KỶ YẾU HỘI THẢO QUỐC TẾ

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KINH NGHIỆM QUỐC TẾ VÀ BÀI HỌC CHO VIỆT NAM

INTERNATIONAL CONFERENCE PROCEEDINGS

ECONOMIC REFORMS FOR INCLUSIVE AND SUSTAINABLE GROWTH

INTERNATIONAL EXPERIENCE AND LESSONS FOR VIETNAM

NHÀ XUẤT BẢN KHOA HỌC XÃ HỘI

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INTERNATIONAL EXPERIENCE AND LESSONS FOR VIET NAM

NHÀ XUẤT BẢN KHOA HỌC XÃ HỘI
HÀ NỘI - 2014

International Conference
Economic Reforms for Inclusive and Sustainable Growth: International Experience and Lessons for Viet Nam
Hanoi, 24-25 March 2014

OPENING SESSION

Present on the podium: (1) Ms. Nguyen Phuong Nga, Vice Minister of Foreign Affairs; (2) Mr. Nguyen Xuan Thang, VASS President; (3) Mr. Nicholas Rosellini, UNDP Deputy Assistant Administrator and Deputy Regional Director for Asia and the Pacific; and (4) Ms. Pratibha Mehta, UN Resident Coordinator and UNDP Resident Representative in Viet Nam.

Keynote speakers: H.E. Mr. Pham Binh Minh, Deputy Prime-Minister and Minister of Foreign Affairs, and Ms. Helen Clark, UNDP Administrator.

1	Introduction to the joint MOFA-VASS-UNDP Conference	Ms. Pratibha Mehta, UN Resident Coordinator and UNDP Resident Representative
2	Keynote speech Development Vision: Viet Nam towards 2020	H.E. Mr. Pham Binh Minh, Deputy Prime Minister and Minister of Foreign Affairs
3	Keynote Address Agenda for inclusive and sustainable human development	Ms. Helen Clark, UNDP Administrator

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SESSION ONE

Economic Reform: The Challenge of Inclusion

This session will refer to topics raised in the keynote speeches and focus on the importance of inclusive growth. It will highlight the nexus between economic growth and inequality and the importance of inclusive institutions.

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<tr><td>1</td><td>Introductory remarks (remarks will link the issues raised in the above speeches and highlight the importance of inclusive growth - to set the scene for session two and three)</td><td>Prof. Nguyen Xuan Thang, VASS President</td></tr>
<tr><td>2</td><td>Why inequality matters for economic growth: The global debate and lessons for Viet Nam</td><td>Prof. Jayati Ghosh, Jawaharlal Nehru University</td></tr>
<tr><td>3</td><td>The role of institutions in economic reform: A perspective from Viet Nam</td><td>Mr. Nguyen Xuan Thanh, Fulbright Programme</td></tr>
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SESSION TWO

Economic Reforms for Inclusive and Sustainable Growth

This session will focus on priority reform areas. How can short-term macroeconomic stabilization and medium/long-term measures of structural and institutional reforms be balanced? What are the opportunities and challenges; relevant international experiences and lessons learnt; and priorities for Viet Nam? The session will be divided into three parts:

I. Strengthening the Financial Sector

II. Enhancing Competitiveness: The Role of SOE Reform

III. Enhancing Competitiveness: Industrial, Agriculture and Rural Development

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<tr><td colspan="3">I. Strengthening the Financial Sector for Inclusive and Sustainable Growth: International Experience and Implications for Viet Nam</td></tr>
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<tr><td>1</td><td>Financial Sector Reforms in Viet Nam</td><td>Mr. Pham Xuan Hoe, Deputy Director, Monetary Policy Department, State Bank of Viet Nam</td></tr>
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<tr><td>3</td><td>Financial Sector Reform: Lessons from Indonesia</td><td>Dr. Syafruddin Temenggung, Former President of IBRA, Indonesia</td></tr>
<tr><td colspan="3">II. Enhancing International Competitiveness: Reforming State-Owned Enterprises (SOEs) - International Experience and Implications for Viet Nam</td></tr>
<tr><td colspan="3">Chair: Mr. Vo Tri Thanh, Vice President - CIEM</td></tr>
<tr><td>1</td><td>SOE Reform in Viet Nam</td><td>Mr. Nguyen Dinh Cung, President - CIEM</td></tr>
<tr><td>2</td><td>SOE Reform: Experiences and Lessons for Viet Nam
This presentation will focus on</td><td>Prof. Gary Jefferson, Department of Economics and the International Business</td></tr>
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	the role of SOE reform in improving competitiveness. It will build on examples from China and other relevant countries.	School, Brandeis University
3	SOE Reform and China's New Reform Agenda	Prof. Zhang Jun, Professor of Economics at Fudan University and Director of the China Center for Economic Studies
4	SOE Reform in Indonesia	Mr. Laksamana Sukardi, Former Minister of SOEs, Indonesia
SESSION TWO (cont'd) **Enhancing International Competitiveness: Industrial, Agriculture and Rural Development**		
Chair: Mr. Tran Dinh Thien, Director Vietnam Economic Institute, VASS		
1	Institutions for Industrial Development: Experience from South East Asia	Prof. Richard F. Doner, Emory University
2	Avoiding Middle-Income Trap: International Lessons	Dr. Thangavel Palanivel, Chief Economist, UNDP Regional Bureau for Asia and the Pacific
3	Agriculture and Rural Development in Viet Nam: Vision and Actions	Mr. Nguyen Do Anh Tuan, Deputy Director, IPSARD/MARD, Viet Nam

SESSION THREE

Tapping the Potential of Global and Regional Intergration for Inclusive and Sustainable Growth

Changes in the global and regional value chains and production networks accompanied by increasing global and integration provide great opportunities for the region and Viet Nam. This session will focus on the implications of these shifts for Viet Nam, the challenges and opportunities it presents and the measures that will be required to maximize the benefits of such integration. It will discuss how other countries have reaped the benefits of regional integration to promote inclusive and sustainable growth.

Chair: Prof. Nguyen Quang Thuan, VASS Vice President

1	International Integration and Inclusive Growth: Challenges and Opportunities for Viet Nam	Mr. Vo Tri Thanh, Vice President - CIEM
2	Taking Advantage of Shifting Global Value Chains and Production Networks: Implications for the Region and Viet Nam	Prof. Shahid Yusuf, George Washington University
3	Trans-Pacific Partnership (TPP) and Free-Trade Agreements: Challenges and Opportunities *This presentation would focus on institutional reforms and capacity required for Viet Nam to maximize the benefits from global integration.*	Prof. Rob Lawrence, Harvard University

CONCLUDING SESSION

The Way Forward and Closing Remarks

Present on the podium: (1) Ms. Nguyen Phuong Nga, Vice Minister of Foreign Affairs; (2) Mr. Nicholas Rosellini, UNDP Deputy Assistant Administrator and Deputy Regional Director for Asia and the Pacific; (3) Prof. Nguyen Quang Thuan, VASS Vice President; and (4) Ms. Pratibha Mehta, UN Resident Coordinator and UNDP Resident Representative in Viet Nam.

	Closing remarks	Mr. Nicholas Rosellini, UNDP Deputy Assistant Administrator and Deputy Regional Director for Asia and the Pacific
		Ms. Nguyen Phuong Nga, Vice Minister of Foreign Affairs

OPENING SESSION

INTRODUCTION TO THE JOINT MOFA-VASS-UNDP CONFERENCE

Pratibha Mehta
UN Resident Coordinator and UNDP Resident Representative

Thank you Vice Minister, Madame Nga for your introduction.

Excellency Mr. Pham Binh Minh, Deputy Prime Minister and Minister of Foreign Affairs, Professor Nguyen Xuan Thang, President of the Vietnam Academy of Social Sciences, Mme Helen Clark, UNDP Administrator,

Excellencies and Ambassadors and representatives of international organizations, distinguished conferenced speakers and participants,

Ladies and gentlemen,

Today is a big pleasure to welcome all of you to this conference entitled "*Economic reforms for Inclusive and Sustainable Growth: International Experience and Lessons for Viet Nam*".

I would like to begin my introductory remarks by paying tribute to the *Doi Moi* visionaries. Back in the mid-1980s, when the country made big choices that shape its transformation to a modern and secure nation. Vietnam's performance in the post transition period has been truly outstanding. Setting the pattern on a high growth path of about economic growth and bringing about exceptional level that is poverty reduction and human development and achievement of the majority of the Millennium Development Goals. Confirming that the choices made then were the right ones. And it is also important to underline that by and large, these outcomes that are attained with relative, including an income distribution.

However in recent years, some of the positive trends have slowed down and VN now stands at the new crossroad. The global financial crisis of the last decade has revealed a number of structural problems in VN's economy and arguably, the roots of this situation run deep. VN has attained an economic model that is achieved through an expensive growth and emphasizes the utilization of under utilized capital and labor as opposed to ones which also secure greater productive efficiency and moving to a value chain. Although poverty reduction has continued, disparities between rural and urban areas, geographic locations and between Majority and minority communities have become more entrenched. These interlocking issues underscore the importance of bolt and new thinking and the pre-examination of short and medium term economic policies as well as institutional reforms.

This conference is therefore very timely and UNDP is extremely pleased to collaborate with the Ministry of Foreign Affairs and the Vietnam Academy of Social Sciences in organizing this conference at this very important juncture. As the agenda shows, we have brought international experts of different backgrounds and perspectives together. They are leading policymakers and researchers. The main objective of the conference is to review international experiences and ideas for inclusive and sustainable development and the discussion is structured around 4 substantive areas: the financial sector and capital market reform, the reform of the SOEs, industrial and agricultural development and the role played by trade policy in a way that can brought inclusive and sustainable development in VN.

In closing, I would like to remind that thanks the organizers from the Ministry of Foreign Affairs and the Vietnam Academy of Social Sciences for the leadership in making this conference happen. And on behalf of all co-organizers, I would like to once again extend a very warm welcome to all participants and wish everyone a very productive and stimulating exchange of ideas.

Thank you very much!

KEYNOTE SPEECH

Pham Binh Minh
H.E. Deputy Prime Minister
and Minister of Foreign Affairs

Ms. Helen Clark, Administrator of the United Nations Development Program,

Ladies and Gentlemen,

First of all, I am very happy to attend the Conference today with the theme "*Economic Reforms for Inclusive and Sustainable Growth: International Experience and Lessons for Viet Nam*" hosted by the Ministry of Foreign Affairs in collaboration with the United Nations Development Programme (UNDP) and the Viet Nam's Academy of Social Sciences. I would like to extend my warmest welcome to Madam Helen Clark, UNDP Administrator and distinguished guests for presenting and contributing to the Conference. Your share of experiences and policy recommendations on measures towards sustainable and inclusive growth would be valuable reference for Viet Nam's government in our reform efforts.

Ladies and Gentlemen,

We are living in the world that is moving and changing rapidly. The context of world economy after the crisis is opening up new opportunities for development, but also poses critical challenges requiring countries to make greater efforts in order to not fall behind.

Multi-layer economic linkages, especially the emergence of new-generation FTAs with a wider coverage and higher level of commitments, will create new development space while posing challenges to domestic reforms to be compatible with new rules of the game. Lessons of the 2008-2009 global financial crisis emphasize the importance of more sustainable and balanced growth models. Public debt crises, financial risks, environmental degradation, the gap between the rich and the poor, and rising socio-political instability in various areas around the world have shown that the traditional growth model is no longer relevant. Finding new ways toward a sustainable and socially and environmentally harmonious economy is thus not only an urgent demand, but also an important driving force to accelerate economic recovery at both global and national level. Accordingly, economic reform and innovation and fundamental changes in economic thinking and growth model are the most significant way to build a more sustainable, balanced and inclusive economy.

In my speech, I would like to exchange with you on how Viet Nam is doing to achieve our strategic development goals towards 2020. Firstly, I would like to highlight some of Viet Nam's socio-economic successes thanks to the reforms as well as challenges facing our country in the process of repositioning the Vietnamese economy in the new global context.

Ladies and Gentlemen,

After nearly 30 years of reform (Doi Moi), Viet Nam has obtained remarkable achievements in socio-economic development. Once a underdeveloped nation, Viet Nam has become into a middle-income economy. Between the launching of reform in mid-1980s and 2011, the economy was doing very well with the growth rate of 7% per year. After slowing down in the 2011-2012 period due to impacts of the global financial crisis, our economy is making positive recovery. Macroeconomic stability is restored. Economic growth reached 5.4 % in 2013 and is expected to achieve from 5.8 to 6 % in 2014.

Besides economic goals, Viet Nam has attached special importance to social development, creating opportunities and conditions for the people to participate in socio-economic development and enjoy the fruits of development. Viet Nam has mainstreamed the Millennium Development Goals (MDGs) into the socio-economic development strategy and other national programs on education, health, labor, poverty alleviation, environmental protection and climate change. To date, Viet Nam has accomplished 5 out of 8 MDGs ahead of schedule, especially in sucha areas as poverty reduction, gender equality, universal education and health care.

Poor-households fell from 58% in the early 1990s down to 7.8% in 2013. According to the Human Development Report 2013 (HDR) issued by the UNDP, Viet Nam belongs to 40 developing countries that made progress beyond expectation in human development with index increasing by 41% during the past two decades. According to the International Telecommunication Union (ITU), the number of internet users in Viet Nam is nearly 31 million, accounting for about 34 % of the population and ranking the 3rd in Southeast Asia and the 8th in Asia. This demonstrates Viet Nam's strong resolve and efforts in increasing the human development has been acknowledged by the international community. In recent years, despite negative impacts of the global economic downturn, our social security programs were not cut, but continued to expand. This is the evidence of Viet Nam’s consistent policy and strong determination in aligning economic growth with social equity and progress.

Taking the advantage of the favorable international environment, Viet Nam continues to expand the market, mobilizing enormous resources from outside for socio-economic development. Viet Nam is actively negotiating to join multi-layers economic linkages in order to maximize opportunities of integration, more deeply integrate into global supply chains. Viet Nam is negotiating 6 FTAs with its key partners, notably the Trans Pacific Partnership (TPP) and the Regional Comprehensive Economic Partnership of East Asia (RCEP). Foreign economic relations are an important driving force for promoting growth, restructuring the economy and creating jobs.

Viet Nam's outstanding achievements in the last 30 years are always associated with development rethinking and reform efforts with two key issues as follows:

First, transforming the centrally planned and subsidized economy into the multi-sector market economy. This, in substance, is a comprehensive reform process to unleash production forces. A typical example is that the breakthroughs in agricultural management helped transform Viet Nam from a food deficit country into the world's leading exporter of rice and many other agricultural products. The expansion of business freedom for every economic sectors has better tap the endogenous strength, inflamed the spirit of entrepreneurship, and turned Viet Nam into a dynamic economy.

Second, promoting international economic integration, in other words, transforming a closed economy into an open one with active integration into the global economy. International economic integration has broadened the development space, harness external resources for national development and provided an important impetus for stepping up the domestic economic reform to keep pace with the development trend of the world economy.

Ladies and Gentlemen,

Looking back at the past development journey, besides the achievements recorded, we are fully aware that our economic growth is not sustained, growth quality, productivity and competitiveness are still low. Despite abundant workforce, the amount of unskilled labor remains high. Livelihood for some population groups is still difficult, particularly the ethnic minorities or those living in remote and mountainous areas. The challenges regarding the environment, climate change, natural disaster and epidemics require more resources and efforts to deal with.

Viet Nam has been exposed to major challenges as a middle-income country, notably the risk of lagging behind and falling into the "middle-income trap". Experiences in the development process have shown that only countries which are persistent in reform, with well-functioning institutions and increased competitiveness could overcome the "middle-income trap". For Viet Nam, achieving middle-income status is a significant result of the past 30 years of reform. However, to overcome the middle-income trap and promote sustained and inclusive growth in the coming period, stronger efforts are needed to renew development thinking and vision as well as strengthen the resilience and determination of the whole economy.

In the light of this, the 2011-2020 Socio-Economic Development Strategy of Viet Nam underlines the resolve to step up comprehensive reform based on three strategic breakthroughs namely perfecting the market economy institution, developing high quality human resources and modernizing infrastructure in order to turn Viet Nam into a basically modern and industrial country by 2020. To which, I would like to underline the two major directions as follows:

First, promoting sustainable development serves as an overarching objective from now until 2020 with the central tasks of accelerating economic restructuring, transforming growth model, considering quality, efficiency and competitiveness the top priorities. Socio-economic development must go hand in hand with environment protection.

Second, bringing into full play the human factor, considering people as the master, driver and target of development. Economic growth must be harmonized with cultural development, social progress and justice. The State guarantees human rights, citizen rights and the conditions for all people to maximize their creativeness and enjoy full development. It is essential to continue fundamental and comprehensive reform of the education system to capitalize on population and human advantages, promote human resource development in association with science-technology development.

Ladies and Gentlemen,

As our discussions in this Conference will focus on concrete issues of sustainable and inclusive growth, I would like to emphasize some major directions in Viet Nam's development strategy until 2020 related to the Seminar's theme.

First, to regain the momentum of rapid growth and sustainable development, Viet Nam needs new driving forces. Prime Minister Nguyen Tan Dung's 2014 New Year message emphasized that 'such driving force must come from institutional reform'. Therefore, reforming and improving the market economic institution is an urgent and strategic need to unleash national potentials. In the coming period, Viet Nam will further accelerate the economic institutional reform, the State guarantees that market will play important role in resources allocation, regulation tools and policies will be put in place to ensure social progress and justice. We are determined to step up reform and equitization of state-owned enterprises, including economic groups, focus efforts on creating a fair and competitive environment that is most favourable for people and enterprises to expand business.

Second, continued agricultural industrialization and modernization is of great importance to ensure inclusive and sustainable growth in Viet Nam, as agriculture sector accounts for 50% of labor and 70% of rural population. In our economic restructuring efforts, Viet Nam attaches special importance to the acceleration of agricultural restructuring and the development of new rural area towards a modern and environmental - friendly agriculture. Apart from priorities given to the development of agricultural infrastructure, we focus on addressing mechanism and policy bottlenecks to unleash the labor force in agriculture; identifying strategic industries and products to develop production-processing-distribution chains; giving priority to industrial and services development to increase values and competitiveness of agricultural products.

Third, to enhance competitiveness of the economy by a long-term strategy in which the top priority is for education and training. Viet Nam's biggest advantage is human and the young and abundant labour force, therefore education and training of knowledge and skills in commensurate with demand of the market and business is the optimal way to enhance national competitiveness. This is also the best means to ensure all people can equally enjoy the fruits of development and benefits of international integration. Therefore, in our development strategy to 2020, Viet Nam is determined to introduce fundamental and comprehensive reform in education and training aimimg at enhancing quality and unleashing potential and creativeness of each and every individual, thus developing high-quality human resources for national modernization and industrialization.

Forth, green growth is an important element of sustainable development, a momentum for economic restructuring that is associated with transformation of growth model as well as a great contribution to climate change response. Viet Nam is working hard to implement 'the National Strategy on Green Growth for 2011-2020 and Vision 2050' with a focus on reducing greenhouse gas, boosting the use of clean and renewable energy, encouraging the development of environmental-friendly and natural-resources saving industries and promoting sustainable consumption.

Ladies and gentlemen,

The reform in Viet Nam in past 30 years proves that economic reform and international integration are the right choice, which proceeds from the demand of national development and enables Viet Nam's development to catch up with the mainstream of growth in the world. Therefore, the determination to carry out economic reform together with the active international integration is key to create a new "leverage" for Viet Nam to achieve rapid and sustainable development in the future. Economic reform should combine with active international economic integration, because we cannot clap with just one hand. Fostering international integration is both an opportunity and impetus for domestic economic reform. On the other hand, international integration can only be effective if it is closely associated with economic reform under a comprehensive strategy.

Viet Nam's economic integration is entering a new phase as the ASEAN Community will be established in 2015 and FTA negotiations with key partners finalized, especially TPP and RCEP.

To make the best of development opportunities in the new playing field, Viet Nam will endeavor greater efforts to push institutional reform, improve legislative and policy, increase economic competitiveness, enhance awareness and information on integration and integration capacity.

Ladies and gentlemen,

Viet Nam is proceeding to a crucial development stage that requires more innovative development thinking and determination to promote reform and active international integration. We are making utmost efforts to realize our goals and vision to 2020. However, in reality, quite a few difficulties are arising as we encounter complicated issues that have never happened in Viet Nam or the world. Therefore, in this conference, the Vietnamese Government wishes that international scholars and experts will share with Viet Nam new ideas and experiences of sustainable and inclusive development. I therefore would like to suggest some concrete issues for your discussions:

First, strengthen the role of the state as development shaper in relation to other institutions in a market economy which is increasingly integrating into the world.

Second, how to build a modern economic architecture to achieve sustainable and inclusive growth?

Third, how to accommodate the relationship between short-term macro-economic stability and medium and long-term structural reform?

Fourth, what kind of new role that agriculture plays in sustainable and inclusive growth?

Fifth, what should be done to “squeeze into” and make the best use of benefits from global value chain and production networks given the emergence of multi-layer economic linkages?

The path to sustainable development is a bumpy road. Apart from our national resilience and aspiration to thrive, we hope UNDP and the international community as a whole will continue to support as our companion so that Viet Nam could successfully implement its development strategy. Once again, on behalf of the Vietnamese Government, I would like to express my sincere thanks to UNDP for your enthusiastic assistance in co-hosting this meaningful conference. My profound appreciation goes to Madam Helen Clark and experts and researchers for attending the conference and sharing ideas with us. I am convinced that your valuable contributions will make our conference a success.

Thank you very much.

KEYNOTE ADDRESS

Helen Clark
UNDP Administrator

It is a pleasure for me to deliver this keynote address at the International Conference: "*Economic Reforms for Inclusive and Sustainable Growth: International Experience and Lessons for Viet Nam*". UNDP is pleased to be a co-organizer of the conference with the Government of Viet Nam and the Viet Nam Academy of Social Sciences.

The theme of this conference, Economic Reforms for Inclusive and Sustainable Growth is very pertinent, both for Viet Nam, and for the world at large.

Over the last two decades hundreds of millions of people have been lifted out of extreme poverty, defined as living on under $1.25 per day, and the income levels of countless millions more above that line have been lifted too. Viet Nam has enjoyed its share of this success story.

Nonetheless, an estimated 1.2 billion people in our world still live in extreme poverty, 870 million people are going to bed every night hungry, 1.3 billion people do not have access to electricity, and almost 2.5 billion do not have access to the improved sanitation called for in the Millennium Development Goals.

These numbers convey an important message: despite rapid growth rates in many countries over recent decades, growth has often not been fully inclusive, and the world's poorest and most vulnerable peoples and countries continue to face significant development challenges.

This conference comes at an important time for Viet Nam. With an average GDP growth rate of 7.3 per cent from 1990 to 2010, Viet Nam was one of the fastest growing economies in the world, with per capita income by the end of those two decades almost five times as high as it was at the beginning. The proportion of the population living in extreme poverty here fell from 63.7 per cent in 1993 to 4.3 per cent in 2010. More than 97 per cent of Vietnamese households now have access to electricity and other modern sources of energy. Important progress on gender equality, including in education, employment, and health has also been made.

Viet Nam's economic and social success has improved the lives of many, but important challenges remain. Even though the level of income inequality has been relatively low in Viet Nam compared to many other emerging economies, income and non-income disparities between areas and population groups have been rising, and so have perceptions of inequality, not least in voice and power. While the female participation rate in the labour market is high, at 72 per cent, Viet Nam is among the few countries in the world in recent years with a widening gender wage gap. Inequalities are also significant between ethnic minorities and other Vietnamese citizens.

Now, facing economic slowdown at home, the Government Viet Nam is looking to shape second-generation economic reforms proactively, to lift economic growth and enable the continuation of the remarkable socio-economic progress of the last two decades. Strategies which promote inclusive and sustainable growth will be important to the success of these reforms, allowing all the people of Vietnam to benefit from growth. Environmental sustainability too will need to be addressed as an integral part of these strategies. Right now Viet Nam's energy intensity is high, and its greenhouse gas emissions are growing rapidly.

UNDP's 2013 Human Development Report, "*The Rise of the South: Human Progress in a Diverse World*", recognised Viet Nam as one of a number of high achieving and dynamic countries where progress on human development had been particularly strong. The Report argued, however, that if global human development is to continue to rise, inclusive and sustainable pathways to development must be followed.

In my comments today, I will consider some of the reasons why current development models globally have not been conducive to inclusive and sustainable growth. I will then offer some perspectives on how Viet Nam could address these issues in its reform agenda.

Inclusive and sustainable growth - why does it matter and why have current development models not led to it?

Poverty eradication, reducing inequalities, and promoting environmentally-friendly development are defining challenges of our era.

Last September, UN Secretary-General Ban Ki-moon and I launched the report on the global conversation facilitated by the UN development system on the post-2015 development agenda. Viet Nam was one of the first countries to hold a comprehensive national consultation as part of that process.

The findings of the global conversation contain some important messages. The feedback was that people want inequalities addressed, between men and women, rural and urban areas, among different ethnic groups, between rich and poor, and on other dimensions. People also called for better governance which would see services delivered and resources allocated fairly.

A new report by UNDP comments on these challenges, "*Humanity Divided - Confronting inequality in Developing Countries*", notes that great and persistent inequality in the midst of plenty is a paradox of our times. It shows how income inequality at the global level, on average, and in several regions has been rising in the last two decades, even as economies have grown and global poverty levels have fallen.

In Asia, this trend is particularly striking, with the majority of the region's population living in more unequal societies today than they had two decades ago - despite impressive economic growth.

Inequalities have a negative impact on the well-being of people and the prospects of society as a whole. Income inequality, for example impedes long-term growth prospects, and dampens the poverty-reducing impact of growth. It is associated with a host of poorer social outcomes, ranging from low health status and educational achievement to higher crime rates. Inequalities can also generate political instability; erode social cohesion and government legitimacy; and undermine capacity for the decision-making necessary for reform.

Yet, the widening of gaps in income and wealth, or on other dimensions of well-being, is not an unavoidable price which must be paid to advance development. UNDP's new report on inequalities lists many countries which have managed to reduce income and non-income inequality significantly through a combination of progressive economic and social policies. The experiences of Japan and South Korea in this region, for example, have shown that rapid economic growth can go hand-in-hand with low and even falling inequality.

The challenge of environmental sustainability has also featured strongly in the global consultations on post-2015. There is widespread awareness of the high cost to ecosystems, including to our climate, of traditional growth and development pathways.

Ultimately, and as highlighted by the UNDP 2011 Human Development Report, *"Sustainability and Equity: A Better Future for All",* the pursuit of equity and sustainability are inextricably linked - one will not be achieved without the other.

Key factors which appear to have limited the inclusiveness and sustainability of growth to date include the following:

1. *Growth has been uneven* across sectors and locations: between rural and urban sectors, and across provinces, regions, and

countries. Roughly three-quarters of the world's poor live in rural areas, while growth in many countries has been concentrated in urban and/or coastal areas. In Viet Nam, poverty remains overwhelmingly a rural issue, with ninety per cent of the country's poor, and 94 per cent of the extreme poor, living in rural areas. To an extent this is a by-product of rapid industrialization and urbanization, but ways can be found to secure greater balance and inclusion in development so that no one is left behind.

2. *Jobs and livelihoods* are the primary vehicles through which people participate in the economy. *Employment growth* relative to GDP growth, however, has been low and declining in many countries. Almost 202 million people were unemployed around the world in 2013 - an increase of almost five million over 2012 levels. The bulk of the increase in global unemployment has been in the East and South Asia regions, which together accounted for more than 45 percent of the estimated new jobseekers worldwide in 2013. Growing capital intensity in economies does impact on jobs, but the challenge is to move economies up the value chain and create more and better jobs.

3. *Large disparities* in asset holdings, including land, and *unequal access* to quality goods and services, such as education, health, credit, infrastructure, and social protection, have prevented the poor from fully participating in and benefiting from growth, thereby aggravating existing income inequalities.

Public spending on education and health is low in Asia compared to other regions. In Viet Nam, spending in these areas as a percentage of GDP is higher than for a number of other countries in the region, but the efficiency of this spending remains an issue. Coverage of social protection systems overall in Asia is low, compared to that of emerging regions like Latin America and Eastern Europe. Access to formal financial services is often lacking for many too.

4. The *nature of globalization and shifting global value chains* is also a factor in limiting inclusiveness. While factors such as trade

competitiveness, foreign direct investment, and new technologies present opportunities for countries like Viet Nam, they often favour capital deepening and increase the demand for skilled workers whose wages then grow at a faster rate than do those of the unskilled. This, particularly when combined with labour market policies which weaken the bargaining position of less skilled workers, can exacerbate existing income inequalities.

