by SOBs hinder financial market mechanisms from functioning well.

Let's look at the progress of the monetary intermediation function in Viet Nam on the basis of the two-tier banking index (TBI). The TBI (Refer to Box 4-1) was 0.6 immediately after the introduction of the two-tier banking system (in 1989), and rose to 1.1 in 1994. Although it shows an improving trend, the figure is extremely low and the rate of increase is slow. This indicates that it will take considerable time before the commercial bank can manifest a real intermediation function. The ratio of domestic credit balance to GDP was lowest (0.15) in 1992 and shows an improving trend (0.21 in 1994). However, progress has been slow. This proves the difficulty of promoting monetary system reform without reforming the productive sector.

BOX 4-1 **Two-tier Banking Index (TBI)**

TBI is an index comparing a deposit bank's amount of credit accommodation with a central bank's amount of credit accommodation. It is defined as (X/Y) - 1. "X" is the total amount of credits by the bank sector including the central bank to the economic world excluding the bank sector. "Y" is the total amount of domestic credits by the central bank. The value of TBI is high in an economic system where deposit banks are performing an independent monetary intermediation function (20 in Japan and 18 in the U.S. in 1989). The value of TBI is zero in a mono-bank system because the national bank is the only issuing bank and the only commercial bank.

4-2 Public Investment and its Funds Flow

(1) Mobilization of Fiscal Funds

1) Fiscal Issues

According to the 5-year plan (1996 - 2000), the level of public investments must be increased to 10% of GDP for accomplishing the target economic growth. The level of tax revenues must be raised to 21 - 22% of GDP for obtaining the funds required for the public investments. To increase public investments required for accomplishing planned economic growth and for mobilizing the funds needed, Viet Nam has three issues in the fiscal field, (1) securing investment and development funds in the state budget, (2) tax reform for raising incentives for reinvestment, and (3) efficiency improvement of fiscal expenditures.

2) Securing Fiscal Funds for Investment and Development

To secure sufficient public investments, fiscal funds needed for investments must be mobilized by constructing a tax system that can maintain the current tax revenue level (ratio to GDP: 20 - 21%). At the same time, Viet Nam must adjust the current tax system that depends highly on taxation on imports and exports to change smoothly to an open economy (namely, that of AFTA). By means of the tax reform phase II starting in 1995, Viet Nam must accomplish two tasks, mobilization of fiscal funds and establishment of an efficient tax system.

The tax reform planned for 1996 - 2000 has the following four directions: (1) reviewing the current tax items for securing stable tax revenues, (2) constructing a equitable tax system, (3) harmonizing with the ASEAN tax system and the international tax system, and (4) improving the tax collection system. It is planned to adjust and change many tax items in accordance with the basic policy of changing to a unified and simple tax system.

The nucleus of the tax reform are the changes from turnover tax, profit tax, and high personal income tax to VAT, corporate tax, and income tax, respectively. Generally, the taxable base is to be enlarged and tax rates are to be lowered. VAT is anticipated to be the main component of future tax revenues, so it is desirable to introduce it quickly. However, since a business accounting system, daily bookkeeping, and invoice exchanges are prerequisites for introducing VAT, difficulties are anticipated for its complete introduction. Since it is doubtful whether majority of small and micro businesses such as retailers will acquire the business practice easily, the current turnover tax will have to be continued for small and micro business for the time being. Meanwhile, the issue of lowering import and export tariffs involves the following problems that require cautiousness: (1) problem of protecting infant domestic industry from international competition and (2) introduction of tax items (such as special consumption tax) that can substitute import and export duties which are currently the greatest source of tax revenues.

The policy of abolishing the current income tax for high income people and expanding the tax base to all income groups will be effective for increasing tax revenues in future. Since direct taxes such as income tax have high income flexibility, economic growth tends to be directly reflected to tax revenues when the ratio of direct taxes (the ratio of direct taxes to the total tax revenues) is high. The feasibility of strengthening the income tax in Viet Nam in this stage involves some doubts, but actions to increase income tax revenues proved successful in some developing countries.

The Social Insurance Fund is a promising source of medium and long-term funds that can be used for public investments. The insurance premiums that are the source of the Social Insurance Fund consist of (1) employers' burden (15% of the total amount of wages), (2) employees' burden (5% of wages), (3) governmental subsidies, and (4) other. Governmental subsidies are indispensable for paying annuities for the immediate future due to the shortage of insurance premium income. In view of the large percentage of the young population and the potential of future economic growth, the fund will play an important role for the economic development in Viet Nam when it will have surplus funds and use them as medium and long-term funds under a strict management policy.

3) Tax Reform for Raising Incentives for Reinvestment

The targeted tax revenues (ratio to GDP) of the 5-year plan was already accomplished in 1994. Therefore, it is important to direct efforts to more qualitative tax reform in the future. First, the current tax system that has deprived the industrial sector of motivation for reinvestment must be reformed to promote investment. Since tax revenues will be increased in the long-term by encouraging expansion in the industrial sector, this reform is important. The current tax system is characterized by excessive dependence on some tax items. Four tax items consisting of turnover tax, profit tax, import/export duty, and Special consumption tax account for 76% of the tax revenues (as of 1995). Comparing Viet Nam with the other ASEAN countries in the effective tax rates imposed on enterprises, Viet Nam has the highest tax rates, due mainly to the turnover tax. This indicates that an excessive burden is imposed on enterprises. In other words, the current tax system collects a large amount from those which have large funds and are easy to impose taxes on, such as SOEs, foreign investment, and imported goods. This may be reasonable from the viewpoint of securing tax revenues, but lowers enterprises' will to reinvest profits. This is undesirable from a long-term viewpoint because it hinders sound industrial development. The tax system must be changed to a system that promotes enterprise activities under open economy and is suitable for international trading.

4) Efficient Disbursement of Fiscal Expenditures

For increasing public investments, it is necessary not only to increase fiscal revenue sources, but also to raise the efficiency of fiscal expenditures. This requires the following: (a) Distribute more funds to investment and development by avoiding waste in current expenditures, (b) limit public investments to projects of high public nature, and (c) construct an appropriate audit system for efficient fiscal operation.

One of the most serious problems related to budgets is the underdeveloped state of its operation and management system. The fiscal authorities have not tracked the state of budget execution because Viet Nam has no well-established accounting system or a budget law. It is said that an enormous amount of fiscal disbursements has been wasted. To strictly control budget execution, the government is planning to establish a system in which state organizations such as the central bank audit financial statements and accounting procedures of budget executing organizations.

For operating public investments efficiently, it is desirable to decrease the fiscal burden by separating commercially feasible projects from the budget. For this purpose, public investments that are funded by the budget should be classified clearly into capital investments and loans. It is desirable to discontinue financing profitable public investments from the budget. At the same time, it is advised to distribute investment and development funds exclusively to projects of high public nature. One of the ideas for commercially feasible projects is to establish an organization that operates independently from the government and to assign the financing function to it. For example, a public organization such as a national development bank can be established to finance projects preferentially for industries and enterprises having strategic importance for the country in both the public and private sectors. For such an organization to function efficiently, autonomous management without receiving subsidies and a high-level credit examination ability must be established.

5) Intergovernmental Fiscal Relations

A centralized tax collection system compared with a de-centralized one is generally a cost-saving, streamlined, and efficient method for collecting funds and redistributing them. For such a tax system to function well, local tax officers must have high morale. In reality, the centralized tax collection system that the Vietnamese government is trying to establish is often not functioning efficiently. The central government accuses local governments of tax income hiding, while local governments are protesting to the central government that they cannot pay the necessary expenses because local disbursements are controlled by the center. The basic problem lies in that local revenues and disbursements are not linked; disbursements are controlled by the central government, but the tax collection system depends on local governments' revenues.

At present, the Vietnamese government is promoting centralized fiscal management, attaching importance to income distribution among regions. This deprives both wealthy regions and poor regions of a will to increase tax revenues. They are missing tax revenues that could have been obtained under a better system. To get away from the situation that is undesirable for both the central government and local governments, it is necessary to construct a fiscal system that links an increase in local revenues to local disbursements. For this purpose, it is important to provide local governments with an incentive to increase revenues by clarifying the revenue allocation rules between the central government and local governments.

(2) Use of Foreign Savings for Public Investment

Viet Nam has an extremely large demand for public investments for economic development represented by infrastructure investments. The country must continue to mobilize foreign savings for procuring required funds.

Under the current domestic and international economic circumstances, only a limited increase can be expected for grants. Commercial loans are not realistic in view of the high cost. Therefore, ODA loans will continue to be the major fund procurement means.

1) Thorough External Debt Management

Since ODA for the Viet Nam has expanded relatively steadily, ODA loans tend to be regarded as a convenient fund procurement method. However, ODA loans accompany repayment burdens unlike grants and FDI that do not require repayment. Therefore, ODA loans and other foreign debts must be managed cautiously based on an accurate public investment plan and tax revenue outlook.

At present, the Vietnamese government has set a guideline of allocating 10% of the state budget and 15% of the exports to the repayment of external debts. However, critical assumptions for the guideline, such as estimated amounts and their way of calculation of oil reserves, oil production, and the investments required for attaining the production have not been presented. Some governmental officials show a desire to further increase external borrowings based on an optimistic forecasts of oil and natural gas income, without an objective and quantitative future plan.

ODA funds vary in interest rates, repayment conditions, and risks according to the different systems and objectives of donors. Since financing conditions do not strictly reflect the profitability of individual projects, projects must be selected prudently to avoid a discrepancy between cost and benefit. Otherwise, possibilities of being unable to make repayments increase. It is important to set guidelines (matching between funds and usages) for allocating funds to appropriate investments based on their interest rates and other conditions.

The Vietnamese government is considering the issue on foreign bonds of a commercial basis (such as Euro-bonds) because ODA funds are not growing. It is true that such foreign bonds can be issued even at present. However foreign bonds carry high interest rates at present with unrepaid liabilities. It is advised to issue foreign bonds after lowering the fund procurement cost by completing the negotiation with London Club Countries.

4-3 Private Investment and its Fund Flow

(1) Mobilization of Private Savings

The issue in the financial field are to strengthen financial intermediation between savings and investment, and to supply funds necessary for the achievement for the five-year plan.

1) Insufficient Function of the Current Financial System

The reform of the Vietnamese financial system has rapidly progressed since 1988. However, it is difficult to say the financial system fully meets the demand of the market. First, let's take a look at commercial banks as financial intermediaries. Their short-term deposit rates tend to be set higher than middle and long-term ones, making it hard to collect savings of the latter type, while commercial banks are mainly engaged in short-term financing for fear of economic and political risks. Furthermore, they do not make sufficient financial investigations. They make little use of an analyzing method to forecast future proceeds based on financial data. Most of them seem to center on financing based on collateral.

Next, we analyze the general public as fund suppliers. Most of them do not trust financial institutions partly because many credit unions went bankrupt in 1990. Difficulty in withdrawing deposits is considered to be another reason for their distrust in banks. In fact, they fear very much that sources of bank savings may be traced, leading to money capture. Instead they are said to save hoarded cash or gold, and the Viet Nam Living Standard Survey shows they resort to saving in the form of gold, cash or dollars. According to an issue of the "Economist", Viet Nam's general public save gold corresponding to 10 billion dollars (about 140 dollars per capita), which is a considerably large amount of money compared with a $250 per capita GDP. These days more money has been put on fixed deposits due to higher rates, but gold seems to be more attractive as medium to long-term saving measures. They still remember the days when they suffered from hyper-inflation, and do not believe that inflation rates will be stabilized for long. Therefore, it is necessary to make efforts to shift gold or cash saved by the general public to bank saving.

Finally, regarding enterprises as fund users, private enterprises, many of which run self-funded businesses, are less favored than SOEs in acquisition of assets, collateral and access to funds. Though promising, enterprises exporting labor-intensive products are not in a position to be financed by banks due to their insufficient mortgage collateral.

2) Improvement of Fund Flow from the Household Sector to the Enterprise Sector

An important issue to achieve the five-year plan is to strengthen the national financial system and to mobilize household savings for enterprises' investment demand. Banking sector reform is necessary for gaining the people's confidence in banks. Obviously, stabilizing Viet Nam's economy is prerequisite for the stability and development of the financial system.

For Vietnamese companies to raise external funds the general practice is bank borrowing, mostly in the short term. Companies are nearly unable to issue stock to raise funds in the capital market. Furthermore, there is no securities market providing purchases and sales of such debentures and stocks. In this way, the establishment of middle and long-term funds is an important issue for Vietnamese enterprise. They are an urgently required extension of the function of indirect financing through banks in parall with enhancing accountable financial management practices of borrowers. Also desirable is the development of a capital market, the establishment of a stock exchange and the raising of medium to long-term funds.

A. Strengthening of Commercial Banks

Improved bank service is a basic factor to recover bank credibility. For example, when customers apply to open savings accounts, it should not take a long time before they are approved and formally issued. When depositors ask to withdraw their savings, they must be available immediately. Information about customers should be kept absolutely confidential. Moreover, banks are expected to give their customers a saving incentive by offering new financial means such as an inflation indexed deposit and a long-term deposit with large prize money. It is also desirable for banks to improve their credit creation function, and to make banks more accessible for customer utilization. One suggestion is to introduce and discount commercial bills allowing customers to convert them into cash easily.

In line with the above reform, it is important for the government to encourage the people to deposit their money and push a savings campaign forward under a slogan of Vietnamese growth and progress. In promoting national deposits, the government must guarantee that it will not trace the sources of national deposits for, say, two years nor confiscate their money, but remunerate those who have large deposits. At the same time the government should study the feasibility of introducing a tax incentive which could induce the people to make deposits. With this is mind, it is not desirable to impose a tax on interest rates.

B. Mobilization of Medium and Long-Term Funds through Security Markets

At present an urgent task is to expand the function of indirect financing by raising bank deposits to achieve the five-year plan, but in light of industrialized Viet Nam toward 2000 and thereafter it will be very significant to develop a stock market allowing investors to furnish funds for those in need. First, to furnish funds by issuing medium and long-term bonds it is necessary to develop a distribution market that enables investors to quickly convert securities into cash.

C. Institutionalizing the Informal Sector

The existence of informal financing has been pointed out in Viet Nam. Its concrete scale and actual status is not clear, but it is said that there are two types of informal financing: (1) private-sector financing, and (2) individual-sector mutual aid funds known as Ho or Hui. They feature short-term loans, high interest rates, easy procedures, and high risks. A future issue will be to introduce these funds into an institutionalized financing system. What can be considered as a new scheme of institutionalized finance is to build a union composed of only merchants, and to establish a centrally organized body (banks) to operate with surplus funds collected unilaterally from the union.

The union's major role will be mutual aid by union members. When member merchants are in need of operational funds, the union makes a loan to members who have the minimum required deposit balance. The union's surplus funds go to a centrally organized body, run by experts in investment and finance. Furthermore the union collects deposits from its members on a face-to-face method, that is, the union's staff visit each member each month to collect small amounts of money. Another idea is a new type of installment devised to benefit depositors in the long run. Participants deposit small amounts of money periodically over the course of, for example, five-years in an educational loan for children that is available at a low interest rate at a maturity date. The new device can be realized on the premise that the existing informal financing should be matured enough to have a corresponding organization and that entry into the credit union should be designed to greatly benefit its members.

D. Mobilization of Postal Savings Utilizing the Post Office Network

It is desirable to study the introduction of a new network of savings mobilization as a tool to furnish medium and long-term funds. Many Asian countries have introduced postal savings. They successfully mobilize small amounts of funds from the general public, thanks to the postal system's state-run feature and the convenience of its nationwide network that cannot be covered by banks. It is also said that the success of Japanese postal saving system necessitates that a reliable person in a local area is appointed as the post master. Deposits mobilize through the postal office network are utilized for investment or financing in the centrally organized body, helping to furnish medium and long-term funds. It must be studied whether or not a postal savings system, or one utilizing another established system can be developed in Viet Nam.

(2) Supply of Medium- and Long-Term Funds to Industries

For successful economic development in an economic transition period, it is indispensable to foster internationally competitive industries, particularly manufacturing industries that require the supply of medium and long-term funds. Long-term funds are necessary to build plants and purchase machinery. There is also a great demand for long-term operating funds in labor-intensive industries with effective export promotion and employment. Foreign enterprises investing in Viet Nam have demand for domestic funds to hedge exchange rate risks.

However, Viet Nam today has no financial system organized to supply such medium and long-term investment funds to industries, and particularly not to developing private enterprises. This poses a bottleneck to industrial development. Below is an overview of the structure of a financial system that provides a smooth supply of medium and long-term funds to industries.

1) Stabilization of the Macroeconomy

Viewing Viet Nam's actual financial status, interest rates are inversely set lower for the long-term and higher for short-term loans, and there still remains strong concern about inflation, consequently most financing terms are set for as short as three to six months. So precious funds tend not be supplied to the export-oriented manufacturing sector that needs medium and long-term funds, but are supplied to the domestic service sector from which investment is recoverable in a short period, or to short-term financial investment such as the purchase of government bonds or is deposited in banks with high interest rates.

Such a lack of medium and long-term financing is mainly due to the unstable macroeconomic circumstances where there is significant risk in lending and obtaining general credit. In addition to inflation, there is a vicious circle where high loan default rates cause high interest rates, and high interest rates cause high default rates. This situation keeps loans short-term, and limited to close acquaintances. This conspicuous lack of credit creation is reflected in the spot cash payment policy (lack of a draft payment system), still prevailing in Viet Nam's industries.