5. Current growth models have also thrived on *unsustainable patterns of consumption and production*, which are pushing our planet's environmental boundaries in a number of areas.

Greenhouse gas emissions, biodiversity loss, and ocean acidification, for example, are reaching alarming levels. Indeed, by some estimates, more than sixty per cent of the ecosystems and their associated services upon which humanities relies are degraded, overexploited, or already lost.

Two decades ago, tackling climate change was not a major element of development thinking. Today it is a high priority on the global agenda, not least because the world has witnessed so many disastrous climatic events which have set back development progress. Viet Nam itself is highly vulnerable to climatic extremes and the impact of climate change, and has felt the enormous human and economic costs of increasingly severe natural disasters. Recent estimates show that economic damage caused by natural disasters in Viet Nam from 2008-2012 amounted to 1.5 per cent of GDP, up from 1 percent in the previous four years.

A new global deal on climate is critical, and it should include support for adaptation to climate change by developing countries like Viet Nam. That deal needs to be part of a far-reaching global commitment to sustainable development pathways which will change the way in which we produce goods and services; use our land, seas, and water ways; generate and consume energy; and plan our cities and communities. Growing our economies first and cleaning up later is a bleak scenario, which our world cannot afford.

Looking ahead - how could Viet Nam further promote inclusive and sustainable development?

Viet Nam's progress since the introduction of *Doi Moi* ('renovation') economic reforms in 1986 has been remarkable. Growth rates now, however, are lower than they were.

The impact of the global crisis has lingered for many countries, but here weaker productivity growth and competitiveness, underpinned by institutional weaknesses, appear to be significant factors in limiting growth. Viet Nam's development model has therefore been under review, and important steps have been taken:

- In February last year, the Government approved a master plan to restructure state owned enterprises (SOEs) and overhaul the financial system during the period 2013-2020.
- In recent months Vietnam has made significant progress on macroeconomic stabilization and on containing vulnerabilities in the banking sector.

Now, Viet Nam is embarking on its next generation of structural and institutional reforms to ensure its continued development progress and strengthen its ability to integrate further into the global economy.

UNDP suggests that the following critical areas could be considered in the reform process to promote inclusive and sustainable growth in Viet Nam going forward:

1. Adopting measures to improve the productivity and quality of production in *agriculture and aquaculture* as an integral part of the country's wider growth strategy. This is important for creating an inclusive economy, as the majority of the poor continue to live and work in rural areas. Viet Nam's strong egalitarian and poverty-alleviating growth in the last two decades owed a lot to land reforms, an improvement in agriculture's terms of trade, and an increase in public investment in the rural economy in the late 1980s and early 1990s. Now attention needs to be given to adding value to agricultural and aquaculture production so that it can command

higher prices. Farmers and the economy would benefit from more systematic provision of agricultural extension services, better quality assurance and certification, and better branding strategies for Vietnamese produce.

2. *A progressive upgrading of the economy towards higher value sectors overall* is needed for Viet Nam to establish new comparative advantage in the regional and global economy and to create more decent work. This calls for the development of modern and tailored industrial policies which support improvements in skills, the availability of finance, technology transfer, a smart trade policy, and in the quality of research and development. Creating an enabling environment for the SME-dominated domestic private sector, which, while small, is the major source of employment, must also be part of this process.

Continuing efforts toward regional economic integration are important as well. The formation of an ASEAN Economic Community in 2015 represents a major opportunity for Viet Nam to increase its competitiveness, upgrade its production processes, and open new markets, especially given the fast growth of the region's middle class.

3. Expanding opportunities through access to quality and relevant education is critical. Countries like Japan and South Korea moved ahead fast at earlier stages of their development by investing in quality education at all levels, and they focused on innovation and the adoption of new technologies. These steps became the foundations of their transition to knowledge-based economies. For middle income countries like Viet Nam, the challenge is no longer just access to education, but rather the provision of quality and relevant education for all, including at the tertiary and vocational education levels.

4. A modern social protection system is also essential as part of the reform menu. For the first time ever in 2005, more citizens of Viet Nam were over the age of sixty than under the age of five. The sixty plus age group is projected to double in size from nine per cent in 2010 to eighteen per cent in 2030. Viet Nam's economy has been slowing down precisely at the time when it needs to begin to make greater provision for a larger older generation.

Access to quality services here is perceived to be increasingly contingent on household's ability to pay. That is contributing to the development of a stratified system of service provision and to an intensification of existing inequalities. Reform of Viet Nam's social insurance and assistance systems is therefore important at this time, and could include a review of financing and governance arrangements and delivery models. Streamlined social protection can also drive the eradication of extreme poverty in all its dimensions.

5. Given Viet Nam's high exposure to climate disaster, investment in *disaster risk reduction and climate change adaptation* will be an essential part of inclusive and sustainable growth strategies. A dollar invested in disaster risk reduction today can save four or more dollars in the future cost of relief and rehabilitation, and save communities and countries from experiencing huge development setbacks. Modern social protection systems also help build resilience to disaster and facilitate early recovery by ensuring that there is income and other support readily available when disaster strikes.

On environmental sustainability the Government has taken a number of steps including Climate Change and Green Growth strategies, and legal frameworks on environmental protection. The decision taken to phase out subsidies for fossil fuels is important and implementation needs to be accelerated, but the acceptance of phase-outs elsewhere has been dependent on mitigation measures for low income households.

Policies which promote low-emissions growth and climate-resilience will put the economy on to a more inclusive and sustainable path.

6. More transparent and accountable public resource allocation and management are critical for maximizing the development impact of a country's resources. Combating corruption and engaging citizens in development processes are among the documented best international practices in promoting inclusive and sustainable development.

UNDP is pleased to be associated with an innovative performance monitoring system which is contributing to improvements in services in Viet Nam. Since 2011, this Viet Nam Provincial Governance and Public Administration Performance Index (PAPI) has been tracking Vietnamese citizens' experiences with governance and public administration. According to the survey, the poor face disparities in access to services, and citizens are increasingly demanding improvements in the quality of services.

Conclusion

Viet Nam has many strengths, including its relatively young and competitive labour force, its abundant natural resources, and its geographic location at the heart of a dynamic region. With smart policy choices, Viet Nam's future is bright.

In considering its next generation of reforms, Viet Nam can opt for an inclusive and sustainable development pathway. At UNDP, we are committed to supporting Viet Nam on its reform journey, guided by the country's own priorities and by our mandate to advance human and sustainable development.

I hope that this conference will be useful in exploring the reform options for Viet Nam as it strategizes on how to build on its past impressive development achievements, eradicate poverty, and advance human development.

SESSION ONE

ECONOMIC REFORMS:
THE CHALLENGE OF INCLUSION

Short biography of Prof. Dr. Nguyen Xuan Thang - President of Vietnam Academy of Social Sciences

Education: (i) 1979: Bachelor of Political Economy, National University, Hanoi, Vietnam; (ii) 1993: Ph.D. Degree in Economics, Institute of World Economy and International Relations, Russia; (iii) 2009: Professor in Vietnam Academy of Social Sciences.

Working experiences: (i) 1996-2003: Vice General Director, IWE; Editor-in-Chief, Review of World Economic Issues; (ii) 2003-2007: General Director, Institute of World Economics and Politics (IWEP); (iii) 2007-2011: Vice President, Vietnam Academy of Social Sciences; (iv) May 2011 - present: President of Vietnam Academy of Social Sciences.

Selected publications and research work: (i) 1996: "Vietnam and Asia-pacific Countries: Present economic relations and prospects", IWE, Author; (ii) 1999: AFTA and Vietnam's Integration, Institute of World Economy (IWE); (iii) 2000: "Main developed industrial economies after World War II", VASS, Co-author; (iv) 2003: Strategic Adjustments of Major Powers in the Asia-Pacific in the 21st Century, Chief-Authors and Editor; (v) 2009: Support of research on challenges to Vietnam in socio- economic transition, Embassy of France in Hanoi - VASS, Project Director.

A PERSPECTIVE VIEW ON INCLUSIVE GROWTH IN VIET NAM

Prof. Dr. Nguyen Xuan Thang
Member of the Party Central Committee,
President of Vietnam Academy of Social Sciences

This introductory report is composed of three main parts: (i) overview of Vietnam's achievements in reaching rapid, sustainable and inclusive growth in nearly three decades of Doi Moi reforms; (ii) analysis of challenges faced by Vietnam in the coming period; and (iii) recommendations with regard to institutional reforms and policy orientations to help Vietnam maintain a rapid, sustainable and inclusive growth for the future.

1. Achievements from nearly three decades of Doi Moi from an inclusive growth perspective

Looking back at the last period, since the country embarked on the process of Doi Moi in 1986, Vietnam has achieved impressive results in socio-economic development. Vietnam was able to reach and sustain an important growth rate for a long period. According to the "World Development Indicators"by the World Bank, Vietnam's average GDP growth for the 1990-2012 period was estimated around 7.2% - an impressive figure compared to the world economy growth rate of 2.74% for the same period, and growth rate for low income countries of 4.31% and lower middle income countries of 5.01% for the same period. Such a sustained growth enabled Vietnam's per capita income to increase from below 100 USD in 1990 to 1,960 USD in 2013, that is about a 20 times growth. Vietnam moved out from the list of low income countries to join the rank of lower middle income countries. The indicators reflecting other aspects of people's life were also greatly improved, from primary and secondary schools completion rate to improvements in health conditions, morbidity and mortality rates. Vietnam was able to achieve most, even exceeding some, of the Millennium Development Goals (MDG).

Thanks to the rapid growth rate, in only two decades, nearly 30 million people were lifted out of poverry, with poverty rate -by using the General Statistics Office and World Bank standards, fell sharply from 58.1% in 1993 down to only 14.5% in 2008, and even with the new calculation, poverty rate continued to decrease by 3.5 percentage points in the 2010-2012 period. Indicators for measuring inequality such as the Gini coefficietn, relative income of the top 10% richest people to the income of the bottom 10% poorest people also shows that despite the rising inequalities, Vietnam was able to control the level of inequality similar to its development level.

Overall, the 30 years journey of conducting Doi Moi has witnessed a rapid, inclusive and sustained economic growth over a long period, through which, the majority of the population could participate and benefit from the growth process. This was reached thanks to the institutional reforms taken place under the Doi Moi, based on the two pillars of transition to a market economy and enhanced international integration which have been the drivng forces to maximize the mobilisation of resources to serve the country's development process.

Vietnam has made a long jump in the *transition from a centrally planned economy to a market economy with a socialist orientation.* Many changes have taken place in the past 30 years, since the country embarked the Doi Moi process. Most important institutional changes include:

(i) Liberalization of prices, initiated since the mid 80s and by the beginning of the 1990s, prices of most commodities were in principle set by the market;

(ii) Liberalization of agriculture: Since the end of the 1980s, a series of important market institutions were established to enhance agricultural liberalization. In particular, Resolution 10 in 1988 by the Central Committee on agricultural households has led to a fundamental change in economic incentives for the agricultural sector where over 90% of the labor force was concentrated at that period. The next important milestone is the passage of the law on lands in 1993, with 5 transferable rights through which set the market institution for this core resource. The land law continued to be amended in 1998, 2001, 2003, 2009 and most recently in 2013 with important changes towards reinforcing people's ownership on land.

(iii) Liberalization of non-agricultural sectors: In the 1990s, many market institutions were established to speed up the liberalization process and to encourage the development of private sector in non-agriculture in particular and of the overall economy in general, reaching its peak through the approval of the Law on Enterprises in 2000, and which was subsequently amended in 2005, 2011 and 2012. For SOEs, reforms have been in place since the early 1990s.

Vietnam's Doi Moi process *was accompanied by a period of liberalization and international integration*, through which the market economy was developed following international regulations and standards to further enhance the country's participation to the global production networks, open up to foreign investment and technology to serve its modernization process. Vietnam's process of international integration in the past 30 years was consistently implemented under single framework (lower import tariff, especially for production inputs), bilateral agreements (with the U.S., the European Union, etc.), regional agreements (ASEAN, APEC) and multilateral agreements, with the most important highlight being the accession to the WTO in January 2007. Vietnam is currently actively in the negotiations under the Trans Pacific Partnership (TPP).

With these important institutional changes, *accompanied by the fairly adequate allocation of initial endowments also as social* *programs and policies, in particular in health, education and poverty reduction* consistently implemented in the past 30 years have helped opening up opportunities also as enhancing Vietnamese people's capacity in seizing opportunities. Growth in Vietnam has truly been inclusive, with the participation and enjoy of benefit of every citizens.

2. New challenges to inclusive growth in Vietnam in the new era

However, driving forces behind the rapid, sustainable and inclusive growth sustained by Doi Moi in the past 30 years are reaching their limits. It turns out growth is showing signs of slowdown in the past 10 years. The "World Development Indicators" by the World Bank, as previously mentioned, showed a significant slowdown of Vietnamese economic growth, from an average 7.9% in the 1990-2000 period down to only an average of 6.6% for the 2000-2012 period. More importantly, Vietnam's superiority in terms of growth as compared to lower income countries (average growth of 2.8% between 1990-2000 and 5.6% between 2000-2012) decreased significantly, from 5.1 percentage points between 1990-2000 to only 1 percentage point between 2000-2012. Vietnam's growth rate as compared to lower middle income countries (average growth of 3.5% between 1990-2000 and 6.3% between 2000-2012) also fell sharply, from 4.4 percentage points to only 0.3 percentage points higher than average.

Studies have identified some causes ò economic slowdown in Vietnam, especially since 2008, including the slow structural reforms which have led to a growth primarily based on a mobilization of resources (extensive growth) while institutional inadequacies undermined the effective allocation and efficiency of resources, making the economy more vulnerable to shocks. While the global scenario also underwent important changes, becoming more unstable following the global financial crisis started in the end of 2008. Policy inadequacies, especially in coping with large inflows of indirect investment between 2007-2008, leading to a bubble economy which has led resources being actually extracted from the real economy, causing inflation and greater risks for banking and financial systems.

Economic slowdown also has negative impacts *on decent employment in labour market - the core pillar of inclusive growth.* New driving forces from Doi Moi led to strong structural changes in the economy, especially in intra-sectorial movements in agriculture, and inter-sectorial movements from agriculture to industry, trade and services with higher productivity. These economic transformations are reflected in the 4 employment transitions: (i) in agriculture - from low productivity and low income jobs to higher productivity and income jobs; (ii) from agricultural jobs to informal non-agricultural jobs; (iii) from informal to formal jobs, thus with social and health insurance; and (iv) within the formal sector - from low productivity and low income (leather and shoes, garment and textiles, etc.) to higher productivity jobs(such as electronics, etc.). These strong structural transformations, coupled with changes in the structure of employment have allowed for rapid and inclusive growth in Vietnam, especially in helping unskilled labour to participate and enjoy benefits from the growth process.

Nevertheless, data from the Labour and Employment Survey by the General Statistics Office show a slowdown in all 4 employment transitions, in some cases even showing reversing trends. In particular, informal labour is back on the rise, from 74.8% in 2011 to 78% in 2012. At certain moments, employment in agriculture also increased. The employment transition in the formal sector is sluggish, thus despite the strong exports, Vietnam continues to rely on cheap labour.

3. Orientations for institutional and policy reforms to maintain inclusive growth in Vietnam in the new era

In such a context, Vietnam has set out important strategic orientations appropriate to the new era, with the continuation of economic restructuring coupled with renovating the growth model - from extensive to inclusive growth based on efficiency and improved competitiveness of the economy, which focuses on breakthroughs in the three core areas of institutions, infrastructure and human capital.

The global context also shows mixed positive and negative evolvements which may impact on the inclusive growth in Vietnam. The global economy continues its slow recovery, exerting pressures on economies with high degree of openness, including Vietnam. However, despite the continuous global economic and political instabilities, new opportunities have emerged for Vietnam. The growing importance of Asia in general and East Asia in particular, and the relocation of investments out of China to other "locations outside but in the vicinity of China" by multinationals has helped Vietnam to become the new destination of good quality FDI. However, in order to capture large opportunities brought by the Vietnamese geo-economic advantages, which allows to move up on the global value chains and catch up with advanced countries, Vietnam needs to accelerate reforms, especially in institutional reforms as stated in the new year message by Prime Minister's Nguyen Tan Dung.

Besides the institutional and political changes to bring the economy back to the trajectory of rapid and sustainable growth, specific policy interventions are required to promote the inclusiveness of growth. More specifically, obstacles need to be removed also as the establishment of institutions necessary to promote the development of labour market and livelihood for unskilled and vulnerable workers are required. Such sectors include: (*i) agriculture; (ii) labour intensive industries; (iii) construction; (iv) trade and small-scale services. Small and medium enterprises in formal and informal sectors* also need special attention. Institutional and policy constraints that these businesses face, especially those related to access to bank credit, need to be addressed. Supporting industries are often labour intensive and therefore, also needs special attention to help their rapid and inclusive growth. In addition to improvements of outcomes related to decent employment, the social protection system needs to be continually expanded and improved to enhance people's access to important social services.

Above are recommendations related to achievements, challenges and orientations for institutional and policy reforms for rapid, sustainable and inclusive growth in Vietnam. I hope that these sharing will provide open suggestions for intense and useful discussion at this workshop.

Short biography of Prof. Jayati Ghosh, JNU Department of Economics

Born in 1955 and educated at Delhi University, Jawaharlal Nehru University (JNU), and the University of Cambridge.

She is a professor at JNU and has held other positions at Tufts University and Cambridge, lecturing meanwhile at academic institutions throughout India. She is one of the founders of the Economic Research Foundation in New Dehli, a non-profit trust devoted to progressive economic research.

Additionally, she is Executive Secretary of the International Development Economics Associates, a network of economists critical of the mainstream economic paradigm of neo-liberalism.

Outside of academia, Professor Ghosh has been a consultant and researcher for many government and non-government organizations, nationally and internationally. She was the Chairperson of the Commission on Farmers' Welfare, and is currently a member of the National Knowledge Commission set up by the Indian Prime Minister. She has also worked closely with many progressive organizations and social movements.

INEQUALITY AND DEVELOPMENT: ISSUES FOR VIET NAM

Prof. Jayati Ghosh
Jawaharlal Nehru University

Why does inequality matter for economic growth?

Until recently it was common to accept increasing inequality as a "cost" of the development process, which would be mitigated at higher levels of per capita income. However, the experience of the 20th century and particularly of the last three decades shows that increasing inequalities need not be associated with economic growth. Some fast-growing economies have shown reduced inequalities, while rising inequality has been associated with growing, stagnant or recessionary economies. Therefore, the standard analysis that assumes that rising inequality is a price that has to be paid for development at lower levels of per capita income is not valid. Nor is it the case that rich countries always show a tendency for reduced economic inequality: the increase in inequality of both assets and incomes across most of the developed world suggests that domestic political economy changes and the policies associated with this all play key roles in determining distribution.

A related argument is about "constructive" inequality, which results from the rewards to higher productivity, and so provides incentives for hard work, innovation and creativity. In this view, trying to reduce inequality through taxation or other redistributive measures may reduce such incentives and so adversely affect growth. This has also been contradicted by recent research, which has shown high asset inequalities are associated with lower growth. Financial markets generally function imperfectly, so that those without assets to provide collateral cannot access credit, which affects their productivity and hinders the growth process. Inequalities in health and education affect the productivity of workers, hinder the development of their full potential, limit the pool of qualified workers and reduce the aggregate productivity of the economy. They adversely affect domestic aggregate demand by reducing incomes of the majority, which can act as a strong disincentive for investment in the absence of other markets. It can also lead to attempts to generate demand through reliance on credit bubbles that end in financial crises. Most of all, inequalities can become socially and politically dysfunctional, generating tensions and strife that impact upon economic processes and investor behaviour, so that growth is hampered. They can reduce social cohesion and undermine civic engagement and democratic processes as power and political influence get concentrated among the very affluent, and those with power seek to benefit disproportionately from growth and from control over assets.

So on balance, high inequality is generally adverse for economic growth. And the case for addressing inequalities is strong not only for reasons of fairness and justice and for reasons of economic efficiency but also for democracy and social cohesion, which in turn impact upon economic stability and prospects for growth and development.

Forms of inequality

There are many ways of perceiving and measuring inequality. Most commonly it is described in terms of differences in household or individual incomes, estimated through surveys of household income or consumption (which serves as a proxy for income). These differences are then reduced to variables such as the Gini coefficient, or the ratio of the income of the rich (top ten per cent) to the poor (bottom ten or twenty per cent). Another way is to look not across households but in terms of the returns received by factors of production, or very broadly, the different components of national income: wages and returns to self-employment as well as profits, rent and interest. Economic inequalities generally correlate strongly with inequalities in other social indicators, such as in health and education, access to public services and basic needs, social/political voice and vulnerability to shocks - and often one dimension of inequality tends to reinforce others.

Each of these dimensions can then be considered in terms of horizontal and vertical inequalities. Horizontal inequalities refer to spatial differences. In Vietnam, rural-urban income differences have actually come down, as agricultural productivity has increased rapidly and farmers' incomes have improved. In general horizontal inequalities have become less marked than vertical differences within a population in the same location. However, differences in per capita incomes across regions/provinces have increased, especially in terms of the relative backwardness of northern areas.

Vertical differences include differences between those receiving different types of income (wages, profits, rent, self-employed incomes etc); across wage earners with different skills and in different economic activities; between social and ethnic categories; and by gender. In recent years, shifts in control over assets, particularly land, have played an important part in increasing inequality, and these in turn have been related to other non-economic variables like political power. Another process that has driven changes in income is the shift of workers from agriculture to non-agriculture, since households whose members mainly work in the nonagricultural sector earn more than those working in the agricultural sector, and their incomes have grown at a faster pace. In general, wages now more significant source of household income, and wage inequalities also increasing, driven by skill differences as well as particular economic activities. Wage differences are strongly correlated with differences in levels of education, which have also grown, especially in urban areas where richer households rely more on more expensive forms of learning (private schools and tuitions etc). Inequalities in education, access to good employment opportunities, inequalities in access to land, and in connections, power, and influence. There are growing differences across ethnic groups, with the Kinh faring much better than ethnic minorities in all of these variables, but differences within the majority Kinh have also become more marked recently.

Policies to reduce inequality

Addressing inequalities requires a combination of growth enhancing macroeconomic policies with redistributive social policies. What matters to citizens is not just the primary distribution of income, but the "secondary" distribution, which is what results after public intervention in the form of taxes, public spending and transfers that affect the material reality of society. A significant part of the differences observed in disposable income disparities across countries is explained by the redistributive impact of social transfers and taxes. Inequality is generally lower in countries with larger welfare programmes and more fiscal redistribution.

Countries that have shifted the orientation of growth towards the domestic market at the margin, used redistributive fiscal policy measures, emphasised education and health spending, developed universal social protection programmes and wide-ranging social assistance and increased labour market opportunities for those at the bottom, have generally shown declines in inequality even when they are otherwise heavily globalised, as in East Asia and Latin America.

The distribution of disposable income across households and their quality of life are strongly affected by the availability and affordability of essential goods and services. A critical aspect of socio-economic strategy is to ensure public funding for universal provision of basic amenities like access to housing, water and electricity as well as essential social services such as nutrition, sanitation, health and education. A universal approach to the provision of basic infrastructure and social services is essential for reducing inequalities across income, class, gender, ethnicity and location. This should be a priority goal, with the focus on improving quality of such services, since that is important to reduce the propensity of the rich to seek better quality through privatised provision that excludes the poor. Targeting only to the poor creates errors of unfair exclusion and unjustified inclusion, and has been shown to be inefficient and susceptible to elite capture. Further, universalism creates wider public demand for better quality of public services, which in turn enables more progressive tax collection that flattens income distribution even as it produces more social stability. However, within the broadly universal approach, recognising the interplay between social and economic inequalities requires a nuanced approach that recognises specific social patterns and differentiation within social groups and by gender.

The global experience also highlights the role played by macroeconomic policies in reducing inequality - and of lower inequality in achieving more stable macroeconomic outcomes. Ensuring that wages increase along with labour productivity is important in stabilising primary income distribution as well as in assisting countries to recover from the continuing global economic crisis. In those countries where the greater part of employment is informal and the labour force is dominated by self-employed workers, the policy focus has to be on increasing the productivity and remuneration of such activities. This makes policies designed to improve the viability of small scale production particularly important, such as making available institutional credit on affordable terms, access to inputs, technology and markets.

Government's resource mobilisation and spending patterns are essentially distributive in nature. How government policy affects the distribution of income and wealth depends on the level and composition of public spending and taxation. Social transfers and taxes should have an immediate, direct effect on income distribution, although the magnitude of their impact will depend on how progressive the tax system is (income and property taxes are usually progressive while indirect taxes are regressive) and on how much the poor benefit from social transfers and social insurance. The negative effect of indirect taxes on the income of the poor or near poor can be stronger than the positive effect of cash transfers. Fiscal policies can reduce inequality through progressive income taxation and highly redistributive social transfers targeting education and health spending as well as public child and old-age benefits. The impact of such transfers on inequality can be quite significant.

In many countries, a major part of non-wage incomes have been appropriated by returns to financial activities, and it has become evident that this is not beneficial to economies. Financialisation has been associated not just with economic instability and crises, but also with unhealthy concentration of assets and interest and dividend incomes. Policies to regulate finance and bring financial returns to more normal historical levels could still allow financial markets to fulfil their core functions of intermediation between savings and investment. A similar positive role can be played by strategies to curb the excessive concentration of ownership or control that cause rents from land and other resources to accrue to a small section of society.

Reducing wage gaps across skill, ethnicity and gender of workers is also a major means of reducing inequality. The most important strategies in this regard are increasing investment in education and ensuring that macroeconomic policies support employment creation. This clearly played a central role in the rapid industrialisation of East Asia, where increasing education levels improved farmers' receptivity to new agricultural technology and crops and provided the social basis for an educated workforce for the industrial sector, as well as upward social mobility, social and political stability. It also contributed to significant reductions in wage inequalities in the subsequent decade, when the fruits of this expansion in education became evident. A similar process is currently under way in Latin America. Widening access to education and ensuring more female enrolment also at higher levels of enrolment are both important. In addition, institutional changes, such as an increase in minimum wages and other institutional protection of all workers, and bringing them into formal contracts subject to labour laws can be very important in reducing wage inequalities.

Inequalities and Vietnam's reform agenda

Vietnam has experienced very rapid rates of poverty reduction in the past. This was associated with several features that went beyond the rapid growth of national income, to include the effective and pragmatic leadership that was not bound by rigid certainties but responded flexibly to changing situations; continuing equitable land reform and targeted investment in agriculture that raised rural productivity; emphasis on developing infrastructure in backward areas and significant investments in health and education. The strong sense of social solidarity that was essential to social and economic life contributed to making this growth more broad-based than it has been in many other Asian countries and therefore to significant poverty reduction.

However, some less positive features of the growth process are now emerging as problems that need to be addressed: rising inequality, environmental degradation and corruption. To some extent, these were also linked to the growth process. The process of land conversion because of industrialisation and urbanisation - which have been important propellers of economic growth - provides evidence of this link. Thus, land use change has often enabled those with connections and information to gain from land speculation while those without such privileged access have not been able to convert the land they have held into income or other financial assets. Meanwhile, those who have not benefited from industrialisation are often also left bearing the burden of the environmental costs, such as degradation of land and adverse impacts of climate change. Similarly, existing inequalities in education and patterns of social exclusion between Kinh and ethnic minority groups have combined to create differential possibilities of benefiting from the growth process that have increased both income and asset gaps. These gaps in turn enable those with greater economic power to exercise more political power as well.

Therefore, in addition to universal provision of good quality basic services and redistributive macroeconomic policies, institutional and legal reform can play an important role in creating the conditions to reduce inequalities of various types. Five types of strategies are worth considering: relating to strategies for economic diversification, land use conversion policies, public sector activity, financial reform and strategies of regional integration. Each of these is considered in turn, with some pointers as to how reforms in these areas need to incorporate the requirements of greater equity and inclusiveness.

Strategies for industrial development and diversification

A key question in Vietnam as in several other middle income countries relates to how to promote diversification to higher value added activities. The experience of successful Asian countries suggests that it is important to use national policies to promote industrial development, but particularly in those areas that will generate positive synergies for employment, innovation and productivity growth. Therefore, the likelihood of learning economies and technology spillovers are important to bear in mind when encouraging specific sectors, along with other positive externalities that may be generated by certain types of activities. This is important to bear in mind particularly if the focus is on entering global value chains, because it is desirable to avoid getting trapped in low-end production within such chains. Using static comparative advantage as the indicator for promoting particular industries risks getting locked into specialisation in industries that have low learning possibilities, poor dynamic prospects and high environmental costs.