2) Securing Domestic Medium- and Long-Term Fund Sources

Currently in Viet Nam most medium and long-term funds come from ODA, FDI and the budget. Compared with the scale of demand there is scarce supply of medium and long-term funds in the form of fixed-term deposits and stocks purchased by domestic enterprises and people. The issuance of securities is said to be a success, but government bonds, whose redemption period is one year at the longest, are not effective as medium and long-term fund sources, and newly introduced project bonds featuring a maximum three-year redemption period are mainly purchased by SOEs without getting much fund mobilization from general public.

Under review is the establishment of a stock market as a decisive factor for the mobilization of domestic savings, but the private enterprise sector remains underdeveloped and the reform of state-owned enterprises is still under way. The preparation and disclosure system, including enterprise accounting information, is not developed yet, and it will take a long time before effective conditions required by the direct finance monetary market are ready for enterprises.

As mentioned above, allocating part of social insurance funds or casualty insurance companies' funds to medium and long-term financing may be a solution. A considerable amount of medium and long-term funds will be secured by having the social insurance fund invest in long-term bonds such as enterprise bonds and bank bonds.

Significant is maturity transformation to convert short-term deposits into long-term loans. There is a scheme that deposit banks purchase medium and long-term bonds issued by banks engaged in long-term credit. In Japan long-term credit banks had used this scheme for raising funds.

3) Establishment of a Medium- and Long-Term Fund Supply System

It is as important as to secure fund sources to establish a financial system capable of stabilized supply of relatively risky medium and long-term financing to certain industries to be fostered.

Today in Viet Nam, government agencies (the General Department for Investment and Development, the Ministry of Finance, and the National Investment Assistance Fund) and the BIDV supply medium and long-term funds mainly to state-run enterprises.As medium and long-term funds are preferentially allocated to SOEs, particularly to basic industries, they are hardly accessible for private companies, particularly small and medium enterprises (SMEs) or non-basic and unimportant SOEs. Many private companies depend on private high-interest financing for their equipment funds. Furthermore, the overall financial industry is not capable of reviewing a project for effective medium and long-term financing due to a lack of accurate financial data of concerning enterprises and to the banks' underdeveloped audit system.

It should be noted then that agencies supplying medium and long-term funds should make a credit judgment independent of a policy judgment and have professional credit analysis ability based on accoutable financial management practices of enterprises. Direct financing from government to enterprises is not desirable when credit judgment and policy priority are inconsistent. The latter is given priority and this leads to a great danger of accumulated bad debts.

A possible alternative is to change BIDV to an institution specialized in medium and long-term financing with funds supplied by the government for medium and long-term funds, and review ability gained through its long experience in medium and long-term financing credit analysis. In this case BIDV may supply medium and long-term financing directly to leading national and private enterprises, and indirectly to private SMEs through private joint stock banks that receive wholesale banking of medium and long-term funds. At the same time it is desirable for BIDV to prevent bad debts by establishing management autonomy and cultivating credit analysis ability through improved study and training (a change from collateral-oriented to project-analysis-oriented financing).

For immediate effect, a possible measure for long term financing is to further promote utilization of leases such as those for machinery and equipment. State-run banks have already established leasing joint ventures, and it is desirable to support this trend and expand its scope into other sectors such as SMEs.

(3) Mobilization of Foreign Savings for Private Investment

Private investment from overseas generally develops in the following order: FDI (foreign direct investment), financial investment by bond purchase and bank loans, and eventually through financial investment by institutional investors. Viet Nam, on the way to a market economy, has now entered the first stage, and finds FDI a major channel for mobilization of foreign savings.

1) Promotion and Utilization of FDI in the a Long-Term

FDI is very significant in mobilizing foreign savings without accumulating external debts and in increasing productivity of domestic industries through technology transfer. On the other hand, FDI is cost-conscious and volatile in itself. Therefore, it is essential to promote infrastructure development from the medium to-long term viewpoint. It is also imperative to make efforts to promote FDI by immediately improving the acceptance system and removing impediment to disbursements.

A particular concern is that the gap between FDI commitment and actual expenditure has been increasing recently. Foreign enterprises which have announced investment in Viet Nam seem to be deterred by some obstacles or difficulties in implementing FDI.

It is important to secure funding for FDI projects. Primarily essential is the improvement of the domestic system for supplying long-term funds to FDI projects in order to reduce exchange risks and promote investment. In this respect further promotion of the establishment of joint venture banks and support for fund raising in Viet Nam should be considered. Fund raising from overseas should also be promoted, and to that end it is desirable to promote closer relations with other Asian monetary markets including Hong Kong and Singapore through cooperation between financial institutions.

2) Side Effects of FDI = Exchange Rate Management under the Pressure of the Overvalued Dong

The contract-based total amount of FDI to Viet Nam has now reached the same level as GDP, and it is feared that the in-flow of foreign currencies that comes with it will create upward pressure on the dong, impede export competitiveness, and increase trade deficits.

On the other hand, it is feared that a further depreciation of dong will affect external debt problems, and that an increase in export prices will increase trade deficits and cause inflation. As seen in Mexico, a slump in the national currency could cause a vicious circle of increasing trade deficits with rising import prices, sharply dropping foreign currency reserves, and further exchange rates, threatening major economic confusion. Therefore, it is desirable, for the present, to stick to the following foreign exchange rate policy for safety and stabilization.

A. Real Effective Exchange Rates

Currently the nominal exchange rate of the dong to the dollar is stable, but the real rate of the dong has been continuously appreciating due to different inflation rates in Viet Nam and the USA. This threatens to hinder Viet Nam's competitive power in exports.

However, the dollar tends to depreciate against Asian currencies in general. The 'real effective exchange rate,' to be computed by taking the weighted average of the currency rates of all of Viet Nam's trade partners, may not be appreciating so much as the real exchange rates with the US dollar. The problem is not as severe as it initially seems and consequently it is desirable to use real effective exchange rates for more effective foreign exchange rate policy.

B. Acceptance of Dong Appreciation to a Certain Extent

Today's trend of re-evaluating real effective exchange rates has resulted from persisting inflation. This is the cost of past inflation, and in this respect dong appreciation should be accepted to some extent.

Re-evaluation on a moderate level of real effective exchange rates could promote the reform of the domestic economic structure, particularly the rationalization of exports, and this would lead to reinforced international competitive power. This also promotes conversion of the domestic dollar into the dong. The merits of a dong hike need to be noted, too.

C. Dollar Purchase Operations

It is a proper measure for the central bank to conduct dollar purchase operations to cope with the appreciation of the dong. However, this will cause an excessive flow of the dong in Viet Nam, so sterilization is required to absorb it. This sterilization is achieved by selling government bonds, central bank bonds, and debentures concurrently. In this respect the recent issuance of central bank bonds and study into the establishment of a government bond market may be evaluated.

On the other hand, there is a great possibility that such bond selling operations would cause a drop in bond prices or high interest rates. Under the present circumstances the central bank carries out dollar purchasing operations exclusively for state-owned foreign exchange banks and this poses a problem of uneven supply sources of domestic funds. It is accordingly necessary to study the use of other measures along with dollar purchasing operations.

5. Industrial Policy

The startling economic growth demonstrated by countries across East Asia in recent years has attracted worldwide attention to their industrialization-oriented policies. Ambitious initiatives in industrialization form one cornerstone of Viet Nam's 5-year economic plan, and as such, they call for an appropriate set of industrial policies. Drawing on the findings of our own research, in this paper we review the structure of Vietnamese industry and trade as well as the policies that have been integrated into the country's current 5-year plan. From that foundation, we then analyze problems facing new investments now planned in five capital-intensive industrial sectors (steel, petroleum refining, petrochemicals, urea fertilizer, and cement), and explore criteria for successful investment with reference to examples of both success and failure in other countries. In addition, we discuss bottlenecks to foreign direct investment (now an essential ingredient for industrialization in most ASEAN economies), problems of small and medium enterprises and rural industries, and the influences that AFTA and APEC membership will likely have on Viet Nam.

5-1 Structure of Production and Trade and Industrial Policy in Viet Nam

In the production of Viet Nam, agricultural, industrial and service sectors accounted for 27.7%, 29.6%, and 42.7% of GDP respectively in 1994. Industrial sector in ASEAN countries in 1994 is in the range of around 40% (Thailand 39.2%, Indonasia 40.7%) and considerably higher than that of Viet Nam. Simply judging from the ratio of indusrial sector, Viet Nam is currently comparable to Thailand in the early 1980s.

Though indusstrial output in Viet Nam has been climbing strongly for some years now, about half of the total output is in primary goods, and relatively little in manufactured goods. For instance, crude oil, coal, and other fuels accout for 16%, and foodstuffs, 34% (1994 figures). On the other hand, export oriented products such as textiles (textile, sewing and tanning of leathers etc.9.5%) and electronics (2.1%) have small shares. Furthermore, these industries have not increased their shares during this period. This shows that the growth of industrial output resulted from the expansion of domestic market and the increase in export of primary commodities. In other East Asian countries, the rapid increase in the share of textiles in production and employment was widely observed at the initial stage of economic development, subsequently replaced by machineries (electronics, transportation, etc.). From this trend, one can conclude that Viet Nam has not begun ASEAN-style export-led development yet.