For activities that do have the required potential and synergies, a combination of export promotion, domestic protection and credit access is required. There is no reason for these to be confined to either public or private sectors, but the promotion of particular sector or activities must be combined with adequate regulation (including environmental and labour regulation) that protects the interests of all stakeholders and citizens. Here it is important not to ignore small scale units within the broader group of private activities that are actively promoted, especially as these are more employment generating. Therefore, the industrial policy effort should also be to promote and encourage more domestic linkages between upstream and downstream activities, and small enterprises within these in particular.

Strategies with respect to land use changes

Periods of rapid industrialisation are also typically periods of rapid (and often necessary) changes in land use patterns. These however can have uneven and unequal effects, and thereby create inequalities and social tensions. It is therefore important to have secure and equitable policies that provide adequate and even desirable compensation, sensitive resettlement of those displaced, sufficient strategies for rehabilitation and ensuring sufficient future livelihood of those losing out from the process. Where such people are geographically or ethnically concentrated, sensitive responses are all the more important. At the same time, such transitions tend to allow for rapid enrichment of a privileged few. This needs to be monitored and prevented as far as possible, because it creates unhealthy concentration of assets and generates wrong incentives for private accumulation. So checks and balances should be instituted to prevent excessive private benefits from land speculation and control over other natural resources.

Changing roles of public enterprises

Public enterprises remain critical for both economy and society in many areas, particularly for infrastructure and social services, and these should be reformed, strengthened and made more accountable rather than dismantled. It is clear from the earlier discussion that universal provision of good quality public services cannot be achieved without significant public spending on this and public provision. It is obviously important to make such public provision flexible to changing circumstances and accountable to citizens, possibly through greater decentralisation of the control and supervision of such service delivery on the ground. So accountability should be ensured through more decentralisation of control over such activities, allowing groups to local stakeholders to monitor and influence local functioning. In the case of essential infrastructure, international experience shows that it is most quickly and equitably provided by public investment, and the even public-private partnerships whereby the government bears the risks for private investors is typically inadequate to meet social goals and expectations. Therefore public infrastructure and utilities usually need to be expanded and strengthened rather than weakened, and universal access and good quality provision should be the goals. The possibility of cross-subsidisation that exists for state-owned enterprises to meet their social goals should be exploited to the maximum extent. Meanwhile, transparency of functioning and accountability norms should be instituted to prevent corruption and allow for grievance redressal.

Financial sector reform

In the financial sector, the focus should be on more financial inclusion, bringing more of the economy and the population into the ambit of institutional finance in a sustainable and stable way that does not involve boom-bust financial cycles. Once again, international experience suggests that successful economic development requires a bank-based system with close financial control. This permits higher investment than would otherwise emerge from purely market-based financial signals; encourages more rapid sectoral mobility (which is particularly important in the current globalised context) and allows some direction of credit without which no country has industrialised; avoids the bias towards short-term company decision-making that is inherent in a stock market-based system; and reduces problems of instability and volatility that emerge in less regulated systems. To the extent that the socialisation of the risks involved in financial activity is inevitable, it is important to ensure that the benefits accrue to a wider group and to society as a whole, rather than to a small elite, and that the costs of such risks (such as those involved in bank bailouts) are borne in a just manner.

Making the financial system meet social and developmental needs also means a focus on ensuring access to *institutional finance for all*, include small and micro enterprises and small savers in informal activities. This may require the development of specific financial institutions catering to particular segments, such a community banks, co-operative credit institutions, sectoral banks, etc., that have different regulatory principles and are underwritten by the state to ensure stability. It should be noted that microfinance is NOT an effective substitute to the universal extension of normal institutional credit systems regulated by a central bank. Further, since maturity mismatches, unbalanced lending and stop-go financial cycles have become significant problems in many emerging markets with deregulated financial systems, it is critical to ensure that an adequate regulatory framework and effective supervisory institutions with qualified people is put in place before deregulation occurs.

Autonomous industrialisation and some degree of freedom from financial volatility and propensity to crisis also require a degree of control over the capital account of the balance of payments, so as to ensure that the domestic financial system is not infected by problems generated externally and subject to boom-bust cycles generated by flows of mobile capital. It is also important to enable a degree of control over exchange rate movements, which is necessary to pursue other objectives of export promotion and domestic production shifts to higher value added activities. Many emerging markets today are facing problems generated by open capital accounts, in which they are buffeted by small changes in US monetary policy and similar events. Therefore, while there is a case for making some exchange transactions more flexible, utmost caution should be exercised with respect to deregulating capital flows. The issue here is not merely that of gradualism and proper sequencing, since problems are being experienced by countries that exercised care during the process of liberalisation but are now fully exposed with few defences, and since hot money inflows can always generate forces (such as appreciating real exchange rates) that create the conditions for subsequent disorderly outflow.

Regional agreements

Regional agreements must be carefully negotiated to ensure that they preserve policy space in critical areas, including the taxation of multinational enterprises, the ability to engage in independent monetary policy and to develop financial institutions according to the requirements of the economy ensuring development with stability. A major concern in several regional agreements, including some that are currently being negotiated such as the Trans Pacific Partnership, relates to intellectual property rights. These are often seen to require longer patent terms, patent extensions and loose definitions of innovation that enable "me-too" spurious patenting, which would not only increase the control of transnational corporations within the economy and endanger public health delivery, but also prevent domestic innovation and technological advance which is crucial for development. Easing the possibility of technology transfer is not just desirable but essential for late industrialisers, so any legal and treaty changes that undermine this possibility should be resisted.

Similarly, the investment rules need to be examined carefully to ensure that the government retains control in areas that are seen as crucial for the livers and well-being of the population. The investor-state dispute settlement mechanisms embedded in several regional agreements are increasingly up for scrutiny, as the operation of several arbitrations councils has been seen as excessively investor-friendly and undermining of the developmental needs and human rights of citizens in developing countries. Indeed, several developing countries have already renegotiated some investment agreements and repudiated certain international tribunals for this reason. Therefore these provisions also need to be considered very carefully in the negotiations.

Short biography of Nguyen Xuan Thanh - Fulbright Economics Teaching Program and Harvard Kennedy School

Nguyen Xuan Thanh is the director of the Fulbright Economics Teaching Program in Ho Chi Minh City, and a senior fellow at the Harvard Kennedy School. Thanh's work is focused on development finance, public investment, and infrastructure development. His recent and ongoing research projects include cross-ownership in Vietnam's banking sector, Vietnam's infrastructure constraints, and Ho Chi Minh City's development strategies. Prior to joining the Fulbright School, Thanh served as an official in the municipal government of Ho Chi Minh City. At the Fulbright School, Thanh teaches courses on case studies for policy analysis, development finance, and the appraisal of public investment. He directs the overall activities of Fulbright School and its Master in Public Policy program, the first degree program in public policy to be offered in Vietnam.

INSTITUTIONAL REFORMS FOR ECONOMIC DEVELOPMENT: VIETNAM'S EXPERIENCE

Nguyen Xuan Thanh
Fulbright program in Vietnam

Abstract

So far, there is wide consensus among academics and policy makers that developing countries, particularly economies emerging from poverty and recently joined the middle-income rank such as Vietnam need to enact institutional reforms for economic development. The paper discusses on the role of institutions in institutional reforms in the reform context in Vietnam. The paper also presents recommendations for developing economies, especially emerging market economies, need to enact institutional reforms to promote sustainable and inclusive development.

1. The nature of institutional reforms

As we have seen in many conferences and workshops, "institutional reforms" has become a common connotation, but with many existing controversies. What do institutional reforms mean in practice? If we do not clearly identify from the beginning, then institutional reforms range from very important aspects, from constitutional changes to very specific institutional changes, such as a regulation under the Labour code or a new model of micro-credit, etc. There have been various applications of reforms, but only a few have proved historically with evidence-based impact for economic development, and for me, these are important lessons for prioritizing reforms towards a better future.

Institutional reforms and political feasibility

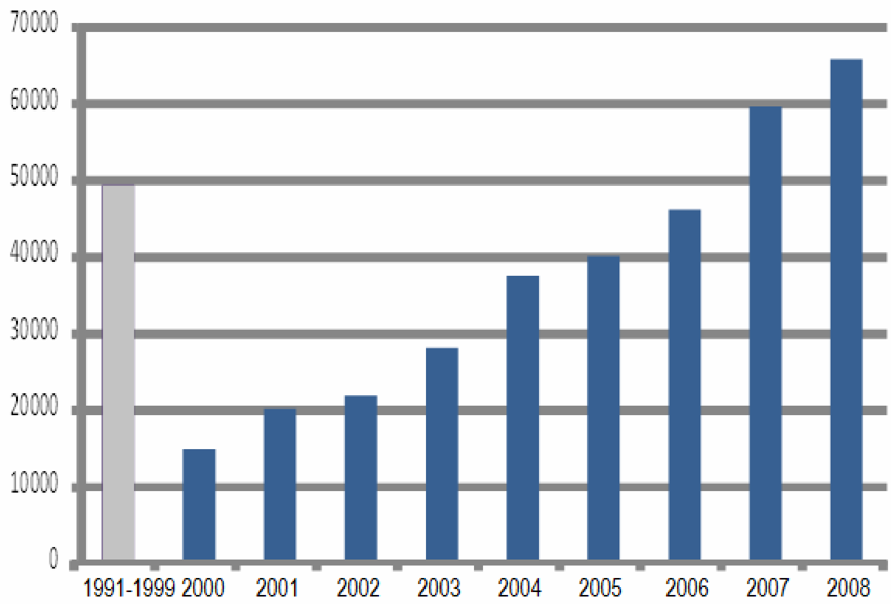
An issue does not receive large consensus, or even cause controversies concerning reforms that we would like to implement but which are not politically feasible. These are not theoretical issues, nor academic, but come from international experience of a country as Vietnam, with reform priorities actually implemented that led to transformation. At present, along the many achievements, Vietnam is in the second slow growth cycle since *Doi Moi* and facing with many challenges.

2. Vietnamese context: two episodes of economic slowdown

Vietnam faced the first period of economic slowdown in the end of the 90s (Asian financial crisis) and took less than 3 years to recover and get back to the growth path. In this second period, we are in the sixth year of slow growth cycle. At present, despite the positive macroeconomic signals, we do still not know whether we have reached the last year of the slowdown period, nor are we still in the middle of it. Looking back at the first slowdown period, Vietnam has implemented important reforms originating from the challenges arisen from the Asian financial crisis. But if we were to identify which institutional reform was really transformative in nature, it is the Enterprise Law, a very important institutional reform of Vietnam. We also completed the negotiations and joined the BTA between Vietnam and the US and the liberalization of the financial sector.

The Enterprise Law is a concrete and strong institutional reform by Vietnam, not only with the promulgation of a law institutionalizing procedures needed to start a business in the private sector, but also establishing the whole system for legal implementation. The result is the quick recovery and return to growth of the Vietnamese economy, especially the increase in production capacity of both domestic and FDI sectors. In only a couple of years, each sector already outperformed the SOEs sector in only 4 years. The BTA between Vietnam and the US has been a strong push for Vietnamese exports. More importantly, by implementing the Enterprise Law and truly integrating to the world economy, the first industrial clusters were established or clusters that already existed in Vietnam but dispersedly. These clusters now serve as fundamental for Vietnam's economic growth, concentrating many businesses, despite their low productivity. For example, only in garment and textile, there are 5,000 garment and textile enterprises concentrated in the area between Dong Nai - Binh Duong and Ho Chi Minh city, and over 200 open-door wood processing firms in a small locality such as Quy Nhon (Binh Dinh). Freeing up businesses, both private and FDI, has led to the concentration of firms, which now serve as the foundation of success in Vietnam.

Figure 1: **Number of Newly Registered Companies**



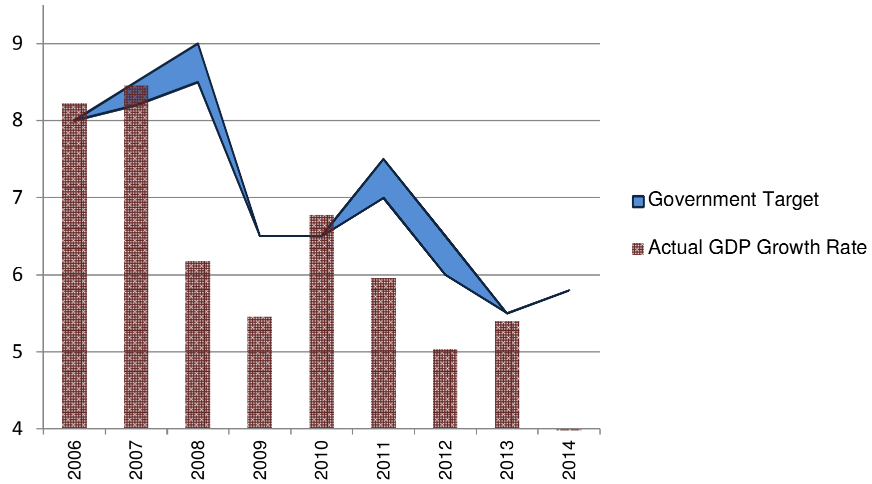
Source: Ministry of Planning & Invesment.

Dualism

Such issues related to institutional reforms require the political feasibility and lead to the growth model in Vietnam, which in this paper, I label, by the concept "dualism".

Following the Enterprise law and international economic integration, Vietnam has to accept redirecting its resources towards the State sector. We may criticize it, but in retrospect, we consider this as the only viable option that ensured political feasibility of the Vietnamese growth model. The objective of freeing up business resources for the private sector and economic integration to attract foreign investments have led to the relax of business rights for the private sector, removing constraints to the private sector while public resources can be directed towards SOEs. With the expectation that both of these sectors will develop, any political resistance against reform can therefore be addressed, serving a strategy which does not consist of scaling down the State sector, nor diminishing its importance, but rather concentrating more resources towards it, while the private sector which was previously controlled and contained, has now been released, so that the reform is widely accepted and promotes our economic growth and reinforces our economic foundation. This is a decision that was politically feasible. The now liberalized domestic private sector will continue to develop. Before, we used to contain its development, with policies that failed to institutionalize business rights of the private sector, but now, policies have been established, and the private sector can develop itself and resources can therefore be channelled to the State sector. Such dualism helped us recover and it took us only 3 years to get back to growth. Public and private investment both increased, fuelling our economic growth. The first economic slowdown was much worse than the present situation. At the time, growth was down to only 4.3% (current growth rate at about 5%), but it took us only 3 years to get back on the growth path. Since then, Vietnam has continued to maintain such a growth model.

Figure 2: **Growth target and actual growth rate**



The original cause was identified as the growth engine, because resources were directed to the State sector. Despite the fact that the State sector is inefficient, wasteful and spread, but the power and dynamism from the private sector, reflected in the continuous productivity increase in agriculture and FDI have somehow compensated the inefficiency of SOEs and the economy continued to grow at 7-8%. At present, the inefficiency of State sector also represents a potential burden in terms of budget and financial collapse, cut out the accessibility to resources by other sectors, including households businesses in agriculture and domestic private firms.

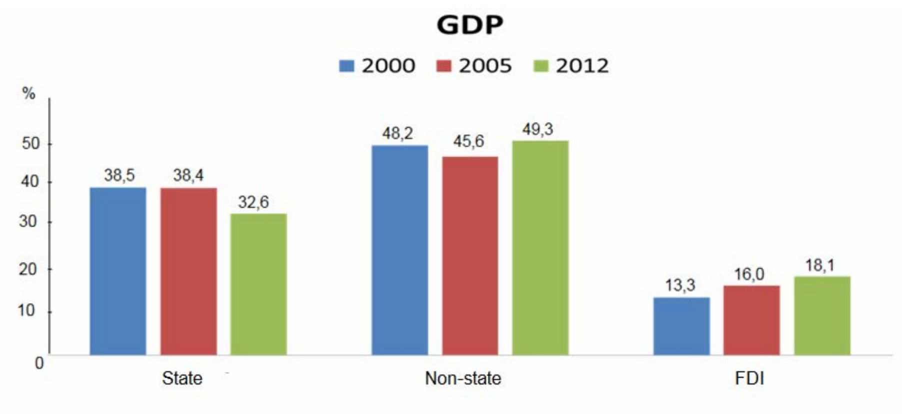
More importantly, for the FDI sector, there is a clear polarization in the performance of these two sectors. FDI firms make full use of existing benefits that Vietnamese firms are enjoying while can overcome all institutional constraints. Regarding the human capital and constraints, FDI firms may use external mechanisms.

From 2000 to 2008, Vietnam's accession to the WTO and international integration were to serve the purpose of this dualism. Vietnam has changed many of its regulations to be more in line with the integration, but following its accession, the institutional system was maintain unchanged to serve the SOEs.

Financial liberalization

Liberalization of the financial sector may look at first as a very positive advance in promoting economic growth. In reality, when liberalizing interest rates and opening up the banking sector, Vietnam is well more advanced than many other countries such as China in developing the private banking system to increase credit for the private sector. But on the other hand, Vietnam continues to maintain its SOEs sector to maintain directed credit. Thus, Vietnam is pursuing two objectives by taking one direction. We want a private banking system to promote the development of private sector while willing to maintain the State sector to maintain the leading role of the State Bank. Such an institutional model generates a hybrid model between private and public sector, or the so-called cross-ownership. This means that not only can the State bank provide credit to SOEs, but there are also SOEs owning banks that can provide directed lending and connection lending. Such a model is accepted because it is considered politically feasible. Its positive aspect is that it both fosters the development of private sector and of SOEs, that's why it is called "dualism".

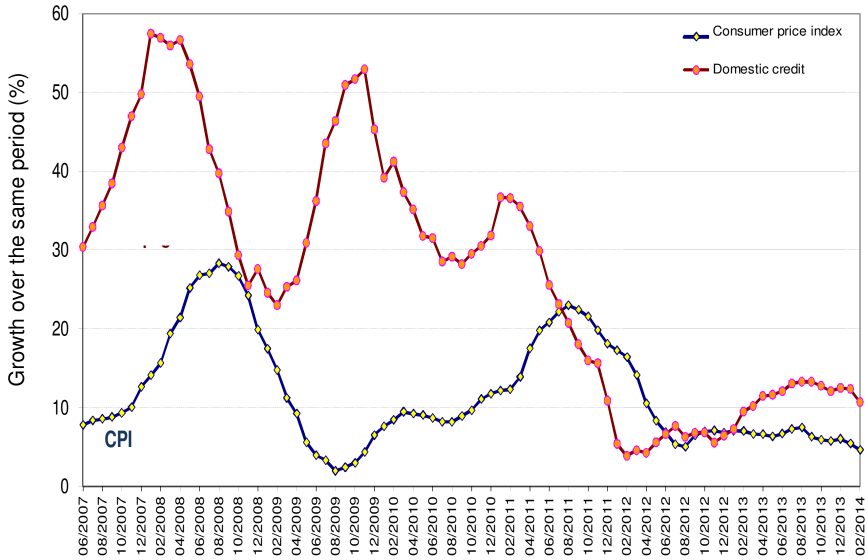
Figure 3: **State sector vs. non-State and FDI sectors**



Source: General Statistics Office.

The Enterprise Law, international economic integration and financial liberalization in the beginning of the 21th century are institutional reforms with strong impact, contributed to the establishment of a new growth model for Vietnam and reaching high growth rates. But at present, this is the cause of macroeconomic instabilities between short-term and medium-term reforms. Short-term macroeconomic stability may leads to two directions. One is that it has become impossible to implement important institutional reform to identify priorities and being politically acceptable in presence of risks of macroeconomic instabilities. But as long as macroeconomic instabilities remain, there is always an option of returning to the old growth model, because for such, there wouldn't be any pressures. With the low inflation rate at present, stability of foreign exchange rate for a long period and rising foreign exchange reserves are the foundations for macroeconomic stability. But the current problem remains the slow growth rate. If reforms continue to deliver low growth rates, then it won't be politically acceptable.

***Figure 4:* From instability to stability: Inflation**



Source: State Bank and GSO.

In the short-term, public investment was expanded in 2014 in an effort to create stimulus for growth, cutting down interest rates, and extension of bad debts settlements, with the expectations that these would be drivers for short-term growth. But looking at the growth model, are these efforts to return to the old growth model based on the two sectors by way of promoting investment and credit growth, or are these efforts towards new institutional reforms? In terms of policy, we see that Vietnam recently focused on SOEs, financial sector reform and international economic integration.

3. Institutional reform priorities and political feasibility?

We could take SOE reforms as illustration. Recent policy efforts by the government in promoting the reform process have been dynamic, with a big momentum: increased transparency among SOEs, establishment of a list of SOEs that will be equitized in the 2014-2015 period, and removal of technical barriers that prevent SOEs to divest from non-core activities. All these actions are the most politically feasible for the present period. No one objects to the requirement for greater transparency among SOEs, nor can anyone object to the acceleration of equitization and coming up with a detailed list of SOEs to be equitized, and by setting clear responsibilities in equitization process, from ownership and business execution. But it would only be political feasible until here. If stronger changes are required, such as changes in the internal administration, corporate governance of SOEs, the 3-in-1 relationships between ownership, line ministries and business management - then this cannot yet be reformed. In reality, different levels of State administration still need to rely on SOEs for political and financial support. If we were to take stronger measures in separating the role of ownership, line ministries and business management, then we would lose the political support. On the other hand, the Vietnamese government still needs to use SOEs as a policy instrument. Technically, we can easily change this, but politically, it is very difficult. Vietnam continues to rely on SOEs, especially on economic enterprises to carry out policy instruments in making investment in infrastructure, and carry out projects for the purpose of industrialization at local levels. Therefore, similar to the previous reform, SOE reform is limited to enhanced transparency and equitization, while separation of ownership, regulation and management faces strong political constraints. Forces for institutional reforms will come from two aspects: being resources allocation and international economic integration, which gather the strongest political also as social support.

Institutional reforms in resources allocation

In the current financial system in Vietnam, the lesson for resources allocation from the old growth model is pursuing dualism, and not inclusive and equitable growth. The institutional framework for the financial sector maintains the directed lending, SOE credit to focus on public investment, which in reality is not public investment, but rather investments carried out by SOEs. Thus, promoting institutional reforms in resources allocation is considered as a priority. A survey conducted on all public investment projects in Ho Chi Minh city in the two years period 2012-2013 shows the majority have completed ahead of schedule and did not exceeded budget estimates as compared to previously. A simple reason lies behind: the easy money and credit supply was stopped. This means that institutions and policies remain unchanged, but because resources have become scarcer, we have witnessed great improvement. Forces for reforms, in this case, need to derive from the new system of resources reallocation. In order to meet political feasibility, first of all, in the current banking system, Vietnam has gradually legalized regulations on credit provision to enterprises also as allowing banks to invest and provide credit. Thus, SOEs are acting in place of the private sector. While there is a question arising, related to the growing impact, both positively and negatively, of the global economy, yet Vietnam appears as strongest in free trade negotiations. Vietnam is now participating in 6 FTA. No other countries participate to that many FTA. Vietnam participates to all big forums and negotiations. When joining ASEAN, AFTA, BTA, WTO, there were a lot of controversies, but this time, there is strong national support. Some say that this has enabled the institutional reforms. SOE and financial reforms remain politically unfeasible. Therefore, Vietnam needs to focus on macroeconomic, fiscal and monetary policy changes in order to reach an acceptable level of growth, supporting trade negotiations. These negotiations will be incorporated into institutional reforms and such reforms will be carried out in a new cycle, new government term. Those with this same view are much supportive of deeper integration. Those who resist to reforms and willing to maintain the game unchanged also expect that deeper integration to the world economy will bring similar results to the accession to the WTO, thus incoming foreign investments and market expansion. To have growth while keeping the game unchanged; the issue here is whether we can use economic integration to promote reforms that lacks political feasibility, but which are realistic because they are very much needed. If we do not intend to use international trade and investment, then no obligation, no commitment can force institutional reforms. As a final point, I would like to conclude with an analysis from a recent publication by Acemoglu and Robinson, entitled "Why do nations fail?" In this publication, they focus on the role of institutions and while it is important to reform, there is a long list of issues. In the context of Vietnam and many other recently emerging economies, this is not a political feasible option. Strategic institutional reform needs to focus on the reform financial resources allocation for the economy to promote other reforms, and using reforms, commitment to international integration to have an official position in managing reform and other greater issues related to ownership rights, bankruptcy law, and market institutions. According to me, political priorities and feasibility force us to focus on reforms. Should we only deal with the economic reform, then priority must be given to resources allocation.

SESSION TWO

ECONOMIC REFORMS FOR INCLUSIVE AND SUSTAINABLE GROWTH

I. STRENGTHENING THE FINANCIAL SECTOR FOR INCLUSIVE AND SUSTAINABLE GROWTH: INTERNATIONAL EXPERIENCE AND IMPLICATIONS FOR VIET NAM

Short biography of Mr. Pham Xuan Hoe, Deputy Director of the Monetary Policy Department, State Bank of Viet Nam

Education: Master in Banking Finance.

Position: Deputy Director-General of the Monetary Policy Department, State Bank.

Working experience: About 30 years working in banking sector, including: 14 years in commercial bank, 11 years and 3 months as manager of 2 branches of Vietinbank, 2 years as Head of debt management division and market risk management divison at head-quarter; many years of experience in non-performing loans management, master thesis in credit risk management; 15 years working for State Bank with different positions as the local branch's credit officer (8 years), Deputy Head of General Department of the State Bank's branch in Thai Binh Province, Division Head of Economic Research Division, Economic Research Department of the State Bank, Deputy Director of the Monetary Policy Department since March 2012.

BANKING SECTOR REFROM IN VIETNAM: INITIAL RESULTS AND CHALLENGES AHEAD

MA. Pham Xuan Hoe

Deputy Director of Monetary Policy Department

State Bank of Viet Nam

1. Achievements of the banking sector

Results obtained through the banking system reforms in Viet Nam from the past 25 years are easily observable. *The first achievement* is the improvement and continuous upgrading of the monetary framework regulating the Vietnamese banking sector following international standards. This has been clear since 1990, when the ordinance on State Bank of Vietnam clearly separated the supervising role of the State by the State Bank and the business role of commercial banks. 10 years later, two ordinances were developed into the *Law on State Bank* and *Law on credit institutions*. These are two important legal frameworks for monetary management, setting the legal framework for the operation and risk management of credit institutions. This also reflects the new approach in the banking sector operation.

The second achievement is the legal framework that establishes the role, positioning of the State Bank as the Central Bank in Vietnam. This is a point that needs to be emphasized, because when the Law on State Bank was officially enacted, it clearly stated the position of State Bank with the mission of monetary and financial stabilization and development an account system. These three missions are included in the four articles under the Law on State Bank, contributing to the further clarification on the role of the State Bank. It is worth mentioning the success of the State Bank in controlling inflation over time. In the period in which the ordinance was enacted (1986-1990), inflation was successfully controlled; despite the increase of inflation between 2008-2009 due to global volatility, the State Bank was able to consistently contain inflation.

The third achievement is that the banking sector was initially separated between the supervising role of the State and its business functions. The State Bank only focuses on establishing a framework and mechanisms for market development, while commercial banks develop and operate in the monetary area. Specifically, we were able to clearly separate policy credit with trade credit. This is an important milestone - that once completed, would be a very good lesson for the utilization of instruments for more effective resources allocation though the financial system.

The fourth achievement is the creation and development of monetary market, contributing to the development of capital market in Vietnam. In particular, in the years when stock market did not yet exist, the State Bank was one of the main players promoting the foundations for a legal framework also as supporting the first steps of the stock market. (When the stock market was spin off, the Securities Commission was placed under the Ministry of Finance, yet there was a strong push for the equitization of State financial institutions, i.e. the State-owned commercial banks). Currently, various strategic partners hold 20% of capital of State-owned commercial banks, such as Vietinbank, Vietcombank, all of which are equitized. In particular, we were able to accelerate the process of SOEs equitization, through which, the creation of enterprises with products to serve the development of capital market.

The fifth achievement is the system of credit institutions diverse in terms of ownership and governance. Changing mentality determined the establishment of a system of joint stock banks, thus strong private banks that provide resources to the private business sector and helping the development of the private sector, contributing to growth in recent years.

Regarding the governance of credit institutions, it is clear that banks have applied models such as joint stock companies, limited responsibility companies, cooperatives, etc. Today, the system consists of 5 policy banks, 54 State-owned banks, 34 joint stock banks, 53 branches of foreign banks, 5 banks 100% foreign-owned, 4 joint venture banks, 4 financial companies, 1 cooperative bank and 1,132 local people's credit funds. Clearly, this stratification of the financial system, in such a banking system, plays a very important role and accounts for over 90% of the financial sector. This division of levels responds well to the allocation of resources. In particular, social policy banks fulfill very well the function of micro-credit, largely contributing to the successful poverty reduction programme in Vietnam.

The sixth achievement is the strengthening of banking assets and financial depth. This is reflected in the assets of the banking sector dominating the assets of the economy (currently over 5 million billion VND), the banking system plays a central role in providing capital to the economy: outstanding credit strongly increased at some points, up to 106% of GDP (adjusted over time) and decreased to 56% of GDP by the end of 2013. Large amounts of capital in the economy (up to 105% of GDP) were mobilized through the banking system. Foreign reserves of the State Bank were reinforce through the control of foreign currency, exchange rate management also as payments by the State Bank (equivalent to approximately 12 weeks of imports).

The seventh achievement is the monitoring framework and system of monitoring agencies (State Inspector Agency) with significant improvement in the safety oversight for each banking sector, especially in the transition from on-site monitoring to monitoring risks. The State Bank is currently finalizing the regulatory framework for the monitoring, evaluation and financial safety oversight according to FSAP.

The eighth achievement is the more and more developed and modern network of payment in the economy. This is reflected in the strong decrease of cash payments to approximately 10% of total means of payment; a strong decline of dollarization (deposits in USD remain over 10%); the payment technology of the banking system updated following international standards. In international payments, thus the payment of credit letters with foreign banks, the system of Vietnamese banks operates well, with good credibility. Many banks have received international payment certified international awards, such as large banks as Vietcombank, Vietinbank, or Techcombank from joint stock banks, or ACB, etc.

The ninth achievement to be acknowledged is the strong advancement in IT system in both software and hardware, which helped improve the integrated management of the banking system, and contribute to the diversification and modernization of banking products and services and provide more benefits to customers. At present, 100% of commercial banks use COREbanking to manage their integrated operations; developing new forms of electronic payments such as Internet banking, home banking; operating a network of 15,000 ATM, POS; develop a modern information management technology with approximately 65 million cards. Credit cards of major international brands are all present in Vietnam, such as Visa, Visa Master, or JP (Japan), etc. 46 million personal accounts in Vietnam show the accessibility of the population to banking services and tools. In many regions, such as the Mekong Delta, farmers show efficient access and use bankcards.

The tenth achievement is the development in scale and in depth of international relations and cooperation, greatly contributing to the improved positioning of the Vietnamese banking system. Vietnam's banking system has received huge financial and technical support from international organizations as WB, ADB, IMF, JICA, SECO, etc. in capacity building. These 10 achievements as stated above show important lessons, in particular related to the institutional framework and the new approach that allowed for the development and recognition of the private banking system as way of increasing resources for the economy.

2. The accumulation of weaknesses along the development process

In parallel with the achivements as stated above, it is important to recognize also the many constraints, weaknesses and challenges encountered during the developing course of the banking system. Some main weaknesses and challenges include the following:

First, in the pursuit of monetary stabilization or inflation control objectives by the State Bank, the positioning of the State Bank was reaffirmed by the law. However, external interventions on the ability to control inflation by the State Bank remain considerable, namely the price regulating system of commodities governed by the State, such as oil and fuel, health services, or training services, etc. In these areas, the State still witholds the regulating power, which despite being gradually liberalized, its impact on the State Bank’s ability to control prices and inflation remains a challenge.

The second challenge is due to the different policies arising from the coordination process, such as investment policies, public policies, or policies governing SOEs; if these policies turn out to be inefficient, then the immediate investment flows are not returned with an equivalent amount of goods, which will in turn cause rising inflation and representing another challenge.

The third challenge comes from the external. These include shocks in world oil price, instability of the external financial world. Together with the enhanced integration, the manifestation of this challenge is becoming clear in:

(1) The process of enhancing control and monetary stabilization by the State Bank.

(2) The structure of financial market development in Vietnam is biased. In terms of terminology, the banking system has been

assigned a a task too big, which is that of procuring capital for the whole economy. This a a challenge in terms of thinking mentality. It exists a view that capital is tied to the banking sector, ignoring the capital market, while the capital market represents a good channel for capital mobilization, not only for good options, good projects, but also good ideas. This is also an important bottleneck and challenge for the banking system.

(3) (Excessive) non-performing loans and cross-ownership degrade the quality assets in the banking system and represent a threat to the financial sector and economic development. After a period of overheated growth, non-performing loans have become a challenge and need a roadmap, a strategy to deal with the problem. Cross-ownership is also an issue that needs to be considered, even though, in my personal opinion, cross-ownership is not bad per se as it allows for the strengthening of technological and management capabilities, if good parters can be identified and capital transfer and connectivity could be enhanced to create market power. However, if cross-ownership becomes excessive and dominated by some interest groups, then it will be detrimental to the financial sector, in particular to the banking system.

The fourth challenge, also a weakness, is that the financial and management capabilities and risk management framework of the banking system are not yet updated to the best international practices. The upgrading process remains slow, basically failing to meet the requirements set out by the refom schedule and process innovation as the country further integrates to the world economy.

The fifth weakness is the policy framework for supervision and coordination between different channels of the financial system in general and the banking sector in particular, that remain incomplete, inconsistent, falling behind market developments, which in turn has led to important cases of risk failure. The problem lies in the integrated monitoring between different sectors, between supervising authorities such as the Banking Supervision and Inspection Agency, State Inspector Agency, State Audit Office, and independent audit organizations. This coordination fails to create a synergy to evaluate the financial and banking sectors. The issue here is whether the integrated supevisory power placed in a single government agency is an overall supervision or specific supervision of each particular sector? This is also a challenge, which according to our view, should be specialized monitoring before hand, which then will require a coordinating agency to integrate all evaluations on financial and banking sectors, and provide policy recommendations also as the ability to control and mitigate risks. Failure to catching up by the monitoring system has led to big episodes of risk failure in the economy and banking sector, causing damages to the image, reputation of the sector.

3. Recommendations

From the challenges and weaknesses as previously mentioned, we would like to propose the following 9 sets of solutions:

For the first set of solutions, it is important to continue to finalize the institutional framework, especially the legal framework for monetary and fiscal management by the State Bank, emphasizing its autonomy in making decisions. Because the State Bank is a government agency, we therefore will only mention the need to strengthen the legal framework for the State Bank autonomy. This is most important. Next, we should finalize the fiscal management framework, especially the coordination between these two policies also as the coordination during the programming of national finance based on the four important national accounts for the policy orientation and impact on each sectors.

The second set of solutions is the integrated development of domestic capital markets: stock market, bond market, interbank market, and the market for debt instruments. As previously mentioned, to correct the biased market development, in te sense that the banking system provides too much capital, it is important to have the best solutions to develop the stock market, bond market, interbank market, and the market for debt instruments. This is one of our recommendations and we hope that a legal framework for the market for debt instruments can be established and accelerate the speed of managing non-performing loans in the banking system

The third set of solutions is finalizing the policy and monitoring framework for the operation of the banking system under the overall structure of financial monitoring system and placing the consumer in this framework (hybrid, consolidated or specialized monitoring systems), coordinated crisis management, financial collapse and bankruptcy of financial institutions, supervision and protection of consumers.

The fourth set of solutions focuses on resources and envisages a roadmap between 5-7 years to completely resolve the current issues of non-performing loans and cross-ownership. This is a core issue for the success of the banking system under Project 254 approved by the Prime Minister.

The fifth set of solutions is to enhance capacity of financial institutions in the banking system. This include four pillars of capital, good corporate governance framework for assets management, risk management framework and human capital framework, especially the professional certification according to international practices and standards, and gradual control of market development.

The sixth set of solutions requires the finalization of regulations on accounting, audit, loan classification and risk provisions, a system of credit rating institutions and transparency of information. This is an important group of solution to promote the development of markets and increase transparency, guarantee that resources allocation are efficiently poured into efficient sectors.

The seventh set of solutions consists of the correct identification of information technology, accompanied by an integrated strategy, coherent policies in the application of IT in the financial system. It is important to overcome the inconsistency over the course of information technology development by commercial banks over time, such as the use of different platforms or lack of an integrated

IT strategy. This creates difficulties for management and incurs significant costs to consolidate technologies from different sources, in an effort to improve the database. We therefore recommend classifying IT risks in a separate category of risk, separated from the general banking operations, because nowadays, technology risks are very diversified and pose significant threats to the banking system. It is possible to mention the increasing external attacks to the system (hack), card or POS frauds to open accounts and withdraw money from the banking system, etc. We therefore recommend its separation for better investment and focus of IT risks management.

The eighth set of solutions is the enhanced research and forecasting capabilities of the State Bank, also as information sharing and coordination with supervising bodies in the financial sector (i.e. the Ministry of Finance, Securities Commission, State Inspection Agency, State Audit Office) or policymakers such as the Ministry of Planning and Investment, Central Institute for Economic Management, etc. It is very important to enable information sharing to enhance the analysis and forecasting capabilities to enact policy interventions in a timely manner.

The last set of solution is the need for proactivity and strengthened cooperation, by taking advantage of the financial and technical support provided by international financial institutions to finalize the monetary institution and development of a sound banking system and financial system in Vietnam.

Short biography of Bhanupong Nidhiprabha, Thammasat University

Bhanupong Nidhiprabha is Associate Professor in economics at Thammasat University. He received his BA in Economics from Thammasat in 1975. After obtaining his M.Sc. from the London School of Economics, he joined Thammasat as a faculty member in 1977.

He also holds a PhD in Economics from the Johns Hopkins University. His research interest is in the field of macroeconomics and international trade.

LESSONS FROM FINANCIAL REFORMS

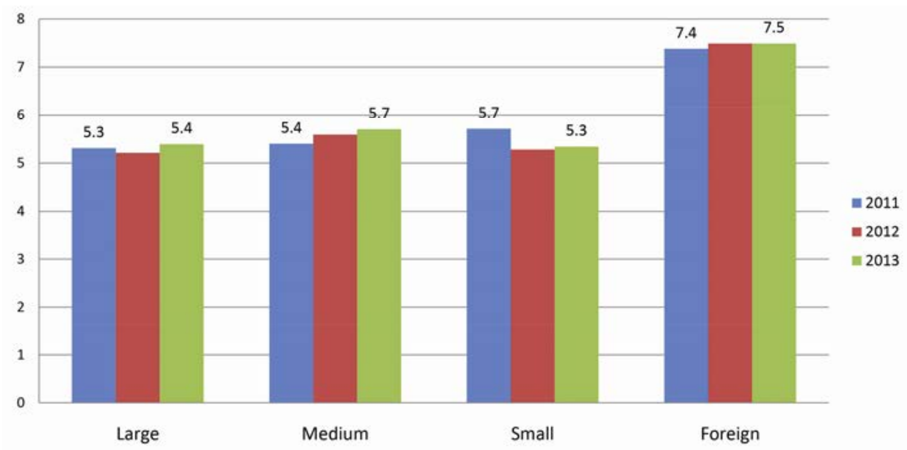
Assoc. Prof. Dr. Bhanupong Nidhiprabha
Thammasat University, Thailand

1. Impact of financial reforms: profitability, perfomance and solvency

The healthy performance, resilience and quick recovery of Asial financial institutions can be attributed to the financial reforms undertaken after the Asian financial crisis and the favorable macroeconomic environment.

The Asian financial sector was vulnerable in the late 1990s. The lack of prudential regulations and sufficient loan loss provisions that prevailed before the liberalization of capital account has led to huge capital inflows and subsequent financial turmoil.

Figure 1: **Thai Banks' Interest Spreads**



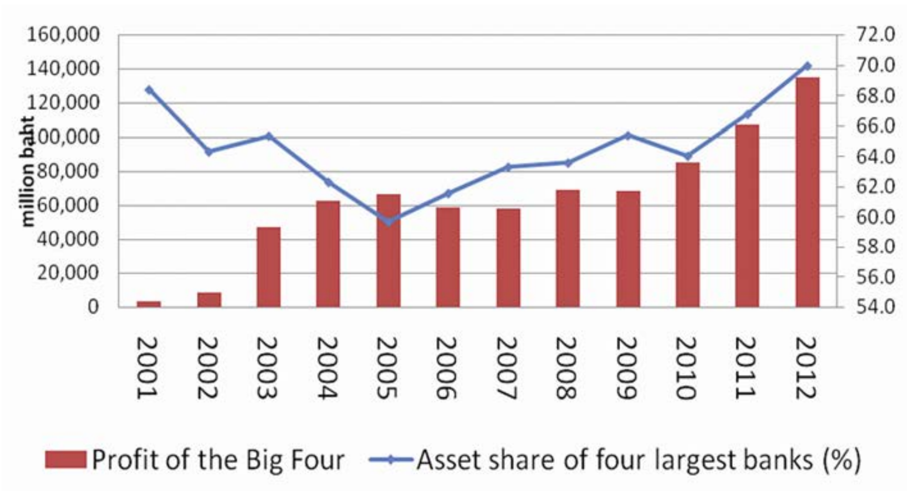
It is important to distinguish between external and internal liberalization, and of course, sequencing is also very important to a successful liberalization process. Foreign banks can improve competition. Capital control or relaxation can encourage capital inflows, but sometimes, inflows can be too much and too fast in such a way that institutions are not prepared to cope with, and before the Asian financial crisis, we did not have sufficient monitoring process in place to prevent damages from such capital inflows. Of course, it has to go along with the exchange rate policy as well as it can encourage foreign borrowings and in particular quite low foreign trade assets and that's how problems were generated with the exchange rate appreciation. The large interest spread between lending and deposit rates bodes well for the monopoly rent of commercial banks.

As we all know, State-owned banks essentially can conduct policy lending to agriculture, to industry, to exporters, importers, but somehow they have to share the ownership with foreign and private banks as well, in order to become more transparent and to improve the disclosure standard. So what happens to the real interest rate? The State bank of Vietnam recently reduced its interest rate by 1 percentage point to around 11% for short-term rate. Now, we need to look at whether that is due to policy matter or not when it comes to the real interest rate; because that depends much on inflation rate as well. We observe a rising trend of deposit rates, and that could be something to do with the inflation rate as well, so in a way, if we can control macro stability, we can control inflation, and thus deposit rate can come down. Deposit rate in the region, in particular Indonesia and Singapore, because inflation rate in these countries is controlled, lending and deposit rates can therefore both be cut down. Comparison between countries in the Asian region in the current context, we need to view that the recent news of 1 percent cut in short-term interest rate has a lot to do with the aim of inclusive growth, but also we have to make sure whether this kind of policy is going to be expansionary or not. It may be a good thing if you would like to revive the economy, but in the end, we have to look at the one fact that macroeconomic environment matters. Even if we have very large lending boom, but the economy is expanding with much problems there, then these problems will contribute to slowing down the economy. Looking at the non-performing loans, the interest spread and again, Vietnam has very large interest spread compared to other countries in the region. What is the reason behind it? Is it because of monopoly State banks power? Is it because of lack of competition? Looking at the spread from year 2000 to 2011, on average, Vietnam and Indonesia both have very large interest spread. Malaysia, Singapore experience rather lower interest rate spread but the spread is pretty much related to banks profitability. We understand that sometimes, policy lending can lead banks with growing non-performing loans, and that can be dangerous, especially when the economy slows down.

It is therefore important to have in place macro prudential regulations, for example when banks expand and extend credit to poverty sectors, they need to have some measures of control, loan-to-value or that kind of ratio. I understand that the State bank has already strengthened such regulations already, and countries in the region have somehow followed the same kind of prudential regulation already. Compared to bank credit in China, remarkably, Vietnam had very strong loan-to-GDP ratio during 2000-2009 and we all know that before the bubble bursts, there’s always a lending bubble. There’s no bubble burst without lending boom, therefore, these sectors become dangerous if the loans are excessively extended.

The transfer of assets from consumers to banks may be reduced by allowing foreign penetration in a way that is appropriate to the country’s liberalization commitments in services.

Figure 2: **Profits of Four Largest Banks in Thailand**



The Asian financial crisis in 1997-1998 may be considered a good thing, since countries in the region were not so much affected by the global financial crisis, as they learned their lessons already. Non-performing loans have been declining all the years for all these countries, because of the rules and regulations that were previously established, as well as the role of the economic recovery. Bank capital adequacy increased sufficiently thanks of the cap in foreign injection. In fact, small Thai banks did not exist anymore. All of these banks have been injected by foreign capital instead of using the Government budget. To bail out banks, we used foreign penetration and in a way, instead of using taxpayers' money, we used money from foreign banks that came in and bought up all these cheap banks during the time of crisis. The Thai financial sector emerged from the 1998 crisis and became stronger and more resilient, thanks to foreign capital injection, good governance, strengthened financial rules, and economic recovery.

Figure 3: **Bank Non-performing loans (% total loan)**

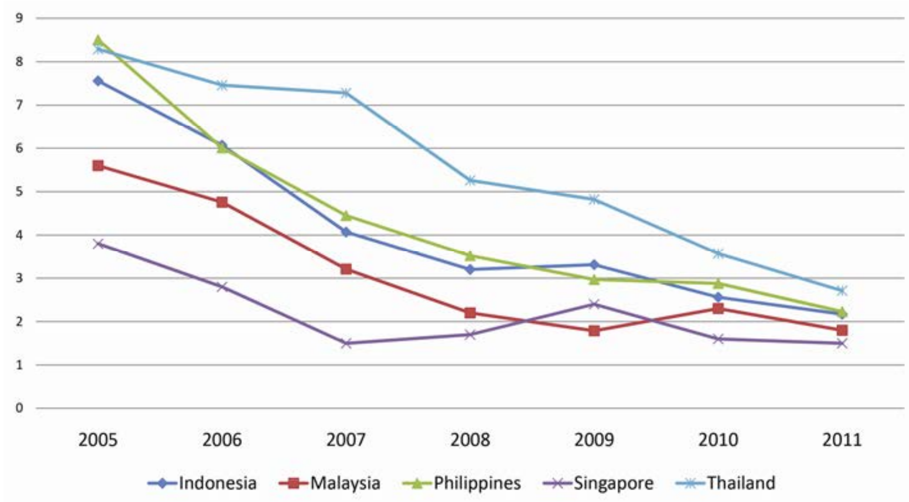


Figure 4: **Thailand's Bank Capital Adequacy during the global financial crisis**

Table 1: **Foreign ownership in Thai banks: Lessons after the crisis**

	1997	2000	2004	2007
Large	22.1	33.4	36.3	38.5
Medium	25.8	9.5	12.2	37.6
Small	6.4	76.7	52.8	55.6

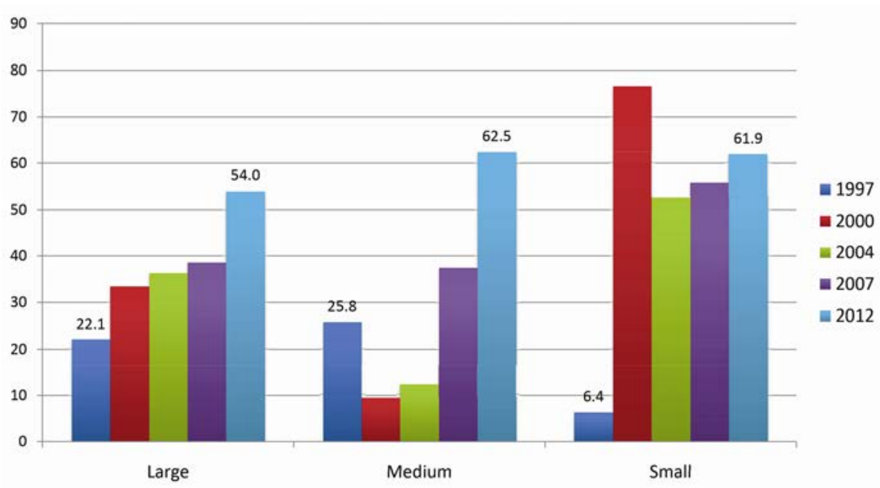
2. Foreign penetration

When it comes to the role of foreign banks, capital injection is extremely important, especially when banks are in trouble. We know that foreign banks can help with the transfer of technology, it can create competition, it helps to avoid the perception of protectionism to encourage foreign participation and it can ensure that technical efficiency. Sometimes banks that go together, coming as large groups, as the four big banks in China, they can experience decisive economies of scale; thus it is clear that size matters. Sometimes we have to think about transparency in terms of quality and availability of information. These kinds of liberalization itself, by allowing more competition, it becomes possible to lower the interest gap and get efficiency. The Efficiency may be measured as:

- By opening up to the financial sector to foreign participation, the financial sector has become more efficient, taking the benefit from competition effect and technology adaptation.
- The large interest margin between lending and deposit rates bodes well for the monopoly rent of commercial banks.
- The transfer of wealth from consumers to banks can be reduced via allowing foreign entry in line with liberalization of the service sectors.

Here, all banks of all sizes have partnerships with foreign banks, through which, we can ensure funds. If we compare with China, a country with more years of doing reforms, China has also liberalized its banking system for foreign banks' participation and competition, but China do so on gradual basis to ensure overall participation while limiting shocks. Financial restructuring cannot be achieved without allowing foreign participation or acquiring shares of less efficient public-owned financial institutions.

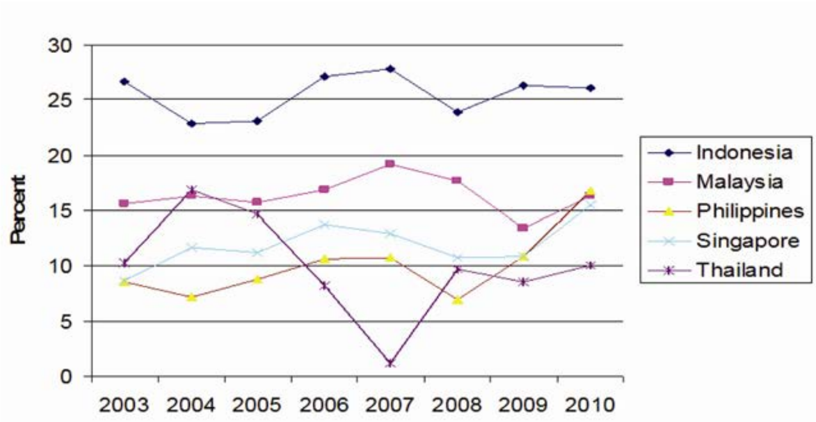
Figure 5: **Foreign ownership in Thai banks**



3. Global financial crisis and the Asian fianncial sector

Financial liberalization can promote growth to the sufficient funds to allocate to priority sectors and thus, to have more and more competition that can ensure proceedings as a result of the strengthening capital funds, but somehow the growing connectedness of global financial markets, Asian financial sectors have become more vulnerable to shocks. In case of Thai banks, you see that interest rate and size matter. Large banks are able to have lower lending spread and enjoy higher profitability. We can measure that efficiency by looking at the spread and profitability. In the case of Thailand, it shows that the assets of four largest banks are very much related to their profitability. So size matters in that sense.

Figure 6: **Return on Bank Equity**



Southeast Asian countries were well prepared as they already underwent financial reform after the 1997 crisis. Non-performing loans dropped sharply after the financial crisis, from 70%. Technically, all those banks were bankrupt, but because of Government injection, and the Government ability to maintain confidence, so there was none went bankrupt, and that helped with solving the problems there. Briefly, just like Vietnam, we have TAMC, the asset management corporation. The problem with this asset management corporation clearly has a lot to do with the fact that they have limited success because of the weak foreclosure and bankruptcy law, which is very critical. Its structural problem causes it to be very difficult, especially during the times of economic slowdown. To recover, banks need to resume lending, and this requires funds which come from the Government and/or foreign banks. It is important therefore to establish a legal framework. Southeast Asian banks did pretty well because of the prudential rules and regulations that were already in place. Looking at return on equity, especially in the case of Indonesia, Malaysia, they perform pretty well. Large amount of profitability derived from the GDP growth of these countries; as a consequence, macroeconomics matters a lot. Prudential rules and regulations have been established before the eruption of the global financial crisis in 2007-2008.

For the subprime crisis, because Southeast Asian economies remain bank-based economies, they therefore cannot rely much on bond markets. In times of crisis, these countries face the problem that they lack sophisticated or developed bond markets. Today, the region still remains a bank-based economy, which makes them difficult to escape the Original Sin. However, developed and advanced countries, with developed and fully developed capital markets still suffer from financial crisis anyway; it is therefore not possible to be determined as a sufficient condition.

With low exposure to the export sector, Southeast Asian commercial banks invested little in collateral debt obligations backed by the US subprime loans.

Figure 7: **Thailand's Domestic Financing Profile**

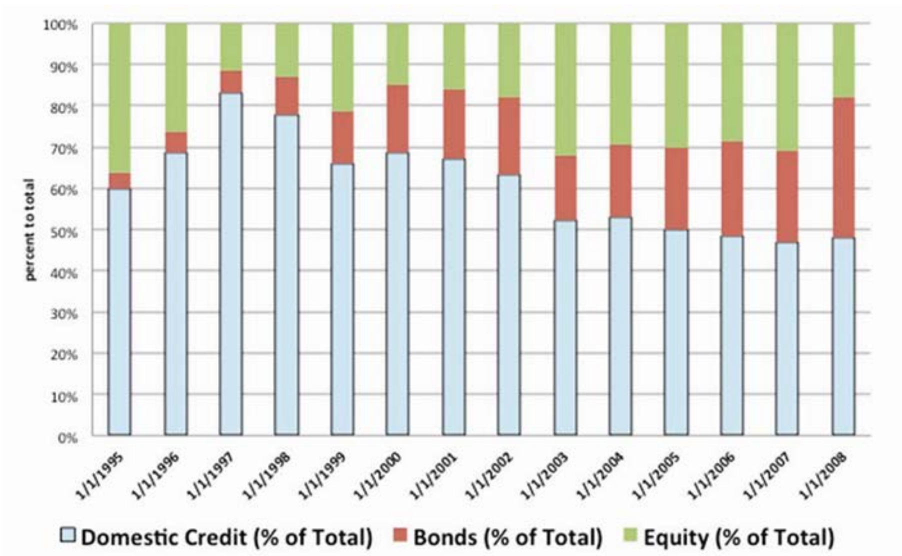
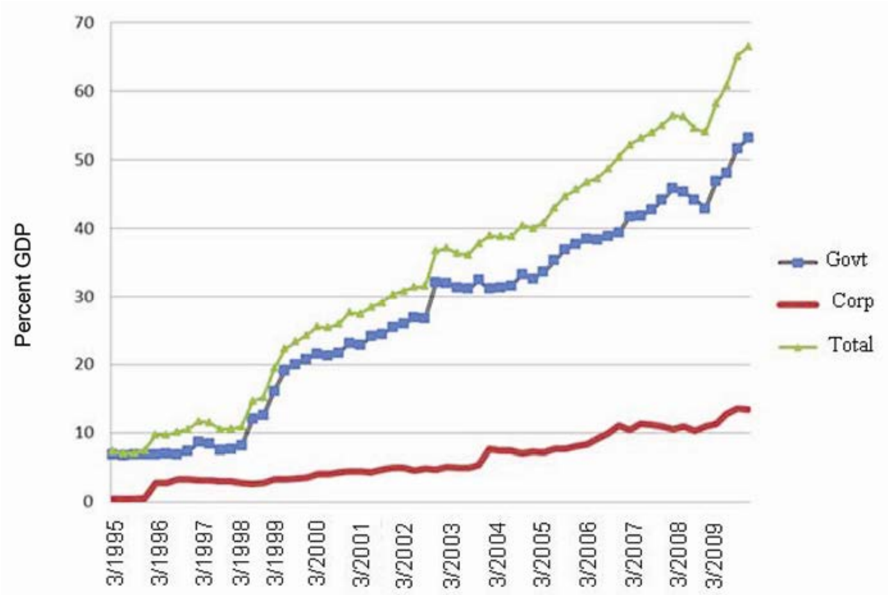


Figure 8: **Emerging local bonds market**



When are banks too big to fail?

In the future, there would always be some banks that fail because of the vulnerable nature of financial firms; the monetary authorities must distance themselves from the too-big-to-fail syndrome.

Sometimes, big banks cannot be allowed to stay and taking risk in such a way that governments can have time to build in other times. So in that case, we need to have market discipline, and sometimes, banks should be allowed to fail if it doesn't cost so much as a system-wide crisis. In case of some Asian countries, we have deposit insurance corporations just to make sure that depositors have to take care of themselves, knowing the risk of putting their money in different banks. It takes time, however, for depositors to learn to protect themselves and realize that deposit insurance programs do not prevent them from any losses caused by failure of financial market and institutions.

Global financial crisis and Thai banks

The Thai financial sector was vulnerable and weak in the late 1990s. The lack of prudential regulations and sufficient capital funds made capital control relaxation in the early 1990s premature liberalization. The ensuing fast and large capital inflows led to subsequent financial turmoil.