Regarding trade, Viet Nam's export to CMEA countries has dropped to a negligible level from 1991, rapidly shifting its destination to the Western markets. The export grew rapidly by 92.3% between 1991 and 1994. Primary goods (mostly food and crude oil) remain the dominant export and accounted for 71.6% of total export in 1994. Among industries, light industries accounted for 18.3% of total export, contributing to 29.6% of total export growth. Almost all of this growth was clothing (weaving and shoes). The current export structure reflects Viet Nam's economy just starting industrialization. Viet Nam needs to diversify industrial export toward skilled labour intensive products such as machinary and electronics, considering the development pattern of other East Asian countries.

In mesuring comparative advantage, RCA (Revealed Comparative Advantage. Comparison of certain country and world average in the export share of certain product.) is widely used. Trade data of Viet Nam shows that RCA of manufacturing commodities are generally very low (See the table below). Among them clothing and accesaries, and footwear show RCA above 1.0 (in 1994, 3.58 and 3.30), showing advantage in these industries. In other East Asian countries, however, these items had shown RCA more than 10.0 at the peak period and there exists great potential for Viet Nam to expand the export of these items in the future.

Table 5-1. RCA of Industrial Goods in Viet Nam

SITC	Commodity	1991	1992	1993	1994
751	office machines	N.A.	N.A.	0.03	0.09
76	family equipment	N.A.	N.A.	0.00	0.00
785	bicycle	N.A.	N.A.	0.14	0.10
78	transportation	N.A.	N.A.	0.00	0.00
84	clothing and accessories	1.94	2.47	2.22	3.58
85	footwear	0.49	0.86	2.55	3.30
896	fine arts products	0.00	0.01	0.01	0.00

Viet Nam's industrial policy also addresses the importance of the efforts to shift the industrial structure to gain a comparative advantage in the international matket, since the industrial sector is expected to be the major driving force for the economic development. The growth of industsrial sector is targeted at 14-15% annually toward the year 2000, with the share of the sector reaching to 34-35% of GDP in the year 2000. To accomplish this target, both export-oriented and import-substituting industries are expected to be promoted. Other elements such as rural development, pollution control and compatibility with the rules of AFTA and WTO must be taken into consideration. Under this environment the government of Viet Nam must choose the best industrial growth path, which leads to the sectoral industrial policy of each industry.

Viet Nam's sectoral targets in the five year plan seem broad-ranging and ambitious in their scope and scale. Moreover, they underscore expectations that the country will be striving in parallel to boost export and import-substitution industries, as well. Above all, the past experiences of other East Asian countries in the cited industrial fields will be of value to the search for the growth path that offers Viet Nam the best prospect of exploiting its comparative advantages. With few exceptions, most Asian countries to date have opted for export-oriented models of growth, and on that basis they typically started by developing their textile industries and other simple labor-intensive sectors, thereby effectively putting their labor forces to work. Next, they shifted their emphasis to more advanced labor-intensive industrial pursuits such as the manufacturing of machinery and electronics. Certain ASEAN member-states in particular found it relatively easy to get their more-advanced, labor-intensive operations up and running by capitalizing on foreign direct investment and importing sophisticated plant equipment developed in the electronics revolution. In view of the current international backdrop, it would appear that shifting from low-tech to high-tech labor-intensive industries, as many ASEAN countries have done, is the best path of growth that would allow Viet Nam to exploit its comparative advantages in certain export industries. Many foreign investors share this view. Indeed, it is a position that seems all the more persuasive if one bears in mind Viet Nam's competitive edge in human resources.

One factor deserving special attention is the importance attached to capital-intensive industries by the sectoral goals of the current 5-year plan. Countries with populations as large as Viet Nam's will eventually need their own domestic chemical and heavy industries. Though industries in these fields can be expected to have a number of favorable spillover effects on other sectors of the economy, they typically demand enormous initial investments and on top of that, will not engage a very sizable share of the labor force at the outset. Unless steps are taken to identify the important features of a given industry and ensure that investments in it are not wasted, the resulting burden on the economy will probably be severe. In the next section, we pursue a multifaceted examination of five industrial sectors thought to be targeted for especially heavy levels of investment under Viet Nam's current 5-year plan, and follow up with several recommendations.

5-2 Five Capital Intensive Industries and Possible Problems for New Investment

Labor-intensive pursuits seem to be the most appropriate approach to industrialization for Viet Nam at present. However, history shows that capital-intensive projects in the heavy and chemical industries have played an important role in the overall industrialization process in some Asian countries (see Box 5-1). In the initial August 1995 draft of its 5-year plan, the Vietnamese government demonstrated strong interest in a number of capital-intensive projects in the heavy and chemical industries that could be expected to effectively exploit the country's natural resources. Following is a discussion of the features characterizing five of those sectors--in steel, petroleum refining, petrochemicals, urea fertilizer, and cement--with attention to international market trends and the possible problems for new investment.

(Box 5-1) **The Korean Experience and the Current Situation in the ASEAN Economies**

In 1973, Korea formulated a master plan for the heavy and chemical industries and embarked on an ambitious program comprising extensive investments in the steel and petrochemical sectors. At the outset, its investments were criticized as being imprudent and simply too big in their scale. However, thanks to expanding domestic demand and heightened exports, the country succeeded in weathering the financial burden. In fact, those investments effectively laid the foundations for much of South Korea's strength in the international market today. It should be noted, though, that the country put more emphasis on domestic demand than on exports. Only in the 1990s have the ASEAN nations reached a stage in their growth at which domestic demand is sufficient to accommodate investment projects in the steel and petrochemical industries.

All of these industries typically demand enormous capital outlays and have long payback periods. Moreover, even small differences in unit production cost can be the dividing line between business success and failure. Another problem is that all the products of these sectors (except cement) are international commodities, and as such, their prices are subject to steep fluctuations influenced by global economic trends and the balance of international-market supply and demand. Viet Nam can expect a sharp increase in domestic demand for the products of its heavy and chemical industries once it reaches a further stage in its economic development. At present, though, that demand falls short of what should be considered an appropriate scale for capital outlays in these fields. This reality demands an in-depth study of such factors as investment timing, trends in international supply and demand, as well as the feasibility of each project that is planned.

The initial draft of the 5-year plan placed stress on exploiting the country's natural resources. However, there is one point here that deserves attention and that has been clearly substantiated by the Japanese and Korean experiences in the field of steel: namely, that domestic sources of raw materials do not automatically translate into international competitiveness. Crude oil and iron ore can be exported as raw materials. However, Viet Nam could face heavy losses and liabilities if the huge capital outlays and other costs associated with transforming those raw materials into finished products are not below the international average. It should be borne in mind that Viet Nam's real strength is in its human resources, not its natural resources. It is of critical importance that the country's industrial policies strive to effectively harness that strength.

(1) Steel

Steel is a sector that demands enormous initial investments and that has a strong influence on other industrial sectors. Largely for these reasons, steel ventures in other Asian nations have typically been started up as state-run, national projects. The extended lead-times involved in steel-mill construction usually demand that the capital outlays be pursued in line with well-reasoned, long-range master plans. Such undertakings have not always been successful in countries neighboring Viet Nam (see Box 5-2).

(Box 5-2) **The Bright and Dark Sides of Steel Mill Investment**

High costs have in some instances made steel-mill operations a burden in certain neighboring countries. To give an example, Country M brought a direct-reduced-iron (DRI) steel mill (with 1.2 million tons annual capacity) into operation in the early 1990s. However, the initial investment proved abnormally high. In addition, the vast distance separating the steelmaking and rolling facilities has severely inflated the trucking costs. As a result, the mill is now running a huge deficit, and as a state-run enterprise, it has become an increasingly heavy burden on the government's finances.

By contrast, a comparable DRI plant brought on-line in Country I has been operating well and is now even under study for capacity expansion. Though economic growth has stoked intense domestic demand for steel in both countries, the two projects described above have demonstrated sharply divergent performance in terms of their profitability. The lesson is that even projects for small-scale, integrated steel plants deserve careful study regarding their feasibility.

Forecasts are that Viet Nam will witness a surge in domestic steel demand during the early years of the 21st century. At that time, it may appear feasible to build a 3-million-ton-class blast-furnace-integrated steel mill. In the event Viet Nam decides to go ahead with such an undertaking, it will be essential to ensure (i) that the project is internationally competitive (e.g., by locating it in a large seaside complex aimed at maximizing the benefits of scale); and (ii) that domestic demand be able to consume a substantial amount of the facility's output. Unless the first of those conditions is met, the country will have to assume a significant share of the costs; that could translate into pressure on the government budget or on consumers themselves. If the second condition is not met, the operation will face heightened exposure to risks stemming from international price trends, and hence, increasingly serious business risk, in turn.