The Thai financial sector since then has emerged from the 1998 crisis and become stronger and resilient, thanks to foregin capital injection, good governance and strengthened financial rules. In case of Thailand, Government bonds accumulated and expanded so much because of the budget deficit ran by the Government, and that's probably the idea that bonds financing are quite important especially in terms of infrastructure.

For Thai banks, CDS banks did now know about that and did not know what it's all about and therefore did not suffer much, which is a good thing. The rapid economic recovery despite the political turmoil in 2010 provided opportunities for banks to expand their credit and enjoy the benefits from rising interest rates. In addition, strong performance of the corporate sector enabled banks to further reduce non-performing loans.

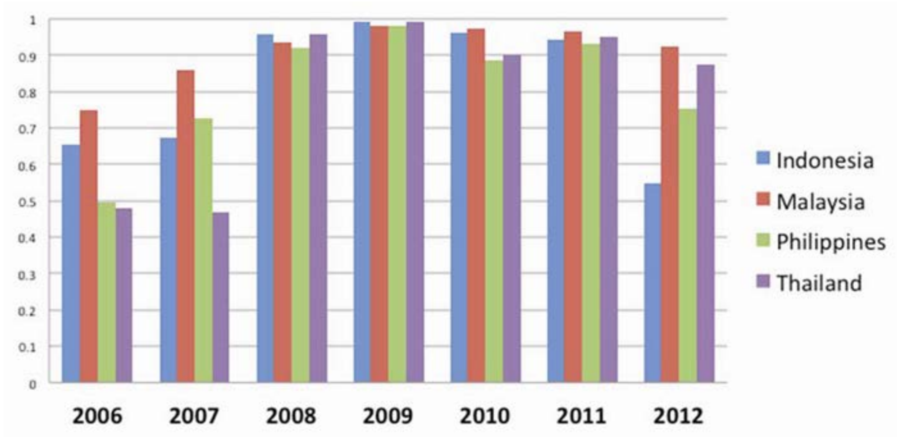
4. Financial integration with Southeast Asian Economies

When the AEC (Asian Economic Community) comes in full flesh, financial liberalization would mean opening up the financial sector to foreign competition to force local banks, in a way, to become more efficient. They have to fight with the new comers from other nations, which will make them become more vulnerable but perhaps they will learn to be resilient as well. Countries in the Asian region move up and down together, characterized not by their GDP, but also export cycles moving up and down synchronously, which is pretty much linked to China's business cycle as well.

Asian financial institutions and their regulators cannot resist the global trend of foreign penetration. By opening up the financial sector to foreign participation, the financial sector has become more efficient, benefitting from competition and technology adaptation. With foreign capital injection, monetary authorities can maintain system solvency while lessening the burden of financial bailouts.

Since the 1997 financial crisis, the Southeast economies have been closely integrated to the world economy through international trade (network trade) and capital flows. As such, it cannot completely shield itself from external shocks. The global financial crisis during 2007-2009 led to export collapse and output contraction in 2009. The debacle of the world's financial institutions and stock market crashes in 2008 had a negative impact on Asian stock markets. The adverse consequence on Asian banking sector was minimal. The banks were able to make profits during difficult times. Most of them did not invest in CDOs nor focus mainly on property lending. The level of non-performing loans continued to decline, while banks enhanced capital strength and provided sufficient loan-loss provisions. The exploitation of economies of scale and scope improved efficiency in their operations. All of these factors are the result of financial reforms undertaken after experiencing the financial crisis in 1997. Southeast Asian banks have been well prepared for the global financial crisis as they have learned a valuable lesson on being conservative and observing stringent prudential rules and regulations. It remains to be seen how vulnerable and resilient the Thai banking system is in the face of the Euro zone problems and fears of a double-dip recession when capital controls are relaxed in ASEAN Countries.

Figure 9: **Stock market returns correlation: Singapore**



5. The shape of things to come

Financial and real sectors in Southeast Asia have become increasingly integrated. The danger of capital market integration is that shocks can be transmitted easily in time of boom and bust. Rules and regulations must be in place in anticipation of financial and trade shocks from the rest of the world.

So in a way, it is not possible to escape. We really have to think and consider about depending on local economy, which we must be prepared. And perhaps capital controls, well I have some kind of caution about that, whether that would make sense or not, because that could destroy the concept of liberalization there, so we have to be careful. Investors are always in panic whenever we change rules and regulations there. Here, just to show that correlation coefficient between stock markets in the region move up and down together, so somehow, foreign investors cannot distinguish between Indonesia, Thailand, the Philippines and Malaysia because they move up and down together, so they are more and more related; that's the kind of vulnerability there. In the future, we need to make sure that rules and regulations are be in place and there would always exist a danger of capital market situation. Especially in the case of Thailand, political instability, weaknesses in legal, judicial and monitoring systems can destroy the confidence, it is therefore very important to establishing rules and regulations to make sure that we have stable government, like other countries in the region, Indonesia, or Vietnam for example, the government is stable, with not so many shocks and there's not much changes around, which is good for confidence. Lastly, competition needs to be enhanced from foreign banks.

Short Biography of Dr. Syafruddin A. Temenggung, Former President of IBRA, Indonesia

Mr. Temenggung received his Bachelor of Engineering (1983, Bandung Institute of Technology), Master of Regional Planning (1990, Cornell University - USA) and Ph.D. Regional Economic and Economic Development (1994, Cornell University - USA).

Work experience: (i) Jan 2005 - present: Chairman and Founder HAKEA and FORTIUS Corporations (Private Companies based in Jakarta); (ii) April 2002 - Feb 2004: Chairman of the National Bank Restructuring Agency (IBRA); (iii) January 2001 - April 2002: Deputy Minister at the Coordinating Economic Minister for International Economic Cooperation; (iv) April 2000 - April 2002: Secretary of the Financial Sector Policy Committee (FSPC); (v) July 2000 - Jan 2001: Deputy Minister at the Coordinating Economic Minister for Investment and Business Development; (vi) May 1998 - July 2000: Director of the Partnership and the Business Development, the Coordinating Economic Minister…

FINANCIAL SECTOR REFORMS: LESSONS FROM INDONESIA

Dr. Syafruddin A. Temenggung
Former Chairman
Indonesia Bank Restructuring Agency

1. Economic Crisis and Formation of IBRA

1.1. Economic Crisis, Banking and National Economy

In mid-1997, the regional economy in Southeast Asia experienced the crisis that was caused by depreciated currencies in the region against the US dollar. The crisis that started with the declining Thai currency against the US dollar followed by the depreciation of other currencies in Asia. In Indonesia, the value of the Rupiah currency against the US dollar experienced a sharp decline from around Rp. 2,500 per US dollar, and even once reaching Rp. 17,000 per US dollar and continued to fluctuate sharply during the year.

The Rupiah currency declining value against the US dollar impacted directly to the business sector. At that time, more than 50% of the business sector was financed by loans in the form of US dollars and was unprotected against the fluctuating of foreign currencies (hedging), and thus the amounts of the loans swallowed to surpass the equity. The matter caused the business sector to experience difficulties in the repayment of its obligation to the banks and the banks was facing problem credits, the value of which continued to increase.

By the declining performance of the banks at that time, the government together with Bank Indonesia liquidated 16 banks at the end of 1998. The liquidation of 16 banks triggered the people's confidence crisis in the banks, which caused massive withdrawal of the people's funds from the national banking system. Entering 1999 the national banking condition did not improve, so that BI and the government decided to freeze and to manage a number of banks recapitalization (79 BBO, BBKU, BTO banks and bank recapitalization).

The monetary crisis that triggered the banking crisis finally caused the crisis of national economic condition to be marked with the stumbling of a number of Indonesia's economic indications to a very low point. Indonesia's economic growth was declining sharply, reaching 18%, compared to that of the previous year. The majority of the companies in the real sector experienced difficulties and needed restructuring. Inflation also was declining from 20% until 60% in 1998. The national economic crisis encouraged the government to take recovery measures immediately.

1.2. Policies on National Economic Recovery and Formation of IBRA

In order to avoid an entire economic destruction, the government applied strategic policies in 3 main fields, namely:

1. Restructuring of the Banking Sector
2. Reducing the pressure on the balance of payment
3. Restructuring the private debts

In order to realize the policies above, the government and the people's representative council (Indonesian: Dewan Perwakilan Rakyat/DPR) amended Law Number 7/1992 on Banking in Law Number 10/1998 Article 37A, which contained the establishment of a special agency in order to manage bank restructuring, and in Article 37B contained the establishment of the Deposit Insurance Institution (Indonesia: Lembaga Penjamin Simpanan/LPS). The government established IBRA on 26 January 1998 based on Decree of the President of the Republic of Indonesia Number 27/1998.

To regulate the duties and authority of IBRA, the Government issued Government Regulation Number 17/1999 that regulates the special agency, namely IBRA.

In accordance with Government Regulation Number 17/1999 that regulates the special agency, the formation of IBRA shall be based on the considerations as follows:

- The weakening of the national banking industry due to the monetary upheavals could results in the impacts that endanger the national economy;

- In order to prevent economic destruction, it is necessary to form a special agency;

- The authority of the agency has the lex specialist against other legislation.

From the consideration on the formation of the IBRA at that time, it is clearly seen that IBRA was expected to become a national economic recovery agent. This role then became the vision of IBRA.

1.3. IBRA Functions and Duties

Operationally, the Functions and Duties of IBRA are regulated in Government Regulation Number 17/1999, which include:

- Restructuring of the banks which established and submitted by Bank Indonesia;

- Settlement of bank assets, including physical assets and obligations of the debtors through the Assets Management Unit.

- Undertaking the repayment of the state money that was channeled to the banks through the assets settlement in the restructuring.

In addition, based on Presidential Decree Number 26/1998, IBRA also runs the implementation function of government security of the banks payment obligation.

Unlike the similar institutions in other countries hit by the crisis, IBRA has the most variable duties that include:

(i) Restructuring company debts and bank assets

(ii) Restructuring and recovering the banks

(iii) Settlement of the obligations of bank shareholders

(iv) Guarantee the liabilities of commercial banks (being an entrusted duty, this should be the duty of the Deposit Insurance Institution/LPS)

(v) Legal/litigation cases

2. Bank Restructuring as Submitted by Bank Indonesia

Of the 79 problem banks during the crisis, 7 banks were state enterprises and were handled by the Ministry of State Enterprises (BUMN), and 72 were problem banks submitted by Bank Indonesia to IBRA. Based on the evaluation and selection processes carried out, in the course the operation of 52 banks was frozen (BBO/BBKU), and 20 banks were recapitulated.

The consideration for freezing such banks was that they had no significant business scale, had relatively big debts, were in violation of the BI regulations, were projected will not be capable of running their business in a sustainable manner (going concern), and the former owners were not capable of investing.

Out of the 20 banks under recapitalization, the bank restructuring further process required 10 banks to be consolidated with Bank Danamon, five to be merged to become Bank Permata and five others were established to become stand alone banks.

2.1. Bank Recapitalization

In order to recapitulate the banks, the government established the selection process that was regulated in the Joint Decree of the Finance Minister and Bank Indonesia Governor Number 53/KMK.017/1999 and 31/12/KEP/GBI year 1999. In accordance with the Joint Decree, the recapitalization was conducted for the banks that passed the selection. The selection was conducted gradually through 3 committees, namely the Technical Committee, Evaluation Committee and Policy Committee. Each of the committees had the members of the teams from the Finance Ministry, Bank Indonesia and IBRA.

The evaluation conducted included the principal matters namely:

- *Financial Evaluation*: The evaluation was conducted by internationally reputable independent accountant and applied a very strict international standard. Based on the evaluation results, the banks that have the Capital Adequacy ratio (CAR) above 4% were classified as Bank Category A, and the banks with the CAR between 4% and negative 25% were referred to as Bank Category B, whereas the banks with the CAR of less than negative 25% fell into Bank Category C.

Based on the CAR magnitude above, it was established that Bank Category A could continue their operation without the government interference; the Bank Category B should join further evaluation; whereas the Banks Category C and could not increase their CAR to become at least -25% are frozen in terms of operation.

- *Business Prospect Evaluation*: This evaluation is the further evaluation of Bank Category B and is conducted by taking into consideration for the franchise value of such banks.

- *Fit & Proper Evaluation*: This evaluation is aimed to determine the capacity and integrity of the management and the shareholders who control the bank.

Based on the evaluations above, the Bank Category B could be classified further to become:

- *Recapitalization Bank*: is the Bank Category B that passed the evaluation and the shareholders are willing to participate in the minimum amount of 20% of the need for recapitalization as of 31 December 1998.

- *Take-Over Bank*: is the Bank Category B that passed the evaluations but their shareholders are not willing to participate in the recapitalization; or a number of banks of the Category B failed the further evaluation but they have the depositors above 80,000 accounts.

- *Operation-Frozen Bank* is the Category B banks that failed the further evaluation.

The amount of fund expended for recapitalization is Rp. 424,57 trillim rupiah 67% of the recapitalization fund is injected into state enterprise banks.

2.2. Merger and Bank Consolidation

One of the ways to restructure the banks by IBRA was consolidating the programs and merge a number of banks. Bank Danamon is now the result of 9 (nine) banks as follows: Bank Duta, Bank Nusa Nasional, Bank Pos, Bank Jaya, Bank Tamara, Bank Rama, Bank Risjad Salim Internasional, Bank PDFCI and Bank Tiara Asia. Bank Permata is the result of consolidation of 5 (five) banks, namely Bank Universal, Bank Artamedia, Bank Prima Express, Bank Patriot and Bank Bali.

1. Bank Danamon

Merger was done for the first time by IBRA was merging nine banks into Bank Danamon.

The merger was initiated at the end of 1999 by merging Bank PDFCI into Bank Danamon. This step provided a framework for the merging of Bank Tiara Asia and seven other BTO Banks into Bank Danamon. On 30 June 2000 the license of merging Bank Danamon and eight other BTO Banks was obtained from BI and from the Ministry of Justice and Legislation. The government issued the bonds in the amount of Rp. 28.87 trillion to finance the merger.

The operating merger was conducted gradually and in a series from Bank Jaya Internasional, Bank Tiara Asia, Bank Pos Nusantara, Bank Rama, Bank Tamara, Bank Nusa Nasional, Bank Duta and Bank Risjad Salim Internasional. The operating merger was settled by IBRA on 29 September 2000, one week earlier than the target contained in IMF's Letter of Intent, which supposed to be in the beginning of October 2000.

The legal merger process of the banks was made on 30 June 2000. It could be said that the merger process was the fastest and the biggest ever in the history of national banking after Bank Mandiri. Following the merger, Bank Danamon has new vision in developing its business, which is becoming the best national bank (to become the best nationwide bank) based on 3 core values: integrity, professionalism and transparency. For the step into the future, Bank Danamon will position itself in its market segment focusing on the retail and consumer sector carefully, while serving the corporation market segment.

On 9 October 2000, an Extraordinary General Meeting of Shareholders was convened and approved the amendment to the composition of the Board of Commissioners and the Board of Directors of the Company as follow up to the completion of the merger process of Bank Danamon and 8 BTO Banks that ran smoothly as of 30 June 2000 (effective date of the legal merger) until 29 September 2000 (end of the operating merger).

2. Bank Permata Bank

Permata Bank was the result of consolidation of five average banks, namely 4 (four) recap banks: Bank Universal, Bank Artamedia, Bank Prima Express, Bank Patriot and 1 (one) take-over bank, namely Bank Bali.

Before consolidation (merger and acquisition) was conducted on these banks, the government had injected the five banks with the recapitalization bonds, each in the amounts of Rp. 4.10 trillion, Rp. 130 billion, Rp. 531 billion, Rp. 51 billion and Rp. 5.3 trillion. By the completion of the recapitalization of the five banks, the government dominated the shares of the banks, each in the quantities of 78.91%, 76.92%, 88.64%, 80.99% and 98%.

In the progress, in connection with the Bank Indonesia regulations on the Obligation for Provision of Minimum Capital (KPMM) of the banks as of 31 December 2001 of 8%, the capital condition of the Recapitulated Banks was unfavorable and difficult to fulfill the minimum capital requirement of 8%. This was due to Indonesia's macroeconomic condition that was not as good as predicted in the early stages of the bank restructuring, such as the unstable rupiah exchange rate against the US dollar and this tended to become high, and the interest rate that was still high. This encouraged IBRA to take further restructuring steps for the four banks.

The Financial Sector Policy Committee (KKSK) through Decision Number KEP 02/K.KKSK/11/2001, dated 22 November 2001, approved the further restructuring of the four banks through the merger and acquisition mechanism.

The merger and acquisition process was started by establishing the status of the Banks In Restructuring (BDP) against Bank Universal, Bank Artamedia, Bank Patriot, and Bank Prima Express by BI after coordinating with the government through the Bank Indonesia Governor Decree, dated 16 May 2002. The establishment of the BDB status and delivery of the mentioned four banks to IBRA were conducted in order to facilitate and expedite the merger and acquisition process to fulfill the KPMM ratio in accordance with the prevailing legislation and to save the state money that had been invested in the recapitalization program for the four banks. In the merger and acquisition process, IBRA established Bank Bali as the platform bank.

The legal merger of the 5 banks was effective as of December 2002, which was marked by the issuance of the merger license from BI and legalization of the amendment to the Articles of Association/Bylaw of the Banks following the merger and acquisition by the Ministry of Justice and Human Rights.

In addition to conducting the consolidation and the merger of 15 banks, IBRA directed the bank restructuring policies for the banks under it. Learned from the previous experience, the handling of the credit loan problem was not optimal and by considering the high cost of recapitalization that was expended, the IBRA resources which handled the problem credits were limited, the banks understood better of their debtor characteristics, and slow development of the real sector; IBRA made new breakthroughs in restructuring Bank BII and Bank Permata.

The breakthroughs applied were making the problem credits policy remain in the banks and not transferring it to IBRA, the elimination/provision formed for such credits problem was given after reduction by the latest appraisal value of the existing collateral; the recovery result over the problem credits handling still remained the benefit to the banks that caused the banks' financial condition to improve, which finally increased the share value of IBRA and IBRA provided the corridors for handling the problem credits for the bank management. The following one year after restructuring, both banks were asked to restructure the problem credits that could be restructured and the sales for the problem credits that could not be restructured. This breakthrough was proven to produce positive impacts because both banks could show improved performance.

The simulation of the calculation of the merger cost required if the problem credits were transferred to IBRA (former method) compared to the result of applying the breakthrough policy above indicates that the money could be saved up to Rp. 633 billion of the bank merger cost with the condition that the problem credits were transferred to IBRA. This could happen because transferring the problem credit to IBRA caused the bank to provide additional provision because the security value of such credits were not calculated. Whereas if they remained with the banks, no additional provision was required.

2.3. Bank Divestment

Following the recapitalization, the government became the majority shareholders in the banks. This role could create a conflict of interest between the owners and the regulator (both of them were held by the government) and had the potential of endangering the condition of the banks. Therefore, in order to implement the principle of good corporate governance, the roles of the owners and the regulators had to be separated immediately.

The recapitalization costs expended on the banks was very large, and therefore the performance of the banks had to be continuously undertaken and improved. Therefore, the bank management had to be done by the competent party to manage the banks. The highly competent bank managers could become the partner of the government in order to make the banks healthier. In addition, divestment was one of the matters to return the banks to the private sector, and thus the ownership of the banks could be scattered more widely. With the wider ownership and new majority competent owners, the public trust in the banks will be maintained better.

Considering the matters above, IBRA made the criteria for prospective of the banks stricter from one divestment to another. When divesting BCA by means of strategic sale to release 51% of its shares, IBRA among others required that the prospective investor was an experienced institution in running the financial business or bank. The BCA Strategic sale was sold successfully to Consortium Farallon. This gave the positive market sentiment to the capital market and money market in Indonesia. This success also increased the trust in IBRA in implementing the following bank divestment program.

Based on the BCA divestment experience, IBRA made improvement in several matters in connection with the divestment processes of Bank Niaga, Bank Danamon, Bank BII, Bank Lippo and Bank Permata. The improved matters included:

- The formation of the Independent Committee that had the members from outside IBRA who were experienced and were experts in the fields of banking, law, economy, capital market and were academics. This committee voted in the selection process.

- The investor criteria were made stricter to become a bank or financial institution and had good international rating.

- The floor price was determined that served as the limit of minimum price offer by the prospective investor. This was for the purpose of preventing the sales for cheap prices.

In the divestment of Bank BII and Bank Lippo, IBRA further made the criteria stricter for the prospective investors by establishing that the prospective investors had to be a bank with the rating of BB-.

1. Bank Central Asia (BCA)

The government share divestment in BCA was conducted in 2003 in two phases: (i) Initial Public Offer (IPO), and (ii) strategic sales. The share offer was made through IPO by selling 664.2 million shares or 23% of the IBRA ownership in BCA. The initial price was established in the amount of Rp. 1,400 per share, and thus from this program IBRA received Rp. 927 billion. This process was completed on 31 May 2000, and further the BCA shares were recorded in Jakarta Stock Exchange (BEJ) and Surabaya Stock Exchange (BES).

The next share divestment was carried out by means of strategic sales by selling some 51% (30% accompanied by 21%) in July 2001. From this divestment program, IBRA obtained the total receipt of Rp. 7.06 trillion. Farallon Capital was the consortium that won the tender sales of these strategic sales.

2. Bank Niaga

After implementation of government share divestment in BCA in the first year, IBRA carried out the share divestment in Bank Niaga in 2 phases, namely (i) Strategic Sales, and (ii) Market placement (drip sales & block sales). IBRA carried out divestment of 51% of the government shares through strategic sales. From the divestment, IBRA received Rp. 1.06 trillion (1.48 of the PBV) and the winner was Commerce Assets Berhad, a leading financial institution in Malaysia and was recorded in Kuala Lumpur Stock Exchange.

Further divestment of 20% shares was carried out by: (i) Drip sales in 2002, and (ii) Block sales that ended on 16 September

2003. From the block sales implementation, IBRA received Rp. 411 billion, and thus the total receipt of sales through the Market Placement (Drip Sales and Block Sales) was Rp. 1.50 trillion.

3. Bank Danamon Indonesia (BDI)

The government share divestment in Bank Danamon was initiated since 20 January 2003. The government share divestment program in Bank Danamon was conducted in 2 phases, namely: (i) Strategic Sales, and (ii) Market placement (drip sales and block sales).

The divestment of 51% of the government shares through the Strategic Sales successfully received Rp. 3.01 trillion from 2.50 billion shares in the amount of Rp. 1,202/share. The winner of the divestment was Consortium Asia Financial Indonesia (AFI). One of the members of AFI Consortium was the affiliate of Temasek Holdings that has DBS Holdings. DBS Holdings was the owner of DBS Bank, a leading bank in Asiaand has the rating of A+. This Strategic Sales process could be completed on 16 June 2003.

The divestment through drip sales (2.65%) and block sales (17.45%) received Rp. 1.30 trillion. Thus, the total receipt from divestment of 71% government shares in Bank Danamon was in the amount of Rp. 4.31 trillion.

4. Bank BII

The divestment program for 71% shares or equivalent to 33.93 billion shares of BII started on 1 September 2003. The divestment mechanism was implemented in 2 phases: 51% through the strategic sales, and 20% through the market placement. Divestment through the strategic sales implemented from 29 October 2003 to 11 December 2003 succeeded in obtaining the receipt of Rp. 1.12 trillion with the tender winner Sorak Konsortium that consisted of Kookmin Bank Korea and Asia Financial Holding. Whereas through the market placement completed in 19 December 2003, IBRA received Rp. 877.7 billion, and thus the total receipt from divestment of 71% of the government shares in Bank BII was in the amount of Rp. 2.00 trillion.

5. Bank Lippo

The divestment program of 52.05% of the shares or equivalent to 2.04 billion shares of Bank Lippo started in August to October 2003. This program in 2003 ended without a winner because the price offer conveyed by the investors was below the price established by IBRA.

After being studied again by taking into consideration the interest of IBRA, then on 4 December 2003 IBRA again offered the divestment program of Bank Lippo. At present the process in the Fit and Proper Test Preferred Bidder by Bank Indonesia. The Preferred Bidder for the sale of Bank Lippo shares was Konsortium Swissasia.

6. Bank Permata

The divestment of the government shares in Bank Permata on 11 February 2004 was approved by the DPR (House of Representatives) for implementation, but the first stage was the divestment through the Drip Sales and the Block Sales of 20% of the government shares in Bank Permata. Whereas the sales through the Strategic Sales were postponed and implemented by the IBRA successor, while awaiting the development of the Cessie case of Bank Bali simultaneously to look at the good condition to implement divestment.

3. Settlement of Bank Assets

3.1. Transfer of Credit and non Credit Assets to BPPN

The process of settlement of the Bank assets is from the process of the transfer of assets in the form of non performing loan and movable/immovable properties in several phases. Every process of the Bank transfer to BPPN the stipulation of which is issued by Bank Indonesia, is followed by the process of the assets transfer or the signing of "Asset Transfer kit" as the media of the transfer of asset. BPPN will then carry out the management and settlement of the credit asset.

Totally, the amount of the credit asset managed by BPPN is:

Table 1: **The Credit Asset managed by BPPN**

Status of Bank	Total Bank	Account	Debtor	Principal (Rp. billion)	% Principal
BBO	10	79,446	30,758	23,794	10
BBKU	42	131,251	119,331	33,217	7
BTO	13	147,427	140,276	43,770	13
RECAP	7	8,925	6,674	24,096	7
Total under BPPN	**72**	**367,049**	**297,039**	**124,877**	**36**
State owned Enterprise	7	6,053	1,229	141,850	41
BPPN		523	9	79,992	23
Total Credit Asset	**79**	**373,625**	**298,227**	**346,719**	**100**

The following Table indicates that the debtor of UKM/retail category (loan below 5 billion) comprising 177,000 debtors or 98% of the BPPN debtors" only " has a loan of 6% of the total credit in BPPN, whereas the debtor of corporate scale (loan above Rp 50 billion) comprising "only" 839 debtors or less than 1% of the total BPPN debtors control the access of banking credit amounting to 81%.

Whereas the distribution of credit based on debtor industry shows that most of the biggest industries as the use of banking credit are property/Infrastructure (25%), basic chemical industry (17%) and trade/service sector (9%).

Table 2: **Credit Distribution in BPPN based on the Debtor Scale**

Category	Account	%	Debtor	%	Principal of Credit (Rp. billion)	%
UKM / Retail	313,760	84	204,886	98	29,367	8
Commercial	7,239	2	1,996	1	27,009	8
Corporate	52,626	14	1,867	1	290,342	84
Total	**373,625**	**100**	**208,749**	**100**	**346,719**	**100**

Table 3: **Credit distribution in BPPN based on Industry**

Industry	Account	Debtor	Principal	% Principal
Basic Chemical Industry	4,016	597	60,608	17
Property/Infrastructure	4,205	1,149	85,920	25
Financial Institution	6,001	4,437	19,072	6
Trade/Service	3,129	850	30,897	9
Agriculture	42,683	293	21,601	6
Various Industries	2,690	433	58,391	17
Consumption Industry	682	165	4.012	1
Holding Company	448	106	22,269	6
Mining	132	37	939	1
Others	309,639	200,682	43,009	12

3.2. Restructuring Policy and the Outcome

To ace he total credit transferred and that should be restructured amounting to more than 3,770,000 thousand accounts belonging to more than 200.000 debtors, BPPN should have a handling strategy for such assets. The handling strategy adopted by BPPN is initially as follows:

- Assets of corporate credit (above Rp 50 billion); the restructuring shall be conducted by BPPN referring to the phases of BPPN restructuring.

- Commercial credit assets (between Rp 5-50 billion); it shall be carried out with outsourcing method, that is to transfer the restructuring to the third party.

- SME/Retail credit Asset (below Rp 5 billion):it should be carried out directly

In fact, the strategy to carry out the restructuring in the corporate credit asset and commercial credit asset outsourcing is not as successful as expected. As we know, from the year 1999 to 2001 the political and micro economy climate in Indonesia was not conducive so that the restructuring process in BPPN was not implemented as intended.

The restructuring process for the debts anywhere in the world, including the restructuring of the conventional debts or the more innovative one through the market mechanism (disposal), is largely affected by the macroeconomic condition. It is not easy to restructure the debts of a company in the condition of very high interest rate, unstable interest rate, high inflation and low demand. The projected performance of the company that underlies the restructuring scheme is difficult to conduct amid the vulnerability of the macro condition. Meanwhile, the disposal process is also difficult to obtain the optimum result due to the high interest rate and non-liquid of the banking sector, let alone the non-accommodating regulations regarding the NPL transactions.

Facing with such a macroeconomic condition above, IBRA initially was unable to do much. Restructuring was practically running too slow and even stagnated; this was indicated by the percentage of IBRA's assets that had been returned to the private sector, which were still minimum. Up to the second quarter of 2002, the assets that had been returned to the national banks and the private sector were less than 20%, although IBRA had worked so hard for nearly three and a half (3.5) years.

IBRA was of the opinion that if such a condition above continued, one of the main tasks of IBRA in returning the state money by among others the debts restructuring process could not be completed until the end of the duty period of IBRA.

In order to overcome the stagnated restructuring process, IBRA applied a number of breakthroughs that could accelerate restructuring and more particularly the running of the real sector. IBRA's breakthroughs emphasized the need to focus on the completion of the restructuring, particularly for the strategic assets, namely the loans that had significant national impacts. The new approach was contained in SK KKSK Number Kep.01/K.KKSK/05/2002, dated 13 May 2002, which emphasized that restructuring could only be applied for the following group of debtors:

- Debtors above Rp. 750 billion: the signing of the Debt Restructuring Agreement should have been reached within 6 months as of May 2002.
- Debtors relating to JITF; the signing of the Debt Restructuring Agreement should have been reached within 4 months as of May 2002
- BUMN (state enterprise) debtors: the restructuring to be continued if the security is higher that the value of their obligations.

The amount of assets successfully restructured by IBRA as of 1998 until 2004 was Rp. 178.03 trillion of the total Rp. 346.72 trillion of the credit assets or some 51%. Whereas the stages in the restructuring process were in the amount of Rp. 142.73 trillion or 42%.

3.3. Assets Disposal Policy

Initially BPPN focused its activities on making efforts of restructuring the debt in literal sense. The disposal program is determined as the last activity of the effort of debt restructuring. Prior to any sale, restructuring was conducted beforehand until the new Debt Agreement was signed. This effort was made for more than 3,5 years since the establishment of BPPN. This approach has contributed to the delayed restructuring and the low BPPN assets recovery level to National Banking, as previously explicated.

In addition to the low level of BPPN assets recovery, the other important matter is the implementation of time value of money concept. The effort of conventional restructuring is an effort that needs considerable time and cost. Thus far, it takes BPPN 1,5 to 4 years to restructure debt. The time needed definitely depends on the condition of macro economy and complexity of a problem.

In addition, the primary principle of the purchase of a disposal is the purchase of sustainable debt. The investors, in a proposition of an offer will always uses a sustainable debt as the main factor in determining the price. In this condition, to find out the status whether a disposal has been restructured or not will not be relevant anymore for the majority of a case.

Additionally, a disposal which not restructured gives a higher level of flexibility for the investors to carry out restructuring activity by itself adjusted to the need of each investor related to the existing regulation either observed from the banking law or taxation law.

Based on the above condition, from the second quarter of the year 2002, BPPN decided to change the paradigm in making effort for restructuring. Apart from the BPPN activity in making effort for conventional restructuring, BPPN has started to focus its activity to make the effort of disposal as a form of restructuring by the market through the programs of the sale of disposal which has not been restructured in BPPN.

The effort to sell the disposal by BPPN is based on the plain concept. Any pricing uses the level of sustainable debt as the determining factor. Despite a large scale of sale, retail sale is still conducted in order to give opportunity to all investors and to create an adequate competition as the effort made to maximize the recovery rate. Therefore, it is an incorrect perception that BPPN has carried out a fundamental fire sale.

In 1999-2001 all sales were carried out of the Cessie restructured, with the priority of the assets with high marketability and sustainable debt level. This policy has impacted on the recovery arte received by BPPN from 1999 to 2001 which decreased significantly. The sale of the Cessie in the form of the invoice of credit card in t 1999 of 51% reached 60,7% in the year 2000, and the recovery rate moved to the figure of 20,8% in the Second Level CCAS IV program.

When BPPN commenced to implement the sale programs in 2002, BPPN focused on accelerating the assets recovery and increase the level of assets recovery. In order to fulfill the first focus, BPPN has urged the national banking to participate in this sale program. The assets recovered to the banking system, the role of bank intermediation will improve and the real sector will also be stimulated.

In facing the challenge of the restriction by the bank regulation, BPPN has requested Bank Indonesia to issue a regulation on the purchase of BPPN assets by the bank. In order to improve the ability to purchase BPPN assets by the bank as well as to reduce the number of the government bonds in such banks, BPPN has implemented the Assets to V Bonds Swap policy enabling bank or investors to purchase the BPPN assets and pay them with recapitulated bonds.

Starting from the year 2002, the unrestructured credits have been sold in BPPN through CULS (Corporate Unrestructured Loan Sales), CASP (Credit Assets) whereas almost all of the restructured Cessie have been sold in CCAS program (Corporate Core Asset Sale).

If compared between recovery rate CCAS, CULS and CASP/CAPSP, then the recovery rate obtained is more or less the same and even the recovery rate for the first CASP was recorded as 28%, higher than all CCAS programs in the year 2002. Therefore, once again, this is contradictory to the perception that BPPN has carried out the fire sale through the sale of the Cessie which has not been restructured. The effort of asset restructuring by the market through the sale program in place of the restructuring by BPPN does not give any negative impact on the BPPN acquisition.

The accelerated recovery of the credit assets through the Program of Credit Assets Sale from the year 2000 to 2004 was very significant, as nearly 95% of the credit asset was recovered to the banking/financial system. The remarkable jump compared to the amount 20% reached by BPPN in the first 3 years of its service.

3.4. Fund Recovery and Fiscal Support

In completing this assignment, the Government and the House of Representative will prepare the annual target expected to gain fiscal support from BPPN as the plan of returning the state money annually. In order to support the assignment, BPPN has made efforts for the restructuring step, disposal of assets and divestment of the company's assets and the banking shares owned in an annual program.

The agreement on the fiscal support level shall be stipulated by the Government and the House of Representatives in a Law on the State Budget. From 1999 to 2002, the agreement on the recovery level always increased, that is from Rp 17 trillion in the year 1999/2000 to Rp 44.9 trillion in the year 2002 and continued by the agreement entered into in the year 2003/2004. Considering that the assets managed by BPPN has been restricted, then the level of recovery has been stipulated respectively Rp 28.5 trillion and Rp 5 trillion.

Based on the agreement on the recovery level, with its hard efforts BPPN has achieved the realization larger than the agreement set forth in Law of the State Budget or with the average level of fulfillment of 122%.

Therefore, in principle BPPN has been able to make efforts to achieve the optimum level of the state money recovery in accordance with the agreement entered into by the Government and the House of Representatives.

Table 4: **Comparison of target and Realization of BPPN**

Years	**State Budget Target**	**Realization**	**% Fulfillment level**
	trillion Rupiah		
1999/2000	17.00	17.13	101
2000	18.90	20.71	110
2001	27.00	48.45 (1)	179
2002	44.90	48.73 (2)	109
2003	28.50	28.44 (3)	100
2004	5.00	9.00 (4)	180
Total	**141.30**	**172.47**	**122**

Notes :

(1) Including Recycle Bonds

(2) Including Premium, Bank Permata Recapitalization

(3) Including Premium

(4) Including Non-State Budget: PT DI, Texmaco and establishment of PPAN

If compared to the total deficit of the State Budget (APBN) from 1999/2000 to 2004, then the average contribution of BPPN for such period is 96%.

Table 5: **Comparison of APBN Deficit to BPPN payment**

Description	1999/ 2000	2000	2001	2002	2003	2004	Total
APBN deficit	43.88	16.13	40.48	20.47	34.44	24.42	179.82
Realization of BPPN payment	17.13	20.17	48.45	48.73	28.44	9.00	172.47
% of APBN deficit	39	128	120	238	83	37	96

4. Final Chapters: Finishing BPPN Tasks and Duties

4.1. Consideration of Finishing BPPN duties

The cabinet Session held on 17 November 2003 has decided that BPPN will conclude its duties on 27 February 2004. Such decision was dopted by considering some matters, among other things:

- Law No.10 of 1998, article 37 paragraph 1, which reads: "BPPN is established if there are problems of the banking system giving detrimental effect on national economy." At present the macro economy indicator shows that the national economy keeps improving.

- Government Regulation 17/1999 article 2 paragraph 4 sets out that "the length of service of BPPN is 5 years from the issuance of the Government Regulation on 27 February 1999" and Government Regulation 17/1999 article 11 sets out that "if after a lapse of time as defined in article 2 paragraph 4 and in the opinion of the Government, BPPN has completed its duties, then the Government shall stipulate that BPPN will cease to function".

- Most of the duties of BPPN have been completed.

- Efficiency, in order to manage the remaining duties, the organization like BPPN will not be needed for the sake of cost efficiency.

BPPN was planned as a special body with a limited length of service (in accordance with Law of Banking No.10 of 1998) with the duties to manage the assets in line with economy recovery. As most of the assets have been managed, a special body like BPPN will not be needed.

- The primary indicator of Indonesia macro economy at present indicates the good condition tending to keep improving. This is a signal indicating that the economy has passed the critical period.

- The national banking indicator and the banks indicator in particular under the management of BPPN thus far have continually improved as well. BPPN has also succeeded in gaining the partners for the Government in developing the banks under the management of BPPN so that the bank will be increasingly healthy and sound.

4.2. Transfer of BPPN Working Function

In accordance with the Government Regulation 17/1999, all assets belonging to BPPN shall be the State assets and in line with the result of the Cabinet Meeting of 17 November 2003, the BPPN working function will be transferred to several units that will continue the duties of BPPN. The new units established to continue the BPPN duties are:

- Settlement Team
- State Assets Managing Company
- The Government Guaranteeing Program Unit

4.3. Settlement Team

The Settlement team was organized in order to settle a number of audits and any administrative duties which have not been completed at the time BPPN ends its length of service. This team will carry out its duties for 6 months and led by Coordinating Minister for the Economy. The duties and responsibilities of this Team are :

- To complete the performance audit by BPK

- To complete the financial audit per December 2003 and per 27 February 2004 by a Public Accountant Office

- To finish the administrative duties such as information management and uncompleted documentation.

- To formulate a recommendation of the settlement of the assets related to litigation.

The outcome expected from this Team are :

- BPK performance Audit Report

- BPPN Financial report per December 2003 and 27 February 2004

- Recommendation for the litigation assets settlement

4.4. Company Managing State Asset

The Company Managing the State Assets is a Body continuing the function of managing BPPN assets available at the time BPPN ends its duties. This Body has a specific duties namely to increase the value of the transferred assets, sell it after 5 years of the expiration of the length of service of this Body. PPAN was established by BPPN, before BPPN ended its length of service on 27 February 2004. The ownership of BPPN of PPAN, in accordance with Law of State Finance will be transferred to the Finance Ministry and the management of it will be conducted by the Office of Minister of State Owned Enterprise.

4.5. Government Guarantee Program

The working function of BPPN as the Body managing the Government Guarantee Program will be transferred to Government

Guarantee Unit under the Finance Ministry. This shall be done until a Saving Guarantee Institution having duty to manage customer savings guarantee is established.

5. Summary

The existence of BPPN for 5 years has relatively provided may lessons to this nation. Therefore, the lessons obtained from BPPN experience will be a consideration and improvement for this nation economy in the future. The experience based on the existence of BPPN is also important to avoid the similar crisis in the future. Any matters recommended by BPPN as the inputs for the improvement in the future among other things :

5.1. The Importance of the Stabilization of Economic Institution

When the national crisis occurred, we ould realize that Indonesia does not have the institutional infrastructures which can reduce the unrest due to the crisis. In order to escape the crisis, the institutional infrastructures of that sort shall be established. The institution is Savings Guaranteeing Institution and inancial Service Authorities. BPPN definitely supports the establishment of LPS as it will reduce the burden of the Government in guaranteeing the customers' savings, the customers an be still protected and the State will have infrastructures to help maintain the banking sector.

BPPN also supports the Financial Service Authorities that will be established forthwith in order to regulate the inancial services. By the establishment of this institution , it is expected that the Government ill issue regulations in the orld of financial services that will be able to stimulate the economic sector.

5.2. The importance of Good Governance in the governmental sector, banking sector and business sector

If we look back, the economic crisis arising is resulted from the weakness of good governance. The weakness of good governance, banking and companies has also weakened the principles of the economy of this country. Therefore, the efforts for improvement of good governance in the banking sector and business sector (in company level) should be continually made.

Good governance, will enable the government to conduct effective control of the activity of banking and business sector. Good governance in the banking sector is believed to improve banking stability.

If those elements are combined with good governance, we are convince that the economy will be continually improved.

5.3. Legal Reform and Political Stability

Despite rapid development in the economic sector, the law sector has not been improved. Based on the experience of BPPN, rapid reform in law sector is indispensable. Legal certainty is one of the factors considered for the incoming foreign investment to Indonesia and it will also give the sense of safety to those participating in economic sector. Above all, it has been proved that political stability and security are of the essence in increasing trust for the foreign investors to invest again in Indonesia.

5.4. IBRA's Performance Evaluation

After completing its tasks, IBRA's performances were then evaluated by the Government and the IMF under *Indonesia's Extended Arrangements (1998-2003).* The IMF provided a concise report in Indonesia: Selected Issues completed in July 2004 (IMF Country Report No. 04/189), especially on the performance of IBRA as follows:

"Overall, IBRA was successful in achieving its key objectives. It performed particularly well in stabilizing the banking system, by rapidly restoring the public's confidence, efficiently closing over 50 banks, and merging, recapitalizing, and then returning to private ownership banks accounting for about 25 percent of the banking system. IBRA performed less well in maximizing asset recoveries, as the slow pace of asset sales probably compromised returns. Finally, IBRA's role in supporting corporate sector recovery was

mixed, with initial emphasis on restructuring loan assets proving largely ineffective and delaying real sector recovery.

The absence of an effective legal and judicial framework compromised asset recoveries. Despite the introduction of a new bankruptcy law and other relevant reforms after the crisis, the legal and judicial framework remained weak. In the case of loan assets, this undermined IBRA's position in debt restructuring negotiations, and also reduced the market value of its NPLs. The impact on recoveries under the shareholder settlement agreements was also significant, as few effective steps were taken by the relevant authorities to enforce the agreements. Although the creators of IBRA had anticipated such problems, and therefore vested the agency with extrajudicial powers to facilitate asset recovery, the agency only availed itself of these powers on a few occasions, as its enforcement efforts were stymied by judicial opposition.

However, the most important constraint on IBRA's effectiveness was the absence of clear political support. During the first few years of its existence, IBRA's operations were hamstrung by conflicting views within government regarding how best to maximize asset recovery, and a reluctance to sell assets at discounts to their principal or assessed values. Beginning in 2001, government support for IBRA's asset recovery efforts increased, and asset sales accelerated as a result. However, the continued absence of strong political backing for the enforcement of the shareholder settlement agreements is likely to have undermined recoveries from these obligations".

II. ENHANCING INTERNATIONAL COMPETITIVENESS: REFORMING STATE -OWNED ENTERPRISES (SOEs) - INTERNATIONAL EXPERIENCE AND IMPLICATIONS FOR VIET NAM

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STATE-OWNED ENTERPRISES AND THE RESTRUCTURING PROCESS IN VIET NAM

Dr. Nguyen Dinh Cung

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Viet Nam has long recognized the need for State-owned enterprises (SOE) reforms and so far, has achieved significant success. Nevertheless, the speed and level of SOEs restructuring is low, taking too long with unsure outcomes. Defining the role of SOEs and State management of SOEs falls short from international standards. Poor business efficiency and competitiveness, which in turn reduce the efficiency and competitiveness of the economy. Addressing these issues lie at the heart of the SOE reforms in Viet Nam in the present and coming period.

1. SOE in the Vietnamese economy

Up to date, Viet Nam has 949 wholly-State owned firms operating as limited liability companies with one single stakeholder[1], of which: 54% are local SOEs, 36% are placed under Ministries and branches and 10% are under state-owned corporations. Regarding their operations, about 65% are business oriented, while the remaining are firms providing public goods, operating in national defence, state forest and agriculture enterprises. In addition, SOEs also include 1,217 companies in which the State owns a controlling share (as of 2012).

1. Steering Committe for enterprises Reforms and Development (1/ 2014).

Total State capital in SOEs is over 2,500 trillion VND, equivalent to annual GDP, of which State equity accounts for over 1,000 billion VND[1]. The majority of assets, capital and important resources of SOEs are concentrated in the 106 state corporations and economic groups.

In the Vietnamese business sector, SOEs account for 27% of total capital, 44% of fixed assets and long-term investment, 25% of revenues, 37% of income before tax, 20% of industrial output; but only account for a small share in the domestic commercial sector and agriculture and fishery product markets[2], etc.

According to the report issued by the Steering Committee for Central enterprises Reforms and Development, SOEs contribute to about 30% of GDP and total State budget revenue, excluding the crude oil contribution from the Oil and gas state corporation. SOEs have been assigned to manage, exploit most of natural resources; hold large influence in key sectors such as energy (electricity, coal, oil and gas, petroleum, etc.), financial credit, banking, air transportation, railway transportation, post and telecommunication, food export, assembly plant, water supply, raw material inputs for agriculture production, construction, etc.[3]

2. Overview on SOE reforms

2.1. Objective

- The collapse of the centrally planned economy at the end of the 1980s caused a strong and direct impact to the Vietnamese economy, marking the beginning of market institutions. In such a

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1. State capital in SOEs was 700 billion VND in 2010; 810 billion VND in 2011; 1,019 billion VND in 2012. Total assets in 2011 was 2,274 billion VND, and 2,570 billion VND in 2012.

2. GSO (2011).

3. Over 85% of electricity, gas and oil production; 90% of telecommunication services; 98% of domestic air transportation; 56% of financial services and credit; 70% of export rice; over 80% of chemical fertilizers, etc.;

context, restructuring of Vietnamese SOEs arose both as an objective requirement and as a solution for diminishing the interventive role of the State and an increased self-regulating capacity of the market and business community.

- Requirements for SOEs reforms not only arise in economies in transition as in Viet Nam. In many countries, besides their undeniable role, SOEs always reveal weaknesses arising from protectionist policies, isolation of SOEs from competition, dissolution and bankruptcy. Benefits deriving from are small compared to the costs incurred by State resources. From these international evidence and experience, since the early 1990s, Viet Nam began its SOE reforms, which not only derived from the requirement of alleviating the managing role of the State but also with the aim to improve competitiveness and efficiency of SOEs, in the hope that SOEs can contribute to enhance the competitiveness of the whole economy.

- Throughout the process of SOE reforms, despite some changes in the internal and external environment, but the mission and role of Vietnamese SOEs did not seem to have changed much. SOEs ha always been positioned as the key element of the State economy, playing the leading role in the orientation and control of the economy. This is the objective and also a characteristic that affect the quality and outcome of SOEs reforms so far.

2.2. Review of the restructuring process

Theory and practice in SOEs reforms have come out with the following solutions for SOEs reforms: reform of the regulating framework (foster motivation and material responsibilities, enhanced autonomy, forcing SOEs to become more competitive, etc.), restructuring, transfer of ownership (equitization, diversification of SOE ownership), improved corporate governance, and termination (dissolution, bankruptcy of weak performing SOEs). All these measures have been implemented in Viet Nam to varying degrees in each period:

- At the end of the 1970s, the Vietnamese economy was in a deep crisis due to the influence of a highly centrally planned economy characterized by State factories and cooperatives. In such a context emerged the first initiatives of SOE reforms. Some initiatives were proposed and implemented in order to make use of the goods - money relationship, market relationship, creating favourable and flexible conditions for enhanced production capacity and business performance of factories. These measures set the foundation of SOE reforms at the end of 1980s, most notably the self-autonomy in business operation of State-owned factories by Decision 217/HĐBT in 1987.

- The 1991-1993 period focuses on the restructuring to control the number of SOEs created in too much excess in the previous years, and restructuring loss-making SOEs. The number of SOEs was cut from 12,300 SOEs down to over 6,000 SOEs in only 3 years.

- In the 1994-2001 period, for the first time, a legal document on SOEs was enacted, obliging SOEs to operate by the laws. A series of SOEs were reorganized into newly established State corporations; gradual experimentation and expansion SOEs equitization, assignment, sale, franchise and lease of SOEs were subsequently initiated.

- Between 2002-2006, transfer of ownership was strengthened. The number of SOEs opting for equitization and ownership diversification sharply increased; only between 2003-2006, nearly 2,700 SOEs were privatized. The Enterprise Law was amended with the objective of enhancing the adoption of corporate governance principles in SOEs, approaching SOEs with diversified forms of business ownership. The establishment of State-owned economic groups across sectors, with the objective of become the core driving forces of SOEs in orienting and guiding the economy. SOEs maintain an expansive role and development (in terms of sector and areas of operation) with the continuous growth dynamics in capital and assets.

- Since 2007, ownership transformation and equitization of SOEs were slowed down. There is nothing new in the contents of

SOEs reforms, mainly focusing on the transfer of all SOEs to be governed under the Enterprise Law, to repeal the SOE Law; economic restructuring to seek to overcome the consequences of expansive growth model based on capital growth in previous years.

In summing up, Vietnamese SOEs restructuring forms show patterns similar to international experiences, despite the different objectives pursued. The general approach is a gradual adaptation to changing context and not executing the SOEs equitization as the experience of Eastern European economies.

3. SOE reform policies in Viet Nam

3.1. Restructuring the legal and institutional framework

Before 1995: The State directly controls SOEs through legal documents and administrative acts. The organization and operation of SOEs are not secured by a single legal document.

In 1995: The National Assembly enacted the Law on Enterprises, marking the beginning of legal and institutional reforms of SOEs. The State control SOEs through legal tools, replacing the direct management, administrative and objective tools. SOEs are officially recognized by the law as a legal entity separate from the State; with separate capital and assets, and have business autonomy. The State, as owner, is responsible for the amount of capital invested in the firm. Weak performing SOEs need to be dissolved, going bankrupt as all other firms.

In 2003: The new Law on Enterprises was enacted, setting the legal framework for enhancing SOE reforms following market reforms. SOEs do not only include firms of sole State ownership, but also other firms with diversified ownership in which the State has a controlling share. This time, the Law on Enterprises has legalized all measures of ownership transformation and legal procedures of SOEs; officially recognizing through legal documents on the importance, sustainability and necessity for equitization, sale and transfer of SOEs into limited liability companies. SOEs in which the State is not the sole owner (100% of registered capital) will need to change to the category of firms with diversified ownership.

In 2010: 1/7/2010 is the important moment of legal framework reforms for the operation of SOEs in Viet Nam following a market economy. All SOEs are required to change to limited liability companies, joint stock companies as regulated by the Law on Enterprises, which also means that SOEs now have a legal entity and organizational structure similar to private firms; ending the legal separation between Vietnamese firms by their forms of ownership. In principle, SOEs are placed under the same legal framework as other firms.

However, in reality, this principle has not yet been respected. SOEs, especially limited liability with the State being the sole owner continue to managed by a series of specific documents regulating their ownership relationships, financial control, human resources, wages, capital investment, etc.

In the meanwhile, market economy and SOEs have not yet become fully compatible, especially with the State intervention and the continued situation of monopoly or market dominance by SOEs. SOEs in general continue to receive preferential treatment from the State related to important national resources, therefore they continue to maintain their dominant role or monopoly position in most of key sectors or highly profitable sectors of the economy, such as oil and gas, mining, electricity, simple chemicals, railway transportation, airway transportation, credit, etc., which represent a factor adversely affecting economic integration, implementation of international commitments. Still in many cases, the State directly interferes with the economic life of firms or affecting the competitive relationship between firms on the market through measures such as financial support, debt relief, debt removal, debt extension, concessional credit, business premises, market information, employment policy, wages, etc. for SOEs.

3.2. Policies for SOEs structural adjustment

The nature of SOEs structural adjustment policies so far remains in how to identify which SOEs will be the ones that the State needs to retain 100% of ownership or controlling share or withdrawal of State ownership in order have investment policies, transfer of ownership, corporate governance, or withdrawal of State ownership in sectors that no longer require the State to continue to maintain ownership and moving capital to other sectors, etc.

During the period of centralized planning, SOEs were responsible for securing and providing the majority of products and services for national demand, except for some small consumer products, which were provided by collectives and cooperatives. SOEs were present in almost every sectors and business areas.

Since 1990, the change in economic development perspective has led to the necessity for a classification of SOEs. Results of this review were the significant reduction in the number of SOEs, from about 12,000 to 6,264 SOEs in early 1994.

Since 2001, the SOEs classification rules were adjusted several times in order to reduce the portfolio of firms in which the State holds 100% of shares or a controlling stake. If such rules were implemented, SOEs would only be operating in sectors of national security, defence, public utilities and some important industries deemed of "great influence".

Reviewing the implementation of SOEs structural adjustment policies so far show the biggest result is the reduction in number of small SOEs, while the remaining SOEs expanded their scale. The average SOEs asset size is dozens of times higher than private enterprises in the Vietnamese economy.

However, outcomes from the SOEs restructuring process so far have not been able to reach the stated objective:

- After many years of reforms, sectoral restructuring, the SOEs sphere of activities was not changed much, failing to comply with the requirement of “focusing on key sectors and areas of critical importance”. SOEs continue to be present in many economic sectors and areas, including areas and sectors that do not require the State to maintain a 100% ownership.[1].

- Results from the SOE restructuring process remain at the reduction in number of SOEs, without any significant influence on the mechanisms of state resources allocation, adjustment of State functions, sectoral restructuring and performance of SOEs. The positioning of SOEs in the overall economy and business sector does not show any significant change, with the "business" function of the State remaining large, growing value of State equity in SOEs, etc. These are not consistent with the State's role in a market economy; this is also the biggest drawback of SOEs restructuring and reform policies implementation in Vietnam.

The above issues are due to the inconsistencies in the legal documents regulating the classification of SOEs, in the conflicting objective and lack of commitment in implementing restructuring policies for SOEs, in addition to the objective difficulties arising along the equitization and State equity withdrawal process.

3.3. SOEs equitization policies

- SOEs *equitization* in Viet Nam is the transformation from a company in which the State is sole owner into a joint stock company with multiple shareholders, in which the State may or may not hold a share, depending on sector, industry, and importance of the activity.

- *Objectives* of equitization are being continuously revised through different periods[2], in which, the ultimate objective is to

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1. Firms with 100% State-ownership operating in trade, services, tourism account for the majority (36%), while these are sectors in which is not necessary for the State to maintain sole ownership.

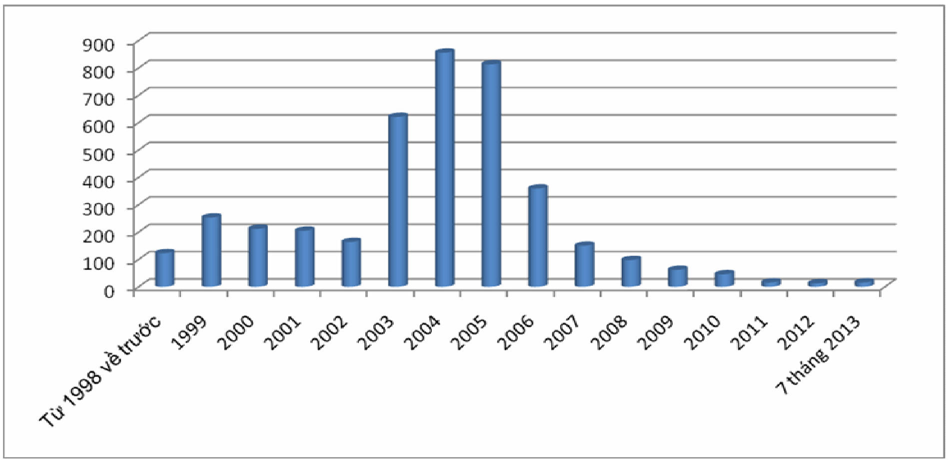
2. In the beginning, the main objectives were to: i) improved pperformance; ii) mobilization of social capital; and iii) to protect the interest of workers. In 2002, equitization policies focus on another objective, which was the harmonization of interests between the State, businesses, investors and workers. In 2004, another requirement was added "to operate in transparency and disclose of information by market principles; to recover

enhance business performance and business captivity based on the legal transformation, innovation management, mobilization of social capital, enhanced and protection of shareholders interest, workers and the State.

- SOEs equitization was first experimented in 1992 with the issuance of Decision n. 202/CT by the Prime Minister on 8/6/1992. After 4 years of experimentation, equitization was officially launched through the issuance of Decree n. 28/CP in 1996. Since then, the Government has issued 7 decrees amending, supplementing or replacing such Decree.[1].