Though it is anticipated that Korea, Taiwan, and other Asian countries will pursue aggressive capacity-expansion programs in the years ahead, infrastructure projects have been fueling steep growth in demand for steel products. For that reason, the shortage of steel in some ASEAN economies is expected to last beyond the year 2000. Demand in the marketplace slackens, though, whenever a new, large-scale facility goes into operation; accordingly, a close eye should be kept on capital investment trends in Korea and Taiwan, two countries that will be positioned to export more of their steel output in coming years. One feature of the steel industry in most ASEAN economies, now, is that electric furnaces and rolling mills produce most of the steel aimed at meeting domestic demand. Another is that steel-related capital-spending plans are concentrated in projects to build or expand medium-scale electric-furnace steel mills (up to 1 million tons annual capacity) and hot-rolling mills.

Domestic reserves of iron ore do not afford a country's steel industry a competitive advantage in the international market, as can be seen from the success of Japan and Korea, two countries which lack such reserves. Essentially, steelmakers in those two countries sought to cut their costs by importing quality iron ore in quantity with special ships, and by engaging in the mass-production of steel at large seaside complexes. Their effectiveness in that undertaking has been substantiated in the marketplace. By contrast, an integrated steel mill built on the assumption that domestic reserves will be its source of iron ore faces the danger of becoming tied to a captive mine and losing its flexibility. In the end, rising costs could force its eventual failure. Accordingly, when planning to build a steel mill that will do business in the international market, the issue of feasibility should hinge on the question of whether it will be able to establish a cost structure that allows it to compete on export prices with counterparts in Japan, Korea or Taiwan.

(2) Petroleum Refining

Viet Nam has shown interest in establishing and running export-oriented petroleum-refining operations near its oil fields. In East Asia at large, however, it is anticipated that such projects will be sited closer to final sources of demand than to oil fields. There are several reasons for that outlook, all having to do with the questionable profitability of export-oriented refining facilities located near oil fields--not just in Viet Nam but in other countries as well. First of all, new facilities of that kind would not be cost-competitive with Singapore, which is currently the region's principal center for exports of refined petroleum products. Second, patterns of oil-product consumption and standards of quality differ by country. And third, such facilities tend to have difficulty in selling the by-products of their refining processes.

Viet Nam also has plans to set up joint-venture refining operations funded with foreign capital. Should such ventures eventually materialize, it will be of the utmost importance to sustain their profitability. Additionally, Viet Nam will have to clear a number of hurdles related to its administrative structures and other issues. Foreign investors who have shown interest in forming joint-venture arrangements may abandon their plans unless Viet Nam can overcome its hurdles and guarantee that such projects will be satisfactorily profitable (see Box 5-3).

(Box 5-3) Is Petroleum-Refining a Lucrative Business?

As an industrial sector, petroleum refining should be recognized as a business that runs on extremely thin margins. Though the situation may have been otherwise during the oil-shock years, refineries over the past decade have turned an average margin per barrel of only US$1 or so. That works out to around US$30 million per annum, assuming that a refinery processes 100,000 barrels per day, 300 days out of the year. Refineries still have to deduct their interest payments and depreciation costs from that total. Petroleum refining is only one link in the oil business chain, which comprises the acquisition of exploration and extraction rights, exploration and extraction operations, oil production, refining, petrochemicals, distribution, and retailing. It is therefore critical that oil-refining projects properly balance the interests of investors and the recipient country.

In not a few cases, conflicting interests between investors and the recipient country have stalled progress on projects for refineries funded with foreign capital. One refinery project in Country C, for instance, has been put on hold due to just such conflicting interests. Basically, what happened is that foreign investors sought steep payroll cuts as a measure to improve productivity at the refinery in question. Country C was opposed to that, and in reaction demanded a large-scale payroll increase aimed at creating more jobs.

(3) Petrochemicals

Burgeoning demand and protective policies in many Asian countries have helped their petrochemical industries expand and develop by leaps and bounds in recent years. Among ASEAN economies, state-run enterprises have been leading a full-scale foray into the upstream sectors of the petrochemical field since the mid-1980s.

Despite the importance of ethylene centers as crucial foundations for the basic materials industry, some of their intrinsic features urge caution with respect to the timing of entry into these fields. First, projects in this field require huge investments, and petrochemical products are extremely sensitive to international price trends. For these reasons, upstream petrochemical ventures tend to carry significant business risk. Second, they will be of questionable feasibility unless the domestic market is developed enough to absorb a substantial share of their output. And third, while they are capital-intensive, they are capable of employing only a relatively marginal share of the labor force (see Box 5-4).

> (Box 5-4) **Troubles for New Ethylene Centers in Neighboring Countries**
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> In the event Viet Nam decides to build an integrated plant at some point in the future, it will conceivably be designed to produce import substitutes, as has been seen with similar facilities in neighboring ASEAN member-countries. In that undertaking, though, Viet Nam will find it essential to devote enough study to the domestic development pace of plastics processing and other downstream petrochemical sectors. Petrochemical products for export are prone to wild price swings. On top of that, they generally face long periods of sluggishness punctuated by short booms in business. (International prices for most East Asian petrochemical products are influenced primarily by economic trends in Europe and North America, regions that have excess capacity of their own.) The last short-term boom ended about a year ago; prices have since moved into a weakening trend.
>
> Country T did not conduct thorough enough feasibility studies. Largely for that reason, its upstream petrochemical sectors are now heavily dependent on the export market and consequently have been exposed to higher levels of business risk. A 100-percent foreign-capitalized ethylene center in Country I provides yet another example. Only a small share of its output is destined for the domestic marketplace, and as a poorly profitable export-oriented venture, it is now in financial trouble.

Indonesia, Thailand, and Malaysia have rich reserves of oil and natural gas. As their own track records show, they first cultivated their oil-refining industries and moved to lay the foundations for their petrochemical sectors while drawing on foreign investment to fund the development of domestic ventures in plastics processing and other downstream sectors. Once the downstream sectors entered a growth phase, these countries then decided it was time to build ethylene centers and other upstream facilities.

However, it should be realized that Viet Nam cannot usefully apply the lessons of its neighbors in this area without some adaptation to its own set of circumstances. First, viewing the creation of AFTA, Indonesia, Thailand, and Malaysia have begun moving steadily to liberalize their oil sectors: e.g., by abandoning restrictions on market entry, lowering tariff rates, and lifting ceilings on foreign investment. As a latecomer to the field, Viet Nam has found the international community less and less tolerant of the protective policies it has followed so far. Secondly, Singapore and other countries are now pursuing capacity-expansion plans aimed at expanding their share of the Asian market. It thus stands to reason that cost-competitiveness will become an even more influential factor than ever in determining whether a project is commercially successful or not.

These factors essentially underscore the importance of devoting ample study to the content and duration of industrialization policies that will be within the bounds of international tolerance, particularly when a project is carried to the implementation stage. In addition, they point to the need to carefully gauge whether a project will be cost-effective enough to compete at the international level.

(4) Urea Fertilizer

Urea -fertilizer plants are highly capital-intensive and, as such, demand appreciable injections of ODA and other foreign investment for their construction. It is therefore essential to carefully examine their feasibility not only in terms of domestic agricultural policy or the use of natural gas, but also with attention to such factors as the outlook for international supply and demand, and the question of whether they will be cost-competitive enough to withstand the ups and downs in international prices.

Annual growth in world demand for urea fertilizer averaged over 5 percent during the 20-year span to the end of the 1980s. As it happens, that period was marked by an ambitious drive in capacity expansion, with the result that conditions of excess capacity have predominated since. The 1980s witnessed a global glut of urea fertilizer, together with a collapse in the price of naphtha. These developments set the stage for a sharp plunge in the international price (per ton) of urea fertilizer, resulting in fluctuations as broad as $60 per year. During that period, whenever international prices weakened, fertilizer plants not cost-competitive with plants in neighboring countries saw their operations slip below the break-even point and accordingly found themselves threatened with operating losses (see Box 5-5).

(Box 5-5) The Hardships Suffered by Urea Fertilizer Plants in Neighboring Countries During Protracted Slumps

In the mid-1980s, estimates are that the production cost per ton averaged US$180 at a urea fertilizer plant (with annual capacity of approx. 500,000 tons) brought into operation around that time in Country M. Had market conditions forced the plant to ship its output at a price of US$100/ton, it would have faced losses totaling around $40 million a year.

In the late 1980s, Country T had plans to build a new, 670,000-ton-capacity fertilizer plant that would have been a state-run venture. However, the entity that would have been responsible for the plant's operation (the country's National Fertilizer Corporation) was dissatisfied with the findings of a project feasibility study conducted by an international aid organization, and therefore called on a university professor to re-evaluate the project from an impartial standpoint. Though this aroused the public's interest, the project was ultimately called off.

In Country B, the late 1980s saw completion of work on three fertilizer plants (of comparable scale, each with annual capacity of around 500,000 tons) that were designed to utilize natural gas as their chief raw material. When construction work began, estimates were that the three plants would all have production costs of around US$115/ton. Had they been forced to sell their output at under US$100/ton, they would have each been saddled with losses of over $20 million per annum.

An examination of fertilizer-plant earnings structure reveals that essentially three factors influence final production costs; raw-material costs, plant construction costs, and operating rates. Naphtha and natural gas are the principal ingredients used in the synthesis of ammonia, and as such, they are the main components of variable cost. Procuring raw materials domestically and sustaining high operating rates will help plants stabilize their production costs. Domestic agricultural policies and international price trends will be the key factors influencing sales.

Urea fertilizer is a typical international commodity; its price reflects global trends in supply and demand and fluctuations in the price of naphtha and natural gas, the two principal materials used in its manufacture. The past year or so has witnessed a recovery in the price of urea fertilizer, and partly for that reason, plans for new urea fertilizer plants are back in the news. It should be noted, however, that in 1994 and 1995, the former Soviet republics together had excess capacity in the range of 8 million tons, an amount equivalent to over 10 percent of global capacity. There is a chance that trends in this area of the world will drastically upset the balance of the global urea fertilizer market. In fact, it is strongly likely that the international price of urea fertilizer will remain highly volatile for the next five years.

(5) Cement

The products of the four industrial sectors already discussed--steel, petroleum refining, petrochemicals, and urea fertilizer--have status as international commodities. Accordingly, plants engaged in their manufacture tend to be directly exposed to international price competition. Another feature is that such commodities are usually the object of tariffs, price controls, or other protective policies that place a burden on the national economy. Cement, by contrast, is an important basic material used chiefly in infrastructure and buildings. Since cement is bulky and would thus impose high shipping costs, the industry is fundamentally "indigenous." In addition to these factors, though, it should be noted that Viet Nam is endowed with extensive limestone reserves, and that the domestic construction boom has fueled a sharp expansion in demand for concrete, presenting favorable market conditions for the siting of domestic cement plants.

Though cement plants typically require less investment than do plants in the petrochemical or steel sectors, they are machinery-driven undertakings nonetheless, and accordingly require lengthy periods before they begin to show a return on investment. At present, financial difficulties have limited efforts in capacity expansion by Viet Nam Cement Corporation. Furthermore, the current difficulties involved in mobilizing domestic private-sector capital essentially mean that new undertakings in capacity expansion will have to depend on direct investments from foreign firms.

While foreign investors are attracted by the above-noted factors characterizing Viet Nam's domestic business climate, some have expressed concern about the stability and transparency of policies influencing cement prices and the outlook for electric utility rates. In addition, some feel that seaside cement plants in Viet Nam could be cultivated into internationally competitive hubs for cement exports. However, the influx of foreign direct investment could end up hampered over the longer term if foreign companies are saddled with an excessive share of the cost burden associated with the development of port and transport facilities and other elements of essential infrastructure.

Policies for the cement industry should take into account the indigenous features of the sector itself and allow for finely tailored capacity expansion plans shaped by forecasts of local demand. In view of the high shipping costs, local fluctuations in supply and demand could undermine the stability of corporate earnings even if the market is balanced at the national level. In any event, the favorable conditions for the sector suggest Vietnamese entrepreneurs could enter the cement business once the domestic private sector accumulates enough capital. On-site mixing of cement delivered in dry, bag form by truck is the standard pattern of cement consumption in Viet Nam. Accordingly, steps to cultivate the cement industry could also be expected to promote the development of indigenous cement packing and trucking operations and other downstream processes that would provide more jobs to engage the labor force.

5-3 Bottlenecks to Foreign Direct Investment

Foreign direct investment (FDI) has been the indispensable element of economic growth in ASEAN countries and will be so in the case of Viet Nam, too. In 1995, 394 projects (excluding Oil and Gas) were licensed for US \$ 6.6 billion, which is 62% more than in 1994. In contrast to this rapid increase, implementation or actual investment is not growing as fast as license approval. The accumulated implementation rate declined to 39% in 1995 from 60% in 1991. This decline is mainly due to the increase of the weight of manufacturing projects, which require several years to implement, but might partly reflect desatisfaction of foreign investors with the current situation of Viet Nam.

A standard procedure for FDI has not been established and foreign investors have to cope with situations case by case. In order to analyze this "many doors" environment of FDI, we divided the flow of investment activity into three stages. First stage: Getting investment license, Second stage: Construction of plant, Third stage: Business operation.

In the first and second stages, various administrative problems were pointed out. Among them quite noteworthy is the issue which might relates to the reform of state-owned entaerprises (SOEs) in Viet Nam. In fact, applications for projects viewed as having the potential to infringe on the interests of existing state-owned enterprises (SOE) have in the past been turned down, or their applicants pressured to alter proposed equity stakes or project content (see Box 5-6).

(Box 5-6) **The Relationship between Promotion of Foreign Direct Investment and Reform of State-Owned Enterprises**

Measures to overhaul Viet Nam's SOEs should be pursued within the context of the larger, national strategy for industrialization. It should be noted that it will take time to establish effective systems of social insurance or frameworks supportive of a market economy. On that basic understanding, Viet Nam has the option of aiming for a soft landing based on the two-track approach demonstrated by China: namely, by (i) revitalizing its SOEs while (ii) simultaneously working to cultivate its non-state-owned corporate sector. To that end, efforts would be centered on establishing a business environment that allows state and non-state enterprises to compete fairly with each other on a "level playing field." In a country with the scarcity of private entrepreneurs Viet Nam currently suffers, it may be necessary to pursue joint-ventures between SOEs and foreign investors, the chief objective being to enhance the management efficiency of the former. In certain respects, FDI approval policy in Viet Nam seems guided by a desire to protect the interests of existing SOEs. Continued reliance on this sort of protective policy, however, would not only preserve the entrenched inefficiencies of SOEs, but would also discourage foreign investors and hence hinder steady inflows of FDI--now a key ingredient of Viet Nam's strategy for industrialization.

Our study is mainly focused on the third stage, as interviewees were those whose businesses are already in operation. Most widely observed complaints were; a) it takes time and effort to acquire import licenses of input materials for production from the Ministry of Commerce and concerned ministries, b) high import tax for parts has created obstacles for foreign affiliated companies, and c) accumulative turnover tax is penalizing the development of domestic production. These factors lead to an increase in the price of products and reduce their competitiveness.

Throughout stages, each ministry deals with both informal discussion and application from foreign investors, basically case by case. A yardstick of one ministry sometimes contradicts the measure of another. As a result, foreign investors tend to perceive that there is no one consistent policy for FDI, reducing the attractiveness of Viet Nam.

5-4 Problems of Small and Medium Enterprises and Rural Industries

Rural farm households account for the majority of Viet Nam's population. Owing to the emphasis on regional balance, the country considers rural industrialization and the development of small and medium enterprises (SMEs) to be especially serious policy challenges. To be sure, SMEs and rural industries have an important role to play on several fronts: creating new job opportunities, developing the supporting industries for machinery, electronics, and other modern sectors, contributing to an improved balance of payments through heightened finished-product exports and the substitution of intermediate goods produced domestically for imports, in rural modernization and poverty alleviation, and in alleviating disparities between urban and rural areas. Japan and other neighboring Asian countries valued the role of SMEs in their economic development and, from the perspective of enhancing their market economies, they all moved at a comparatively early stage to actively promote SMEs.

Viet Nam's efforts in this area, however, have only just begun. Small and medium enterprises and rural industries in the country currently face a plethora of difficulties, and still appear unable to fully exercise their latent potential. The findings of this provisional joint study and of past studies all suggest that rural industries and SMEs in the manufacturing sector face problems of the following kind.

First is the shortage of capital. Though bank loans to the private sector have recently been on an upswing, they seem limited in their scale. Hence, while many SMEs and independently run businesses have plans to expand, they lack the funding to put those plans into action. In some cases, it is difficult even to obtain access to bank credit. Moreover, since most financing is short-term and carries high interest rates, SMEs that do have access nonetheless find it difficult to obtain medium- and long-term financing. Viet Nam needs to devote study to its financing frameworks for SME operations, including steps to establish a system of credit guarantees.

Second is the scarcity of market data. Many SMEs appear to be seriously frustrated with the lack of information, particularly on domestic market sectors exhibiting growth in demand. This situation seems to urge that consideration be given to mechanisms for the sharing of information on the Vietnamese and foreign markets.