- The total number of equitized firms as of January 2014 is 4,065 companies.

***Figure 1:* The number of SOEs going under equitization through the years**



Source: Computation from various sources.

from the situation of internal equitization inside a business; to closely relate to capital and security markets".

1. Decree No. 25/CP in 1997, Decree No. 44/1998/NĐ-CP, Decree No. 64/2002/NĐ-CP, Decree No. 187/2004/NĐ-CP, Decree No. 109/2007/NĐ-CP, Decree No. 59/2011/NĐ-CP and Decree No. 189/2013/NĐ-CP.

- *Targets of equitization* are companies that are not solely owned by the State. In terms of scale and types of SOEs undergoing equitization, the equitization prices so far is to expand the range of targets, from only equitizing small scale SOEs has now extended to State corporations, State economic groups, and State commercial banks with unlimited scale. Similarly is the extension of potential buyers who can first purchase shares, with the participation of foreign investors.

- The *interest* from SOEs equitization has been confirmed: The State collects equity withdraws from direct investment activities and minimize its intervention on production activities; enhanced competition of firms. Equitized SOEs all display improved business performance and results. Corporate governance is improved, with a significant reduction of regulations privileging the State as market regulator; setting the foundation for a level playing field between equitized SOEs and private firms, limiting any distortions arising from competition; preventing any significant extraordinary intervention by public authorities in business operations; contributing to enhanced professionalism of State ownership in SOEs management; ensuring transparency and protection of interest of small shareholders, employee shareholders, and interested parties, especially regarding equitized SOEs listed on the stock market; enhanced capacity building of management and administration of equitized SOEs following the Law on Enterprises.

- Since 2007, the equitization process was slowed down, falling behind plans, and between 2011-2013, only 99 companies were equitized. The government and public authorities conducted a formal assessment of objective reasons (due to global financial crisis and economic recession; failure to sell shares due to the lack of potential buyers and strategic investors, etc.). Besides are also other objective reasons such as: failure to comply with market principles in selling shares, setting a too high of a price compared to actual demand; companies and public agencies do not want to sell at low prices; in some cases, there was intentional delay due to private interests, etc.

3.4. Transfer, sale, dissolution and bankruptcy of SOEs

The sale of SOE is the transfer of an entire ownership in a SOE into a collective, individual or another entity's ownership in exchange for money. The transfer of a SOE is transfer of total ownership of the SOE to another legal entity without the collection of money. Since 2001, the Government has issued 4 decrees regulating the sale and transfer of SOEs.

The consolidation, merger, dissolution or bankruptcy is regulated under the Law on Enterprises and Bankruptcy Law in 2004.

According to reported data, between 2001 and 2013, 139 SOEs were transferred, 117 were sold, 450 were merged, 119 were consolidated, 215 were dissolved and 89 went bankrupt.

These SOEs subject to restructuring are primarily local, small-scale companies, with unfavourable business conditions, out-dated equipment and technology, poor performance leading to prolonged loss.

At present, SOEs subject to transfer and sale are almost non-existent. The plan for the sale and transfer of SOEs is basically completed.

The difficulties lie in those companies subject to dissolution, bankruptcy but cannot complete such process of dissolution or bankruptcy. Some SOEs subject to dissolution, bankruptcy but are unable to complete such a process due to difficulties in handling debt, with large outstanding debt, non performing loans, prolonged loss accumulated from many years, and the assets liquidation process associated with many obstacles, etc.

The actual number of bankrupt SOEs is very low compared to the number of SOEs that need to go into bankruptcy. This is partly due to the complexity of legal regulations, partly because the State and interested parties do not want the company to go bankrupt. There remains the situation of firms undergoing bankruptcy but which continue to exist and receive maximum support and privileges under forms of capital injection, debt freezing, debt rescheduling or debt relief, etc.

3.5. Improved corporate governance in SOEs

Improving corporate governance is among the key measures that receive most attention in its implementation by the State and government throughout the process of SOE reform.

The transfer of all SOEs into joint stock companies, limited liability companies following the Law on Enterprises as any other private companies is a good condition to improve the corporate governance of SOEs.

Enhanced international integration and trade, especially following Viet Nam's accession to the WTO, commitments and implementation of bilateral and multilateral agreements represent both opportunities and pressures for Viet Nam to approach and implement practices of good corporate governance of SOEs.

Viet Nam has gradually changed its State management towards a unification of different business types. The equality and avoidance of any discrimination between SOEs and other companies are regulated by the law.

Management of SOEs by the State as owner has showed positive changes, with increasing accountability and transparency. Small shareholders and other stakeholders in SOEs are protected by the law and similar to other types of firms.

The efficiency and accountability of the management and administration system of SOEs is increasingly improved. Many State-owned corporations, economic groups and SOEs have good corporate management, good competitivity and actively participate to international economic relations.

Nevertheless, compared to international standards and practices, in general, SOE management in Viet Nam still does not meet the requirements, as expressed in the following key points:

- Current institutions are insufficient to operate and apply standards of modern corporate governance in SOEs. The actual support for SOEs (in debt settlement, capital investment, lender of last resort, bankruptcy, etc.) creates inertia and lack of pressures for SOEs to operate by market principles and compete with other firms.

- Ownership agencies of SOEs have both a managing and supervising role of SOEs while also being responsible in issuing policies in general, therefore it is difficult to preserve objectivity in management, one of the reasons for failure of market discipline application in SOEs as previously mentioned.

- The execution of rights and responsibilities of State ownership in SOEs remains poor. There is lack of a professional apparatus capable of skills and resources in meeting the management demand of owners. The exercise of rights, responsibilities and obligations of State ownership remains fragmented, inconsistent in principles and in processes, especially for important State economic groups and corporations.

- The objective of most SOEs operations remains unclear, with economic objectives interlinked with socio-political goals, lacking grounds for review, evaluation, and adjustment of business operations. SOEs remain defined as “public tool to support government in regulating the market and stabilizing the macro economy”[1].

- There is insufficient motivation, pressures and responsibility on SOE managers for more efficient performance. Internal and external management and monitoring remain low. Poor disclosure of information and transparency, lack of effective tools for the public to monitor SOEs. Corruption, waste, fraud, insider trading in SOEs do not show any decreasing signs, and are becoming increasingly sophisticated, etc.

4. SOE reform in Viet Nam in the coming period

According to official statements, SOE reforms do not show any new forms or measures but mainly rely on measures previously implemented:

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1. Decision No. 50-KL/TW (2012) of the 6th meeting of the 11th Centra Committee of the communist Party of Viet Nam.

- On SOEs structural adjustment policies, Viet Nam will implement measures focusing on key stages in the following areas: national defence and security; natural monopolies; provision of basic public goods; some backbone, high technology industries with significant spill-over" (Decision No. 50-KL/TW of the 6^{th} meeting of the 11^{th} Central Committee of the communist Party of Viet Nam in October 2012). For the implementation of this directive, the Prime Minister has directed, reviewed and prepared to issue new criteria for the classification of SOEs, which will serve as the base for further assessment and classification of the current 949 SOEs wholly-owned by the State, from which to identify which companies need to be maintained 100% State ownership, which ones to be equitized, to sell part or the totality of State share, etc.

- The Vietnamese government affirmed its commitment to further *promote equitization and withdrawal of State capital in non-core industries* for the upcoming period, by which, between 2014-2015, 432 SOEs will be equitized with measures deemed as "decisive" because:

+ The Prime Minister, ministries, provinces to have the authority to approve and decide which companies to be listed as companies to be equitized, and are responsible to supervise and closely monitor to ensure a timely implementation.

+ Companies that meet the requirements to go on IPO will execute IPO following current regulations. Companies that do not meet the IPO conditions yet will be transferred into joint stock companies in which stakeholders will include the State, State Capital Investment Corporation, unions, employees, strategic investors (if any) or other voluntary shareholders. Depending on the specific conditions in each company, the State may hold the absolute majority of shares.

+ The focus of the equitization implementation plan is Ho Chi Minh City, Ha Noi, the Ministry of Culture, Sports and Tourism, the Coal and Mining Corporation, the Maritime Corporation of Viet Nam and a number of ministries, provinces, economic groups and corporations.

The government is also in the process of amend and supplement new mechanisms that are more appropriate, feasible for the *sale, transfer, dissolution and closing down of 22 companies;* to promote the divestment of State capital in non-core industries by state corporations and economic groups which was identified at 22,000 billion VND; issuance of Resolution 15/NQ-CP dated on 6/3/2014 to address issues in capital divestments, divestment of inefficient funds, sale under face value.

- Some other solutions:

+ Continue the promulgation of legal documents; finalize the institutional framework for the management and operation of SOEs.

+ SOEs need to adopt standards of modern business management and become highly effective. To finalize an internal set of rules. To enhanced staff management, higher legal compliance, higher discipline in management and administration. To promote the application of scientific and technical progress into manufacturing and management activities in order to lower costs, improve labor productivity, product quality to obtain higher total factor productivity, etc.

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A graduate of Dartmouth College (A.B.) and Yale University (Ph.D.), Jefferson has lived and taught at the Chinese University of Hong Kong and at Wuhan University in China and frequently travels to China for his research and speaking engagements.

REFORMING SOEs: LESSONS FOR VIET NAM

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Abstract

This paper reviews the experience of SOE reform in several countries - primarily China and also Brazil, Singapore, and S. Korea - and attempts to draw lessons that may be relevant for Vietnam's reform effort. Chief among the lessons are: i) a clear allocation of property rights and low transaction costs involving well-functioning company, contract, and commercial legal arrangements; ii) competitive product markets, including exposure to global competition and technology; iii) relatively open capital markets that allow for FDI and the diversification of SOE ownership; iv) clearly defined expectations concerning the public purpose performed by SOEs; and v) effective transparency and monitoring to determine the extent to which the SOEs are fulfilling their commercial and public goals. Among these factors, an open and competitive market system has been most central for incentivizing focus on restructuring China's SOE sector.

1. Introduction

Many countries, including Viet Nam, retain a substantial number of state-owned enterprises (SOEs). In most of these countries, SOE reform is an ongoing process. This paper focuses on the lessons drawn from the SOE experience of four countries, primarily China, but also Brazil, South Korean and Singapore, as they have managed the challenges of their SOE systems.

Representing a range of levels of development, market size, and approaches to the management of their state-owned companies, the experiences of these countries combine to present Vietnam with a variety of lessons that merit consideration.

The central organizing principle for interpreting the experience of China is the critical role of competition in driving the SOE reform process. China's large population, which has supported the operation of multiple factories within single industries and the proliferation of township and village enterprises, combined with the influx of foreign direct investment and a relatively open trading system, has enabled a high degree of competition within many industries. During the 1990s, competition led to the erosion of SOE profits, which then motivated China's central, regional, and local governments to seek ways of restructuring the SOEs under their administrative supervision. The result - company law, the furlough of millions of surplus workers, and sell-off of thousands of smaller SOEs, in part to prepare for China's 2001 accession to the WTO - led to rising productivity and profitability during the late 1990s and early 2000s. Together these outcomes underscore the importance of continued competition and ensuing pressures to upgrade corporate governance and technology. In China, an industrial environment, rich in alternative business models and technology transfer, have substantially facilitated the fruits of competitive restructuring. The lessons of Brazil, S. Korea, and Singapore offer useful lessons that relate to smaller economies.

2. The SOE problem - Bottom-to-Top Spill-Up Commons

Before discussing comparative perspectives on SOE reform, it will be helpful to describe the essential problem of the state-owned enterprise. The problem begins due to weak governance resulting from an ambiguous assignment of managerial and residual control rights. A consequence is that the SOE becomes like a commons in that its assets evaporate due a mix of shirking, weak management, poor performance, and outright theft. By underperforming and accumulating losses, SOEs require bank bailouts, thus extracting resources from the banking system and causing it, the next tier in the institutional hierarchy and also largely state-owned, to accumulate non-performing loans.

To minimize consequent chronic losses using their own devices, banks are left with the choice of imposing a large spread between deposit and loan rates, thus displacing resources from households and more competitive business enterprises. In addition, struggling banks often receive bails outs through government subsidies and loans, thus leading to fiscal deficits. Financing the fiscal deficits requires a combination of higher taxes and printing of money. Whereas the more onerous taxes displace resources from productive activities to loss-making enterprises and banks, printing money, erodes the value of the currency, thus creating inflation and creating inefficiencies through the distortion of prices and trade.

In essence, the spill-up commons causes a country's enterprises and banks to function as public goods. That is, their weak assignments of property rights and monitoring of their assets creates the *non-excludability* problem. At the same time, the tendency for bailouts to operate at successively higher levels of government enables the survival of state-owned enterprises and banks, thereby causing the assets of the loss-making state system to be effectively *non-diminishable*. When the resources of the SOEs and banks are on the verge of becoming dangerously depleted, the central government - the treasury and the central bank - step in to replenish the resources of the state-owned enterprise and banking systems.

Again, the core problem of the SOE commons is the unclear assignment of property rights. One Chinese word for state-owned is *quanmin*, i.e., owned by all the people. Without the clear assignment of authority to monitor the resources of the enterprise and banking systems and the incentive to capture the residual resources that accrue from effective monitoring, the state-owned resources evaporate.

3. The Evolution of China's SOE Sector

Here are some salient facts highlighted in Tables 1 and 2 that characterize China's system of SOEs and its reform from 1998-2011. Specifically, from Table 1, we see that over this 13-year period:

➢ The number of SOEs declined from nearly one-third of the total number of industrial enterprises to approximately 5%. The numbers indicate that about one half of this decline to just one-eighth of the 1998 proportion can be explained by the exit or conversion of nearly three-quarters of the SOEs that existed in 1998. The other half of the proportional decline resulted from a doubling in the total number of enterprises over the 13-year period.

➢ The SOE share of total industrial output declined from nearly one-half to 26%; the share of industrial assets fell from 69% to 42%. That the overall share of assets to employees in 1998 was not highly tilted toward the SOEs (i.e., 68.8 to 60.5) but then in 2011 had risen to more than two-to-one (i.e., 41.6 to 19.8) indicates that the firms exiting the SOE classification were relatively labor intensive, while those remaining were likely to have further deepened their capital intensity.

Although the incidence of SOEs in individual sectors has clearly declined, China's SOEs still play a dominant role in core industries, such as petroleum extraction, electric power generation, coking, and nuclear fuel. As shown in Table 5, their dominance in these industries is reflected by the proportion of total industry output and assets under their control. While not dominant, SOEs continue to occupy substantial roles in metal manufacturing (e.g., iron and steel) and transport equipment. By comparison, as suggested above, SOEs have retreated from the more competitive and more labor intensive industries, retaining less than 10% of industrial output in food processing, textiles, apparel, chemical fibers, electrical machinery and equipment, and electronic and telecommunications equipment.

Table 2 shows a variety of average figures for SOEs, privately-owned enterprises and those enterprises that were wholly or partially funded with funds from Hong Kong, Macao, or Taiwan or foreign-funded. From Table 2 we see that over the period 1998-2011:

➢ In terms of average size, whether measured by assets or employees, the SOEs substantially outsize their private and HMT-foreign counterparts, particularly with respect to their assets on hand.

➢ All three forms of ownership types exhibit substantial improvements in their average return on assets during the 1998 to 2011 period. Notably, however, from 2006 to 2011, the relative robustness of the SOE falls both as measured by return on assets (ROA) and the asset-liability ratio. One likely cause of this sag in asset efficiency was that China's SOEs were key vehicles for the implementation of China's expansive economic stabilization program implemented pursuant to the 2008 international fiscal crisis.

➢ Valued added per employee, that is, the labor productivity of the average surviving SOE, has grown substantially faster than that of private and HMT-foreign-owned enterprises; at the same time the growth of assets per employee in the SOE sector has also significantly outpaced that of the private and HMT-foreign firms. The relative surge in SOE value added and assets per employee further suggests that the firms that dropped out of the state sector during 1998-2011 were relatively small and comparatively labor-intensive compared with the firms that retained their SOE designation.

In Table 3, we use the data on the levels and implied rates of growth of value added per worker and assets per worker in 1998 and 2011 to compute estimated rates of total factor productivity TFP) growth over this 13-year period. Because the implied rates of TFP growth are sensitive to the choice of the weight associated with capital (i.e., capital's output elasticity under the assumption of constant returns to scale), we use two different assumptions for capital's weight: 0.50 and 0.67.[1] The results in Table 3, whether computed using $\alpha = 0.50$ or 0.67, show impressively high rates of

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1. Because (as shown in Table 1), the rate of growth of SOE assets grew more rapidly than employment, the greater the weight assigned to capital, the lower the rate of growth of total factor productivity. Given the relatively rapid rate of growth of SOE assets, in order to offer both middle-ground and conservative sets of TFP estimates, we compute the TFP estimates in Table 3 using weights for capital (designated by α) of one-half and two-thirds. In the U.S. the relevant factor income weights are typically in the vicinity of labor = 1/3; capital = 2/3.

TFP growth for all three ownership types; however, regardless of the choice of weights, the most exceptional growth rates, are for the SOEs.

More than any other factor, these exceptional rates are likely to have been driven by the SOEs having shed a huge portion of their workforce; as shown back in Table 1, the decline in the SOE employment share exceeded two-thirds, while the SOE value added share fell by less than 40%. Notwithstanding the rapid growth of assets during 1998-2013, we also see in Table 2 a substantial rise in the average return on assets. While the SOEs ROA in 2011 is substantially less than those for the private and HMT-foreign-owned enterprises, the rate of ROA increase from 1998 to 2011 was substantially greater for the SOEs than for the other two ownership types. This surge in SOE TFP, including the ROA, is consistent with Figure 1, showing capital's marginal productivity in China LME SOEs bottoming out during 1996-1998 and then rising sharply during 1998-2005. This result of relatively high SOE TFP growth is also consistent with the findings of Jefferson, Rawski, and Zhang (2008) who estimated the comparatively rapid rise of TFP in China's SOE sector during 1998-2005. However, given the extent to which SOE productivity lagged in 1998, they found that this SOE productivity surge represented only a degree of catch-up, leaving SOE productivity still significantly behind that of enterprises in the non-SOE ownership classifications. Nonetheless, this period of productivity surge and catch-up subsequent to 1998 includes reform lessons that are of potential value to other countries seeking to improve the performance of their state enterprise sectors.

4. A Brief History of China's SOE Reform

Before outlining China's SOE reform process, it will be helpful to clarify the definition and administrative setting of China's SOEs. The term "state-owned and state-holding enterprises" has been used since the mid-1990s. According to China's National Bureau of Statistics, "state-owned enterprises" are enterprises in which all assets are owned by the State. By comparison, "State-holding enterprises are a sub-classification of enterprises, with mixed ownership, referring to enterprises where the percentage of State assets (or shares by the state) is larger than any other single share holder of the enterprise"[1]. Table 5 examines this ownership condition in more detail.

Only a fraction of the SOEs are managed by the central government; the overwhelming numbers are managed by provincial or local municipal governments. There are three kinds of central SOEs. These are:

- Firms managed by the State-owned Assets Supervision and Administration Commission of the State Council (SASAC). The fundamental purpose of SASAC is to separate the ownership and regulation of the assets and business operations of the state sector. There are approximately 117 such SOEs.[2]

- State-owned financial institutions, and their supervisory authorities are overseen by the China Banking Regulatory Commission (CBRC), China Insurance Regulatory Commission (CIRC), and China Securities Regulatory Commission (CSRC).

- SOEs whose supervisory authorities are in individual central government ministries, except for SASAC, such as the Ministry of Commerce, Ministry of Education, Ministry of Science and Technology, and others excluding the SASAC.

The reform of China's state owned enterprise system can be characterized by five stages:

1. Liberalization of entry. The mid- and late-1980s were marked by a proliferation of township and village enterprises; the late 1980s and early-to-mid-1990s saw the initial surge of foreign-invested enterprises. The rapid entry of non-state firms, combined with the growth of SOEs entailing greater competition among SOEs, led to a substantial erosion of profit margins. By 1996,

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1. NBS, China Statistical Yearbook 2008 (2008), p. 546.

2. http://www.sasac.gov.cn/n2963340/n2971121/n4956567/4956583.html

profits of the state-owned industrial enterprises as a share of GDP fell to nearly zero (see Figure 1), leading to sustained pressure to restructure. One response to rising competition from the non-state sector during the late 1980s and early 1990s was the abolition of the state labor allocation system and the fragmented assignment to SOEs of managerial control rights, principally relating to hiring, firing, and setting compensation levels for employees. These piecemeal reforms did enable SOEs to become more competitive in China's emerging labor market. Prior to these reforms that reassigned labor-related rights from the state to workers and to SOE managers, TVEs and foreign-invested enterprises had begun to hire away the most capable of the SOE workforce.

2. Establish the legal architecture. The Company Law, enacted in 1993:

- Provided a legal framework for corporatization.
- Facilitated the conversion of SOEs to legal entities, including a limited liability corporation with the potential to sell shares.

This formalization of the corporate legal entity enabled China's eventual large-scale privatization, and provided an option for new hybrid ownership forms (e.g. "state-holding" companies that are traded on stock exchanges and other types of shareholding companies).

3. Furloughs (*xiagang*). During the latter half of the 1990s, laid-off workers totaled nearly 40% of the SOE workforce, while the urban collective work force shrank by more than two-thirds. This substantial reduction in surplus labor made public enterprises, both SOEs and collective-owned enterprises, more efficient and attractive to private investment.

4. Diversification of investment and asset structure. The assets of many SOEs became majority non-state owned; through the diversification of their asset structures, many SOEs became effectively restructured and managed by entities outside state administration.

5. "Grasp the large and let go of the small" (*juada fangxiao*). This major policy initiative, adopted at the 15th Party Congress in September 1997, focused attention on restructuring the largest, typically centrally-controlled firms. The objective was to achieve a range of public purposes involving re-organizing the SOEs in the most strategic sectors into larger, more competitive enterprise groups while retaining them under state control. The SOEs to be retained were particularly focused on energy, natural resources, and a few sectors with substantial economies of scale. At the same time, the initiative gave permission for smaller SOEs to be dealt with aggressively through buy-outs or allowing to enter bankruptcy proceedings[1].

China's corporate restructuring was implemented along with the financial restructuring of state-owned commercial banks (SOCBs). The Bottom-to-Top Spillover Model described in Section 2 demonstrates the inseparability of state-owned industrial enterprise and state-owned bank reform. To deal with the bad loans that SOCBs had extended to poor-performing SOEs, four Asset Management Corporations (AMCs) were created. By 1999, these four AMCs had taken control of 1,394 billion RMB from the corresponding four SOCBs. Through the AMC initiative, a total of 404 billion RMB debts in 580 large SOEs were swapped into equities. The three-year plan substantially improved the financial condition of China's state-owned sector - the banks and industrial SOEs. By the end of 2001, approximately 4,000 out of 6,599 previously money-losing SOEs had become profitable.[2]

Three notable features stand out as central motivating and enabling conditions for China's reform and restructuring program: a competitive industrial structure, a significantly diverse ownership structure within the category of "state-owned" enterprises, and a greater clarity concerning the public purpose served by China's

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1. China's bankruptcy law was passed in 2007.
2. OECD (2009), p. 3.

SOEs, including improved transparency and accountability. We discuss these in turn.

5. Competition

Arguably no single factor is more critical for the on-going improvement of the governance structure and performance of state-owned enterprises than their being subject to competitive forces from other home-based companies and foreign trade. Douglas North, the Nobel laureate economist, framed the importance of competition most persuasively: While idle curiosity will result in learning, the rate of learning will reflect the intensity of competition among organizations. Competition… induces organizations to engage in learning to survive. The degree of competition can and does vary. The greater the degree of monopoly power, the lower is the incentive to learn.[1]

A key feature of the sheer size of China's economy - its population and its density, particularly in the eastern portion and along the Yangtze River inland to Sichuan, is the multiplicity of factories that compete both domestically and internationally. Table 4 compares 4-firm concentration ratios in China and the U.S. for 2002 and 2007. While the table also shows the average concentration ratios for these years, it also displayed the ratios for a range of critical 2-digit industries. Comparing the 4-firm ratios for 2002 and 2007, we see a slight drift upward in concentration for the U.S. while the ratios for China in most cases decline substantially. Following this divergent trend, the average and all but one of the 2007 U.S. ratios rise to more than twice the measures of China's industrial concentration. For certain key industries, such as food products and beverages, apparel, and chemicals, and motor vehicles, the disparities are particularly large. For others, including basic metals and electrical machinery, ratios that showed greater concentration for China in 2002 decline substantially by 2007 to exhibit less concentration than those of their counterpart U.S.

1. North (1994), p. 362.

industries. Clearly, by U.S. standards, even with a substantial number of SOEs, China maintains a substantially competitive industrial environment.

We summarized the data in Table 5 showing the proportion of SOE activity across 14 industries in 2000 and 2011. Specifically, as shown in Table 5, in 2000, the share of SOE firms exceeded 20% in all but one of the 14 industries; by 2011, the SOE firm share exceeded 20% in only two industries and had fallen to approximately 5% or less in 9 of the 14 industries.

Summarizing, Tables 4 and 5 show a high degree of competition across much of Chinese industry. Apart from the energy sector, by 2011, across all 2-digit industries, SOE accounted for less than half of total output. Within manufacturing, outside the metal manufacture and transportation equipment sectors, SOEs account for less than 10% of total output. A central thesis of this analysis is that this active level of extensive competition has been at the central driving force of China's reform process.

6. The extensive diversification of SOE ownership

The Chinese experience suggests that since the mid-1990s, state-owned firms have substantially diversified their asset base. While the formal definition of "state-owned and state-holding enterprise" is enterprises which are either wholly state-owned or those in which the state's ownership share is larger than that of any other single shareowner, a close look indicates that a substantial and growing proportion of SOEs are minority state-owned. The profiles of SOE capital structure, shown in Table 6, are reported for 1998 and 2007. According to these data, already in 1998, a significant numbers of the SOEs were not majority state-owned, including 558 large-size SOEs, accounting for 12.2% of China's largest enterprises. While the proportions of medium- and small-size enterprises that were not majority state owned are smaller than for the large-size SOEs, their numbers are greater.

The right-hand section of Table 6 shows the capital share compositions as of 2007. For all sizes of SOEs, the data show a significant decline in the proportions of SOEs that are majority owned. By 2007, the proportion of large-size SOEs that are not majority state-owned rises to more than 40%. While according to the formal definition of a "state-holding enterprise," these are firms in which the largest single shareholder is the state, the statistics in Table 6 makes clear that in many cases - between a quarter and a half of each size category - even as the state may be the largest single shareholder, this status equates with minority ownership. This is a growing trend.

Given this diffusion of ownership within China's SOEs, we hypothesize the decline of an enterprise's formal ownership designation as a predictor of firm performance. We test this proposition by using a panel of data for Chinese firms, i.e., the "above scale" firms, which account for more than 90% of total Chinese industrial output. We split the panel into two subsets - one covering 1998-2003 and the other spanning 2005-2007. Within each period, we estimate two regression equations. In the first, we regress the log of labor productivity (VA/L) on the capital-labor ratio and four official ownership classifications (i.e., SOE domestic non-SOE, foreign-owned, and HMT). In the second equation, we regress the same ln(VA/L) also on the capital-labor ratio; however, rather than use the official ownership classifications, we use the share of the four different types of reported capital, i.e., state, domestic non-state, foreign, and HMT embedded within each firm (Table 7).

The conditions that we have previously analyzed - the relative rise in SOE TFP and the growing shares of non-state assets and ownership in the state sector - are likely to support the following two hypotheses:

1. Relative to the earlier period, the ownership classifications in the later period - and perhaps the capital shares as well - will lose some of their explanatory power. This will reflect the decline in the ability of the formal classifications to predict firm performance as

significant numbers of state-owned firms improve their productivity and as the non-state participation expands in their asset and ownership composition.

2. The relative significance of the formal ownership classifications will diminish compared with the R-sq measures for the capital shares. As the overall asset composition of SOEs looks more like that of non-SOEs, whatever advantage the formal ownership equation may have in the earlier period will be smaller (or even reversed) in the later period.

The results shown in Table 7 largely confirm our expectations. From 1998-2001 to 2005-2007, we see a significant drop in the adjusted R-sq values - from 0.254 and 0.243 in the earlier period to 0.197 and 0.195 in the later period. These declines confirm our expectation that formal ownership designations in China have become less useful as a determining feature of firm performance. With respect to the second hypothesis, we also find that over time the significance of the formal ownership classifications has declined relative to the capital share profiles. This change is likely to reflect the fact that firms within each of the formal ownership classifications, whether state-owned or non-state-owned, are increasingly embedded with capital, which is sourced from outside of the formal ownership classification. While the analysis here focuses on the phenomenon of SOEs absorbing domestic non-state and HMT-foreign capital, we anticipate that state and HMT-foreign capital are increasingly finding their way into domestic non-state (e.g., private) enterprises such that both state-and non-state capital are increasingly embedded in HMT-foreign firms.