Third are the difficulties involved in securing sites for industrial operations. This problem exists nationwide, not only in and around Hanoi or other large cities, but also in smaller cities. In fact, many businesses find it almost impossible to expand their facilities in order to meet burgeoning domestic demand or orders from abroad. For this reason, they are unable to deal with existing noise and air- or water-pollution problems. Viet Nam should explore the possibility of developing industrial parks not only for foreign companies, but for its SMEs as well.

Fourth is the need for management consulting and assistance in product quality control, productivity enhancements, and so forth. Most SMEs in Viet Nam lack management experience or expertise, and thus need help with their managerial affairs when preparing to expand. This situation calls for efforts to increase the availability of management assistance services, for instance, as offered through local chambers of commerce and industry.

A fifth problem, and one that is related to the scarcity of information on foreign markets, is the difficulty SMEs face in directly exporting their products. Export licensing requirements, export quotas, and complicated export procedures all form a bottleneck that effectively forces most SMEs to export their products through state-run trade corporations or SOEs instead. That approach, however, prevents them from gaining direct contact with foreign buyers, and from enjoying the many benefits such contact could afford, including information on foreign market conditions and the acquisition of essential expertise. Small and medium enterprises have also seen their export potential inhibited by the lack of an export-financing system.

Yet another problem, albeit not one faced only by SMEs or rural industries, per se, is the underdeveloped state of Viet Nam's legal code and other elements of business infrastructure. Though efforts to lay its legal foundations are moving forward at a feverish pace, the country has yet to put the finishing touches on its commercial code. Not only that, but some of the newest laws on the books are simply too generalized, making them virtually impossible to enforce in practice. Though the country has sought to compensate with decrees, ministerial ordinances, and administrative guidance, these efforts have been widely criticized for the lack of transparency characterizing their application. The tax code is also a general problem, and one that affects large companies as well. The high tax rate on corporate profits, along with the sales tax and a host of other taxes as well as additional fees collected by government agencies, together have a stifling effect on private-sector business activity. The government has decided to offer tax breaks for businesses engaged in priority fields by revising the profit tax and establishing laws on domestic investment. At present, though, many companies are unable to benefit from any of the incentives ostensibly offered by these legislative changes.

The joint study also found problems with the underdeveloped state of infrastructure (particularly the road networks utilized by rural industry), competition with black-market goods, the shortage of skilled engineers and other professionals, and the backward state of education in rural areas.

In view of the importance of the country's SMEs and rural industries, the Vietnamese government should first come up with active policies of assistance. Next, it would seem essential to put some institution in charge of all the administrative affairs relating to SMEs and rural industries, and to strive to establish an effective administrative system. Once that framework is in place, it will then be necessary to address the problems cited above in earnest.

5-5 Participation in AFTA and APEC and the Expected Impact on Viet Nam

In terms of industrial policy, Viet Nam faces unprecedented pressure to pursue its industrialization within new, unified regional economic frameworks, such as AFTA. Over the long range, it appears that the country's deregulation-led participation in international trade will be an essential condition for its industrialization-led economic advance and eventual transformation into a full-fledged market economy. As other East Asian countries have demonstrated from experience, deregulating trade and investment is a vital part of economic development strategy. Viet Nam should view participation in AFTA and APEC as steps along the path to trade and investment deregulation that will be integral to its long-range policies of industrialization.

AFTA has been engineered to foster opportunities for trade particularly within the ASEAN community, and to encourage expanded inflows of foreign direct investment. To that end, AFTA member-states will take steps to deregulate intraregional trade and investment and cut the cost of doing business with each other by standardizing their legal codes and other institutional frameworks. Participation in the AFTA framework will afford Viet Nam opportunities to boost its exports and lure in more foreign investment, while at the same time allowing it to compete with other countries region-wide.

AFTA participation can be expected basically to have the following effects. In their intraregional trade, AFTA member-countries will be able to expand their exports due to lower tariff rates; reduce the cost of imports of raw materials, parts, and capital goods; and improve the efficiency of their domestic manufacturing bases through competition with imports. Also, measures to deregulate foreign investment can be expected to widen the influx of foreign investment from countries outside the AFTA community. In addition, steps to deregulate intraregional trade will likely have the following, indirect effects on foreign direct investment: i.e., boost levels of investment aimed at expanding exports to

AFTA countries; cut back on levels of investment for domestic manufacturing projects in countries whose markets have to date been protected by high tariffs; and cut back on investments in exports destined for markets outside the AFTA community.

The strength of these effects will depend on the initial economic conditions and competitiveness of the AFTA country in question. To be sure, the benefits of trade liberalization will be limited in countries that do not yet have an adequately functioning market economy or that still suffer bottlenecks in funding, technology, or infrastructure. Prior to joining AFTA, most countries of the region other than Viet Nam had already moved on their own initiative to deregulate trade and investment, and had track records of rapid economic growth. In that sense, Viet Nam will be a latecomer to the fold. Accordingly, it faces the challenge of exploiting the opportunities provided by AFTA participation and surmounting the hurdles to its satisfactory enjoyment of the potential benefits therefrom.

In effect, Viet Nam differs from other countries already party to AFTA in that it bears the following set of initial conditions. (i) It is still an economy in transition. (ii) It is still in the early stages of its economic development. (iii) AFTA participation will demand that it pursue more extensive, far-reaching measures in structural adjustment (deregulation). (iv) It is heavily dependent on AFTA countries for trade (20 percent of exports, 30 percent of imports). During the deferment period for implementation of deregulation measures, Viet Nam will face the necessity of doing everything within its power to address the above shortcomings in its initial conditions, and compete openly with other countries of the region.

Harnessing foreign direct investment will be one of the most effective and important vehicles Viet Nam can utilize to that end, as the rapid pace of industrialization in other ASEAN countries has already shown. Foreign direct investment can play an instrumental role in offsetting Vietnamese deficiencies in such resources as technology, financial might, and management expertise; enabling the country to more quickly draw on its latent comparative advantages, e.g., in terms of quality human resources; and fostering domestic gains in business efficiency. To ensure that foreign direct investment effectively serves these ends, however, it is essential that Viet Nam take steps to establish a fundamentally sound investment climate rather than focusing its priorities in selected projects alone. That is to say, the country needs to develop and improve on its infrastructural essentials for industry, transportation, and telecommunications, establish suitable legal and tax frameworks for investment, streamline its administrative procedures, and pursue policies in macroeconomic stabilization.

Essentially the same arguments will hold for participation in APEC. What is more, the benefits of APEC participation will be even broader in their scope, including regional economic assistance in human resources development and technical assistance programs; assistance for the development of a market-oriented infrastructure; and most-favored-nation treatment from the U.S. and other APEC member-countries. At present, the terms for participation appear less stringent for APEC than for AFTA. For instance, 2010 is the deadline for full regional liberalization, and the deferment periods can apply to a broader set of conditions. Given these features, it seems advisable that Viet Nam actively explore the prospect of participating in APEC as well.

Generally speaking, Viet Nam should strive to maximize the benefits of participation in APEC and AFTA (and eventually, in the WTO). To be sure, international confidence in the future of Viet Nam's economy can be expected to climb, provided it demonstrates an enthusiastic attitude toward participation. While the terms for participation do not appear easy to satisfy, Viet Nam will still have some flexibility regarding the timing, speed, and content of any measures it actually pursues in the arena of deregulation. The prime expectation of countries in their early stages of economic development will be that they demonstrate a medium- or longer-term commitment to the liberalization process. Multilateral and bilateral negotiations on actual deregulation timetables and exemptions (temporary grace periods, at the very least) will still be possible.

6. Agricultural and Rural Development

Vietnamese agriculture has undergone various changes owing to changes in the political and economic environment. The Doi Moi policy and the subsequent renovation process aimed at changing the economic system from a planned to a market-oriented economy. Under the reform process, production and marketing mechanisms were liberalized and long-term land tenure was secured for individual farm households. The economic incentives · farmers gained through the renovation process have enhanced agricultural production. In fact, during the five years from 1991 to 1995, gross domestic product in the agricultural sector achieved average annual growth of 4.5%.

6-1 Factor Analysis of Increases in Agricultural Production

Rice production in paddy equivalent has increased from 19.2 million tons in 1990 to 24 million tons in 1995, representing annual growth of 4.6%. This remarkable achievement has brought an increased and stable supply of food to the people as well as exports of nearly 2 million tons of rice every year.

This rapid increase in rice production has been achieved by an increase in the sown area, a shift in crop seasons from lower yielding winter paddy to higher yielding spring and autumn paddies, and to a lesser degree, the overall yield increase per unit of sown land. The Mekong River delta has led these movements with an increased sown area, a shift to the spring and autumn paddies and a modest yield increase per hectare. In the Red River Delta, on the other hand, the increase was, to a large extent, realized by a unit yield increase and partially by a shift in paddy cropping seasons.

This increase should be regarded as the combined and integrated outcome of the intensification process to which various factors such as high yielding varieties, higher fertilizer application and more intensive pest/disease control contributed, apart from an intensive input of labour. Above all, the investment in irrigation and drainage was most instrumental to the production increase, since the spring and autumn paddies are grown during the dry season, thus require irrigation. High yielding varieties including hybrid rice are available for spring and autumn crops. The yields of these varieties increase with greater intensity of cultivation.

Equally important was the institutional framework established since the renovation.

Indeed, stipulation of land use rights has motivated farmers to invest in ways to increase production. Agricultural prices are determined by market forces which have encouraged farmers to produce crops and livestock of their own choice and giving them responsibility for their decisions. The rural credit system was restructured and re-established through which funds have flowed into farm households.

At the same time, as time passes after the start of the renovation process, there is a concern that the economic incentives offered to farmers may not be sufficient to realize the sustainable development of agriculture. A few worrying signs have started to appear. The recent trend of investment in agriculture, for instance, is not encouraging. There is a need therefore to strengthen the contributing factors which brought about the production increase in the past decade so that their effects will be lasting and more significant.

Rice prices are subject to government intervention through public agencies and state companies both in the domestic and export markets. The recent trend, in which farmgate prices have risen while retail prices have been relatively stable, would suggest a general streamlining of the market and a reduction in the margin between farmgate and retailer prices. In the export market as well, due mainly to improvement of quality, export prices of Vietnamese rice have risen and the difference between world prices has narrowed. However, there is still room for improvement in the public market intervention so as to ensure greater stability of consumer prices and, at the same time, to encourage domestic production.

6-2 Diversification of Agriculture

Diversification of agriculture, together with intensification of production, is regarded as the strategic direction of the development of agriculture in Viet Nam. Geographical expansion of agricultural land is limited and, if possible, difficult and costly. In fact, as commercialization of agriculture has been progressing, supported by the changing pattern of food consumption particularly in urban areas, diversification of farming in introducing new crops, animal husbandry and aquaculture has been taking place.

Diversification of agriculture has also been progressing at the national level. While in most cases diversification at farm and country levels advances simultaneously, specialized production zones of certain crops and livestock are sometimes being created. For example, farming systems incorporating winter vegetables, flowers, and aquaculture with the conventional rice double cropping are spreading in the Red River delta, and zones specializing in rubber and coffee are being formed in the Central Highlands and Northeast South.

In proceeding with diversification at the farm level, the following pose constraints: poor land and irrigation conditions which prevent a variety of crops from being grown, lack of effective marketing systems and transportation facilities, shortage of credit (specifically medium to long-term loans), and a less than satisfactory level of research and development.

A review of the future market prospects of four export crops - coffee, rubber, tea and vegetables - is found out in the Report. These crops were selected because of their importance in further expanding agricultural diversification.

While coffee production as well as exports have been rapidly increasing and new markets are explored the future prospect of the world coffee market appears not wholly optimistic. The present high prices may not last for long as the market as a whole is saturated. Fast growing markets for coffee like Japan and Republic of Korea prefer the high quality arabica beans. Quality control together with an increase in the arabica production are crucial to maintain the export momentum of Vietnamese coffee.

The prospects for rubber are brighter than those for coffee as the demand for natural rubber from the tire manufacturing industry has been increasing and will further increase. As Viet Nam is a new entrant to the world rubber market, quality improvement to establish its reputation is the key for penetration.

Though Viet Nam is a traditional tea exporting country, in view of the saturated world market, future prospects are not promising. Prices are unstable and remain low. Marketing promotion should be vigorously pursued for exploring and expanding foreign markets. Exports to Japan at the trial stage remain small in quantity.

Vegetable exports to Japan, both fresh and semi-processed, are virtually the sole potential exporting market, but have so far been limited due to the unique nature of the Japanese market which requires specific quality, shape, colour, size, taste and delivery timing. Considerable efforts together with establishment of information systems and marketing channels are needed in order to penetrate into the Japanese market.

6-3 Re-establishment of Farmer Organizations

As a result of the renovation policy, in which individual farm households became the basic production units with full responsibility for production and marketing, agricultural cooperatives and production groups were expected to be the service organizations for individual farm households. As a matter of fact, however, few cooperatives and production groups succeeded in adapting to these new roles, while many were dissolved or remain inactive. Even in surviving and active cooperatives, the activities are mostly limited to the maintenance and operation of irrigation facilities. Some "good" cooperatives, however, are providing services like fertilizer supply, plant protection and veterinary services in addition to irrigation, implying that after marketization, those responding to the farmers' needs best will survive and prosper.

A noticeable phenomenon concerning group activities in rural areas is an increase in farmers' small groups. Although a detailed profile is difficult to draw up due to their diversity, these groups, spontaneously formed by farmers for mutual help in pursuing mainly the economic interest of members, should attract attention.

The roles and advantages of cooperatives in a market-oriented economy can not be over emphasized. These roles and advantages however are yet to be fully exploited. While the recent move of the government to enact the Cooperative Law is a landmark step to encourage and build effective agricultural cooperatives, further steps are needed to give stimulus and to facilitate the organization of agricultural cooperatives in other circumstances.

Several issues are raised in order to promote farmer organizations, especially agricultural cooperatives. They include:

(1) To examine the advantages and disadvantages of multi-purpose cooperatives including credit services. Lessons may be drawn from similar cases in Asian countries;

(2) To establish regional and national federations which provide information, guidance, audits and training to individual cooperatives;

(3) To overcome serious obstacles due to the accumulated debts of old cooperatives to state institutions and the arrears of their members; and

(4) As small groups of farmers are the strong promoters of the development in rural areas, a legal framework and preferential conditions should be provided in order to encourage their activities.

6-4 Restructuring of the Rural Credit System

The rural credit system in Viet Nam was restructured and re-established in 1990. The main institutions are the Viet Nam Bank for Agriculture and People's Credit Funds, together with credit cooperatives, and special credit schemes like the Viet Nam Bank for the Poor. These institutions are functioning effectively and complementing each other. As a result, short-term loans are meeting a large part of the requirements, at least for the relatively better-off farmers.

As intensification and diversification of agriculture proceeds and is promoted, the provision of medium and long-term loans should be substantially increased. These loans are, at the same time, to be provided under feasible conditions, in terms of lending conditions as well as in amount, while financing institutions should maintain their viability and sustainability. An emphasis is also placed on lending to emerging subsectors including the agro-related processing industry which would lead to increases in added value in agricultural production and rural employment opportunities.

Savings mobilization and mutual lending based on the cooperative principle has great potential. In this connection, the People's Credit Funds is expected to play a significant role, particularly as a pivotal organization to coordinate and combine credit cooperatives under the new legal and administrative framework.

Special credit schemes which provide funds to specific groups, often at preferential conditions, have their own "niche" in serving these targeted clients. The government should further support these schemes particularly those oriented towards the rural poor.

6-5 Future Policy and Strategic Directions for Sustainable Agricultural Development

From the above observations about the issues crucial to future development of Vietnamese agriculture, the future policy framework to increase production, improve farmers' incomes and enhance rural living conditions are derived. Sustainable development should be achieved through intensification, diversification and strengthened economic incentives.

Sustainable production requires: (a) increased investment in agriculture centering on infrastructure such as irrigation, drainage, land consolidation, rural roads and rural electrification; (b) strengthening research and development for continuous technology improvements and breakthroughs; and (c) institutional arrangements including, among others, extension of improved technologies, accelerated issuing of certificates of land tenure, and credit provision. Public expenditure in these fields should be increased. On a medium and long term basis, discussions at the national level will be initiated regarding the extent and magnitude of investment in agriculture to secure a stable supply of food for the changing pattern of consumption and demand.

In view of the continuing importance of rice as a staple food, and in the farm and national economies, it may be opportune to review the policies and measures to stabilize rice prices. The present mechanism should be scrutinized in respect to effectiveness, resource allocation, and overall policy objectives. Experiences of other ASEAN countries in rice price interventions would provide useful references.

Farmer organizations, specifically agricultural cooperatives, are considered to be instrumental in realizing the advantages and benefit for farmers from a market-oriented economy for farmers. The government recognizes the importance and need of reconstructing agricultural cooperatives and has been taking action to this effect. Although support by the government is necessary, at least at the inception of the reconstruction stage, it must be carefully implemented, lest it discourages the autonomy and initiatives of cooperatives and voluntary participation of rural people. As the rural credit system has been re-established, the pending tasks are to fill in the existing gaps in the system and further expand those areas in which urgent action is required, as pointed out in earlier paragraphs. At the same time, in order to ensure the financial viability of the system including rural savings mobilization, coordination between farmer organizations and the credit system should be considered. Given that investment and other measures are effectively carried out, it will not be very difficult to achieve the targets for food production set in the next phase of the five year plan 1996 - 2000. With the continuing fast growth of the economy, Vietnamese agriculture will face new issues and challenges and is expected to respond to them. The next five years will be crucial in building the base for sustainable agricultural development beyond the year 2000.

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