Here we note two key avenues of cross-classification investment: IPOs and listed companies and overseas acquisitions. Over 4,000 Chinese companies have diversified their ownership through public listing. Table 8 shows that 9 of the 10 largest publicly-traded firms on the Shanghai stock exchange state-owned companies are managed by the China’s central government. One of the unusual features of China’s publicly-traded state-holding companies is that state shares and state legal entity shares, which comprised two thirds of total shares, have not been permitted to be traded in the stock market (see Table 9). The restrictions placed on non-tradable shares were transitory measures, contrived to avoid the controversies over whether state assets should or should not be publicly traded in the early years of the stock market. It was not until 2005 that the reform of exchanging non-tradable shares for state and legal entity shares was launched. However, share-listed share-holding enterprises continue have continued to have large concentrations of state-owned share, which have enabled them to exercise substantial control and interference as the largest share holder. Hence it is hardly surprising that monitoring and supervision by individual shareholders are still ineffective in listed SOEs[1].

Clearly, foreign direct investment in China has considerably altered the capital mix and governance landscape of China's industrial enterprise system. However, increasingly the phenomenon of Chinese overseas investment is significantly expanding the boundaries of Chinese firms, including many SOEs, thus expanding their access to capital, technology, and markets. While state interference continues to be extensive in SOEs, the effective boundaries between many SOEs and non-SOEs continue to be less decisive.

7. State-ownership: transparency, accountability, and public purpose

Presumably, state-ownership confers on an enterprise a public purpose apart from the conventional narrow commercial purpose of a private corporation, which is to provide returns to its immediate owners. Were it not for these non-commercial objectives, state ownership would presumably be unnecessary. The layering on of public objectives that displace resources from the core commercial purpose of a corporation is very likely to reduce its efficiency, as measured by return on assets, profitability, or TFP, the measures used above in this paper to assess performance.

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1. OECD (2009), p. 15.

Among the purposes reflected in public statements of Chinese officials and in regulations of the State Assets Supervision and Administration Commission are:

- Expanding presence in global markets;
- Enhancing access to critical natural resources abroad or domestically;
- Enhancing the corporate brand values of Chinese enterprises; and
- "Strengthen and improve the party construction and construction of spiritual civilization…."

An example of the government's effort to enhance China's access to natural resources is its effort to reduce steelmaking industry's dependence on imports of the iron ore. To achieve this, s China recently announced a plan to create a conglomerate of iron-ore mining giants that would in 10 years produce at least half of its domestic ore.[1] The government intends to form a large mining group to be led by the Anshan Steel Mining Co., a state-owned company that is the country's largest ore producer. The new group would comprise six to eight mining businesses. Given that a commercial enterprise has not taken the initiative to consolidate China disparate iron-ore mining establishments to serve China's steelmakers, it is reasonable to anticipate that the return on investment will be less than that in the private sector. Hence state-ownership and the administrative and regulatory instruments needed to ensure the efficient pursuit of the objectives embedded in this public enterprise need to be subject to regulatory oversight and supervision.

In order to establish a degree of transparency and accountability in the execution of these objectives, which are not strictly profit-seeking commercial objectives, SASAC has issued regulations

1. Wall Street Journal, March 20, 2014, http://online.wsj.com/news/articles/SB10001424052702303802104579450302588753602

clarifying its responsibilities. Many of these relate to provisions that are intended to achieve suitable levels of transparency and accountability. These include, for example, specific provisions concerning:

- Selection and oversight of executives;
- Compensation policy and practice;
- Control of misguided overseas FDI; and
- Procedures for monitoring, evaluating, maintaining accountability.

Other countries, notably South Korea, have established and overseen procedures intended to achieve consistent, effective monitoring of their state-governed enterprises. We examine these reform efforts in the next section.

8. SOE experiences of other countries

Given is size, history of the “big push” for rapid industrial development during the socialist period, and substantial entrepreneurial overseas population, China’s experience with SOE reform is arguably unique. In addition, during the 1980s and early 1990s, the development of China’s robust township and village economy, offshoots of the previous commune factories, provided both SOEs with both competitive impetus and a complementary source of entrepreneurial energy and collaboration. Many of these conditions have not existed in Vietnam. In order to expand the search for relevant lessons for Vietnam, we briefly summarize aspects of the SOE system and reform initiatives of three other countries: Singapore, S. Korea, and Brazil. We discuss these below.

Singapore: Singapore has 13 government-owned companies. Prominent among them are utilities (e.g. Singapore Post, Singapore Power, and SingTel) and companies that compete internationally (e.g., Neptune Orient Lines, Singapore Airlines, ST Engineering). Singapore’s experience shows that a small country economy can mount successful state-owned commercial operations. Beyond those that provide public services, a common feature of Singapore's government-owned companies is their active engagement in competitive international markets.

S. Korea: Kim (undated) underscores a thesis of this paper, which is the importance of competitive product markets and access to a variety of capital sources: "The superiority of private provision depends on capital market efficiency and product market competition. Privatization alone does not guarantee improved performance." Likewise, the effectiveness of state-owned enterprises "…depends on capital market efficiency and product market competition."[1] S. Korea was an early example demonstrating how SOEs in developing nations have room to adopt market-based incentives without resorting to full privatization, entailing corporatization of state-owned enterprises and listing their shares on the stock market.

Kim and Chung (2012) examine whether the government imposition of hard budget constraints on SOEs has affected the operations of SOEs. They make a performance comparison of 22 Korean SOEs between periods when they were under the privatization pressure during 1998-2002 and a period under which they were subject to little privatization pressure. After conducting time-series and cross-sectional regression analysis with a dataset from the 22 Korean SOEs, they found that there existed a statistically significant positive relationship between privatization pressure and the operating efficiency of SOEs. The study concludes that "…while finding ways to privatize SOEs, policymakers need to continually apply privatization pressures on SOE managers in order to impose hard budget constraints on SOEs"[2].

Brazil: Inoue et al (forthcoming): In many countries, firms face institutional voids that raise the costs of doing business and thwart entrepreneurial activity. Inoue et al examine a particular mechanism to

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1. Kim (undated).

2. Kim and Chung (undated). p. 1.

address those voids: minority state ownership. Due to their minority nature, such stakes are less affected by the agency distortions commonly found in full-fledged state-owned firms. Using panel data from publicly traded firms in Brazil, where the government holds minority stakes through its development bank (BNDES), the authors find a positive effect of those stakes on firms' return on assets and on the capital expenditures of financially constrained firms with investment opportunities. However, these positive effects are substantially reduced when minority stakes are allocated to business group affiliates and as local institutions develop.

9. Lessons and conclusions

All four countries surveyed different in significant ways from Vietnam; thus the lessons must be qualified. However, we suggest that two lessons frame SOE reform in every country. The first is that SOE reform is a process, not an event. As a result, successful SOE reform ensues from the quality of the institutions that establish the context for SOE reform.

The second key lesson is that as a process, the challenge is to sustain the momentum for reform. We agree with the observation of Douglass North, cited earlier in this paper, that competition is the central condition that creates the incentives to search for ways of survival. China is the extreme case of an economy that has been able internally to achieve substantial competition in its manufacturing sector; Singapore has achieved this largely through aggressive marketing in world markets. Competition drives search for new technologies and forms of governance that enable firms locked in competition to survive.

The Chinese experience and those of other countries we have surveyed suggest that a variety of circumstances are needed in order to facilitate SOE performance gains within the context of sustained pressures for successful competition. That is with competition incentivizing reform, the relevant agents must have access to the tools required to restructure. These include:

➢ A clear allocation of property rights and low transaction costs involving well-functioning company, contract, and commercial legal arrangements. These conditions are essential for rule-based accountability, the legitimate control of residual income, and for market-mediated restructuring (i.e., sale, mergers, acquisitions, bankruptcy).

➢ Access to competitive capital markets. This access to open, diversified capital markets enables the diversification of assets and governance. Within China, access to FDI, IPOs, and private capital have led to a substantial diversification SOE governance and control.

➢ Access to technology. When competition motivates a search for new technology, upgrading opportunities need to accessible. Opportunities and incentives are needed to undertake intramural R&D, imitate and improve upon technologies through transfer and to collaborate with research institutes, universities, foreign companies. Given the extensive spinoffs of R&D and technology, an aggressive public strategy to access and spread the benefits of technology development, even at the expense of depressing private returns to R&D, is a critical pillar of SOE restructuring within a competitive environment.

➢ Transparency and monitoring to determine the extent to which the SOEs are fulfilling their commercial and public-purpose goals. Governments need to define clearly expectations concerning the public purpose performed by SOEs. Given a clear specification and balance of commercial and social objectives, the means for ensuring transparency and accountability need to be in place.

The January 21, 2012 issue of *The Economist* magazine speculated that state capitalism has made a significant and likely sustained return to the global business scene. The phenomenon of state-owned enterprises has been most evident in many of the most robust emerging market economies, including Vietnam, as well as China, Brazil, and other S.E. Asian economies. *The Economist* observed that the emergent state capitalism in the 21st Century is operating in far more sophisticated commercial environment that did its previous incarnations, such as in China and Vietnam following the Second World War. Today's SOEs are using many of these sophisticated tools - technologies and government structures - to successfully extend their market reach. In any event, as emphasized by *The Economist*, this phase of state capitalism is still in an experimental stage.

Given that Vietnam is a key laboratory in the global economy for this experiment, the following conditions are particularly helpful:

➢ Diversify forms of corporate ownership; don't put all corporate forms in one basket.

➢ Sustain pressure to learn/experiment/adapt; again strive to achieve an internal competitive market structure and open economy.

➢ Create the capacity to analyze the SOE reform experience, i.e., collect data on enterprise activity and performance; make the data available to the academic community for analysis, debate, insight, and understanding. Good research is needed for good SOE policy development and on-going reform.

***Table 1:* Proportion of industrial SOEs as share of all ("above scale") industrial enterprises (%)**

Year	Numbers	Industrial output	Value added	Assets	Employees
1998	39.2 (64,737)	49.6	65.5	68.8	60.5
2002	22.7 (29,449)	40.8	57.6	60.9	43.9
2006	8.3 (24,961)	31.2	46.1	46.4	24.5
2011	5.2 (17,052)	26.2	35.8	41.6	19.8

Source: China Statistical Yearbooks 1999, 2003, 2007, and 2012.

Table 2: **Comparative Performance: Chinese Industrial Enterprises**

Year	Average asset size (million Yuan)	Average number of employees	ROA (%)	Asset liability ratio (%)	Value added per employee (Yuan)	Assets per employee (Yuan)
State-owned enterprises						
1998	115.7	579	0.7	210.2	29,556	199,895
2002	216.6	589	3.0	168.6	65,749	367,608
2006	541.5	723	6.3	177.8	180,648	749,187
2011	1323.3	881	4.0	151.9	519,120	1,500,252
Private-owned enterprises						
1998	13.9	151	4.5	163.6	31,693	92,474
2002	17.8	149	5.6	168.7	44,424	119,520
2006	27.1	132	7.9	169.2	95,057	205,554
2011	70.6	164	14.2	183.2	237,580	432,172
H.K., Macao, Taiwan and Foreign-owned enterprises						
1998	80.7	293	2.0	170.9	52,311	275,119
2002	91.4	306	6.0	183.9	81,313	298,896
2006	126.7	348	7.0	177.7	120,607	364,046
2011	326.4	438	9.8	260.7	220,470	744,774

Source: China Statistical Yearbooks 1999, 2003, 2007, and 2012.

***Table 3:* TFP growth, 1998-2011,**
gTFP = gVA_L - α(gK_L) (annual %)

	Growth VA and assets (K) per worker		gTFP	
	gVA_L	gK_L	α = 0.50	α = 0.67
SOEs	22.0	15.5	14.3	11.6
Privately-owned	15.5	11.8	9.6	7.6
HMT & foreign	11.1	7.7	7.2	5.9

***Table 4:* Comparison of U.S. and Chinese Concentrations 4-Firm Ratios**

Sector	2002			2007		
	U.S.	**China**	**Ratio**	**U.S.**	**China**	**Ratio**
Total	36.5	28.0	1.75	36.8	15.5	2.37
Food products & beverages	43.2	18.5	2.34	43.7	14.0	3.12
Apparel	24.0	7.7	3.12	18.2	5.1	3.57
Chemicals & chem. Prod.	39.8	15.7	2.54	43.2	14.1	3.06
Basic metals	28.4	31.9	0.89	36.9	19.1	1.93
Machinery and equipment	36.3	15.3	2.37	36.4	16.3	2.23
Electrical machinery	32.8	37.9	0.87	27.9	10.5	2.66
Motor vehicles, trailers	63.8	26.2	2.44	57.5	15.3	3.76

Source: Wang and Whalley, 2014.

Table 5: **Industry Market Structure**

	2000*				2011**			
Industry	**Total firms**	**Of which: SOEs (%)**	**Overall gross output share (%)**	**Overall asset share (%)**	**Total firms**	**Of which: SOEs (%)**	**Overall gross output share (%)**	**Overall asset share (%)**
	162,885	53,489 (32.8)	47.3	66.6	325,609	17,052 (5.2)	26.2	41.7
Extraction of petro and natural gas	82	67 (81.7)	94.6	98.9	271	109 (40.2)	92.1	94.4
Food processing	10,676	5,082 (47.6)	35.0	50.8	20,895	614 (2.9)	5.4	8.4
Textiles	10,968	2,361 (21.5)	30.3	46.2	22,945	275 (1.2)	2.4	5.0
Apparel	7,064	638 (9.0)	5.9	12.5	11,750	124 (1.1)	1.4	1.0
Processing of petroleum and coke	993	282 (28.4)	91.6	90.3	1,974	215 (10.9)	68.6	58.8
Chemical products	11,430	3,783 (33.1)	50.4	69.5	22,600	1,124 (5.0)	18.7	29.0
Medical and pharmaceutical	3,301	1,496 (45.3)	49.6	60.8	5,926	419 (7.1)	11.8	20.3
Chemical fiber	834	233 (27.9)	55.0	69.6	1,750	47 (2.7)	8.2	12.1
Manufacture of ferrous metals	2,997	713 (23.8)	73.8	86.4	6,742	312 (4.6)	36.9	54.6
Manufacture of non-ferrous metals	2,538	608 (24.0)	52.0	71.8	6765	466 (6.9)	28.8	43.6
Transportation equipment	6,850	2,832 (41.3)	67.0	71.8	15,012	1,141 (7.6)	44.0	53.2
Electrical machinery equipment	7,845	1,594 (20.3)	19.4	35.6	20,084	557 (2.8)	8.9	15.0
Electronic and tele-commun. equip	4,459	1,330 (29.8)	37.7	51.0	11,364	591(5.2)	8.3	19.6
Electric power production	4,825	4,068 (84.3)	85.5	89.1	5,287	3,509 (66.4)	93.0	90.7

Source: * China Statistical Yearbook (2001); ** China Statistical Yearbook (2012).

Table 6: **Capital Structure of SOEs**

Type of enterprise	**1998**			**2007**		
	Total	**<= 50% state-owned**	**majority state-owned**	**Total**	**<= 50% state-owned**	**majority state-owned**
State-owned enterprises						
Large	4,583	558 (12.2%)	4,025 (87.8%)	688	283 (41.1%)	405 (58.9%)
Medium	8,848	845 (9.6%)	8,003 (90.5%)	3,194	947 (29.7%)	2,247 (70.4%)
Small	43,702	3836 (8.8%)	39,866 (91.2%)	7,322	1,688 (23.1%)	5,634 (77.0%)
Non-state-owned enterprises						
Large	1,658	1,146 (69.1%)	512 (30.9%)	1,356	1,164 (85.8%)	192 (14.2%)
Medium	5,236	4,316 (82.4%)	920 (17.6%)	18,210	17,270 (94.8%)	940(5.2%)
Small	74,402	69,679 (93.7%)	4,723 (6.4%)	236,780	234,469 (99.0%)	2,311 (1.0%)

Source: Based on data from China's NBS annual survey of "above scale" industrial enterprises.

Table 7: **Regression Results [Dep. Variable = ln(VA/L)]**

	(1)	**(2)**	**(3)**	**(4)**
	1998-2001	**1998-2001**	**2005-2007**	**2005-2007**
ln(NVFA/L)	0.265^{***}	0.278^{***}	0.269^{***}	0.270^{***}
	(0.001)	(0.001)	(0.001)	(0.001)
NonSOE	1.075^{***}		0.730^{***}	
	(0.004)		(0.006)	
HMT	1.138^{***}		0.631^{***}	
	(0.006)		(0.006)	
Foreign	1.320^{***}		0.838^{***}	
	(0.006)		(0.006)	
Share_NonSOE		1.023^{***}		0.649^{***}
		(0.004)		(0.005)
Share_HMT		1.059^{***}		0.514^{***}
		(0.007)		(0.007)
Share_Foreign		1.263^{***}		0.768^{***}
		(0.007)		(0.007)
constant	1.121^{***}	1.124^{***}	2.324^{***}	2.388^{***}
	(0.012)	(0.012)	(0.009)	(0.009)
year	Yes	Yes	Yes	Yes
2-digit ind	Yes	Yes	Yes	Yes
N	591,487	585,684	882,909	878,036
R^2	0.254	0.243	0.197	0.195
adj. R^2	0.254	0.243	0.197	0.195

Standard errors in parentheses: * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

***Table 8:* Largest Traded Companies on the Shanghai Stock Exchange (FN)**

Rank	Name	Date of IPO	Ownership	Market capitalization (100 million Yuan)	Ratio to total market capitalization (%)
1	Petro China	2007/11/05	Central SOE	50,131	18.6
2	Industrial and Commercial Bank of China	2006/10/27	Central SOE	20,403	7.6
3	China Petroleum & Chemical	2001/08/08	Central SOE	16,382	6.1
4	China Life Insurance	2007/01/09	Central SOE	12,065	4.4
5	Bank of China	2006/07/05	Central SOE	11,753	4.4
6	China SHENHUA Energy	2007/10/09	Central SOE	10,819	4.0
7	Ping An Insurance	2007/03/01	Foreign	5,078	1.9
8	China Merchants Bank	2002/04/09	Central SOE	4,772	1.8
9	Bank of Communicati on	2007/05/15	Central SOE	4,050	1.5
10	China Pacific Insurance	2007/12/25	Central SOE	3,807	1.4

Source: The Shanghai Stock Exchange, reported in OECD (2009), Table 10.

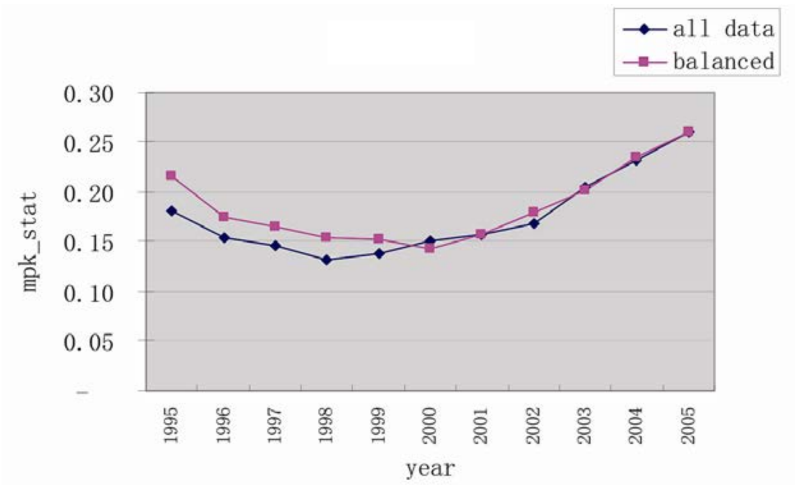
Table 9: **Proportion of Shares by Type of Shareholder (FN)**

Year	Non-tradeable shares*							Tradeable shares			
	Total (100,000,000 yuan)	Sum (% of total)	State share	Legal entity	Foreign Legal entity	Employ-ees	Others	Sum (% of total)	A	B	H
1994	684.54	66.98	43.31	21.43	1.10	0.98	0.16	33.02	21.00	6.06	5.96
1998	2,526.79	65.89	34.25	26.93	1.42	2.05	1.25	34.11	24.06	5.30	4.75
2002	5,875.45	65.34	47.22	16.49	0.91	0.25	0.47	34.66	25.69	2.85	6.13
2006	18,801.25	61.23	20.30	15.61	0.65	0.02	24.65	39.83	26.02	2.02	11.79

Source: China Securities Regulation Commission, reported in OECD (2009), Table 7.

Figure 1: **Returns to capital in China's state-owned enterprise sector, 1995-2005**

(marginal product of capital (mpk) in large and medium - size SOEs) (based on the NBS LME survey, 1995-2005)



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Short Biography of Professor Zhang Jun, Fudan University

A Chang-Jiang Professor of Economics at Fudan University and Director of the China Center for Economic Studies. Professor Zhang received his BSc(1985), M.A (1988), and Ph.D (1992) in economics from Fudan University, and was also educated at the London School of Economics and at the University of Sussex as postdoctoral research student in the UK during 1992-1994.

The areas of his teaching and research have been on China's economic transformation and development, with special references to the evolution of property rights and institutional change, capital accumulation, productivity, structural change and economic growth in China.

Professor Zhang is one of the leading economists in China with many publications both in Chinese and English. Recent academic contributions have been to The World Economy, China Economic Review, the Journal of Asian Economics, the Journal of the Asia Pacific Economy, the Journal of Chinese Economic and Business Studies, and the East Asian Review.

EVOLUTION OF CHINA'S STATE OWENED ENTERPRISE REFORM: POLICIES, PROCESS AND EVALUATION

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1. Introduction

Starting from the mid-1980s, the focus of China's reform in its economic system shifted from the country onto the cities, where the reform of state-owned enterprises (SOEs) became very important. With the original enterprise ownership structure staying put, the reform was mainly carried out in two ways. One was the reformation of the internal system of enterprises. This kind of reform started with the 1979 experiment to expand enterprise autonomy in Sichuan Province. It aimed to stimulate the enthusiasm of enterprise management in their efforts to transform SOEs into economic entities responsible for their own profit and loss. The other, which was arguably more important, was marketization. This reform was carried out by the government after the Third Plenary Session of the 12th CPC Central Committee, which put forward the statement that "the full development of commodity economy is a stage unavoidable in human history." This has not only become the most important historical background for the reform of SOEs, but also the fundamental factor which has affected the implementation of various policies regarding SOE reform over the past three decades.

If we are to summarize the evolution process of China's enterprise reform Policies over the past three decades in simple words, then "pragmatic" and “empirical" would be our best choices. Going through the whole SOE reform process, we find almost no uniform policy prescriptions for the whole nation. There have been different Policies in different periods of time, and many of these policies were triggered by the reform experiments conducted by those pioneering local governments. Over the whole process, local economists have also played an important part by summarizing, publicizing, and discussing these local reform experiments.

2. Enterprises Reform: 1978-1992

After more than a decade of overambitious movements-the Great Leap Forward and the Cultural Revolution, China finally realized how unrealistic its economic plans. were and began to think about how to develop in the future. In response to the irrational development that had been taking place over so many years, the central government put forward a 22-year plan (1978-2000) for the development of the economy and society as a whole at the National Planning Meeting held between November 21 and December 11,1977. Compared with the current practice of making five-year plans, we would find the practice at the time of making long-term plans stretching over 20 years in some instances to be too ambitious. If such a plan had been implemented in the industrial, agricultural, and infrastructural sectors, it would have outstripped what the country would have been able to bear at that time.

Taking this into consideration, the state increased spending on infrastructure construction by 40% in 1978. At the same time, one third of enterprises suffered from chaotic management and production disorder. For example, 13 out of the 30 major quality indexes for major industrial products of national key enterprises were lower than the historical best level; 21 out of 38 major consumption indexes were not able to return to the historical best level; profit for every RMB 100 industrial production value in state-run industrial enterprises was only two-thirds of the historical best level; for state-run industrial enterprises with independent accounting, their loss ratio was 24.3% and the absolute loss value reached as high a s RMB 3.75 billion. Furthermore, this unrealistic and irrational mentality also caused serious imbalance in the national economy.

Faced with this situation, the central government took action immediately. From July to September 1978, the State Council held a meeting, during which the then Vice Premier Li Xiannian put forward the concepts of specialization, and contract systems, and the principle of distribution based on effort made. Li also asked to grant enterprises some necessary independence for them to carry out their own economic accounting, increase revenue, and reduce expenditure according to their own needs. Considering the traditional role the central government gave to SOEs as the manufacturing workshops of the socialist society, this transformation of thought was a tremendous development. It actually initiated the reform of SOEs and made "expanding enterprise autonomy" the starting point of this reform process. But this reform did not materialize until the experiment was carried out in six local SOEs in Sichuan Province in October 1978. These six enterprises were: Chongqing Iron &'Steel Company, Chengdu Seamless Steel Tube Factory, Ningjiang Machinery Factory, Sichuan Chemical Industrial Factory, Nitrogenous Fertilizer Factory of Xindu Country, and Nanchong Steel Factory (Sun 1992). As to the content of the reform, besides the requirement of accomplishing the plan by the end of the year, these enterprises were allowed to keep a little part of the profit and to provide their employees with a small amount of bonus. By today's standards, it would seem that this reform is not even worth mentioning, but it was indeed a big step forward at the time.

The success of the experiment in Sichuan Province provided support for the central government's decision-making. In December 1978, the Third Plenary Session of the 11th CPC Central Committee was held, which turned out in retrospect to be an epoch-making event in China's recent history. This meeting analyzed the reform experiment carried out in Sichuan and proposed that under the direction of national plans, local governments and enterprises should be granted greater power. It also emphasized the roles that laws of economics and the law of value could play in stimulating the enthusiasm of enterprises, together with ideological, political and economic methods. In April 1979, the vice president of the CPC Central Committee and the vice premier of the State Council, Li Xiannian, made a speech entitled "On Adjustment Problems of the National Economy" at the Central Committee Working Meeting. He put forward the guideline of "adjustment, reform, rectification, and improvement," where "adjustment" was the key.

In light of financial constraints under the planned economy because SOE capital was provided directly by the state, such enterprises had no sense of cost at all. So on August 28, 1979, the State Council approved and distributed the following two documents: "Report on Experimental Loan-making Methods for Infrastructure Investment" and "Experimental Ordinance for Infrastructure Loan-making, which aimed to change the provision of infrastructure investment from direct fund allocation from the government to loans via the bank. The loan services were handled exclusively by the People's Construction Bank of China. This became the starting point of SOE external financing system reform or the so-called "fund allocation to loans." After the implementation of some related policies, by February 1, 1985, infrastructure construction and reconstruction investment of all state-owned entities (including SOEs and institutions) and the working capital newly added into SOEs were all sourced from bank loans.

However, if we take into account the changes of national and personal income, we would find another even more deep-rooted reason for this "fund allocation to loans" policy. In fact, the constant increase of personal income and savings and the relatively decreased control of financial resources by the state meant that the government was no longer able to satisfy the needs of state-owned enterprises. Zhan Yubo (2003) analyzed the changes of national savings and fiscal income from the beginning of the Reform and Opening Up policy to 1985 when fund allocation was completely changed to loans, and concluded that this is just a policy change the government made after its own budget constraint changed.

As to the effect of this policy, the increase of SOE autonomy helped such enterprises gain a certain kind of independent economic interest. With management and employees more motivated, these enterprises began to pay more attention to changes in market demand. As a result, they began to do a better job. But at the same time, another problem arose. Due to the absence of a performance assessment system, the state could not effectively constrain the irrational expansion of investment of enterprises. Furthermore, the tension between the state and the enterprises in terms of interest distribution intensified. From 1979 to 1980, China experienced an unprecedented fiscal deficit of RMB 30 billion since its foundation, and its social retail price index rose l.9% in 1979 and 6% in 1980. As a re8ult, the whole national economy was under the threat of inflation for the first time since the Reform and Opening Up process began. To solve this problem, China began to change the focus of its SOE reform from expanding autonomy to the promotion of an economic responsibility system.

As a contracted responsibility system turned out to be a big success in the countryside At the beginning of the Reform and Opening Up process, in the early 1980s when reform began in the cities, it was suggested that a contracted responsibility system should also be introduced in the reform of SOEs, This so-called economic responsibility system is a kind of production management system which is a combination of economic responsibilities, economic rights, and economic interest, and aims to improve the economic efficiency of the whole society under the direction of state plans. According to this system, the relation between the state, enterprises, and individual employees has to be handled properly. Enterprises are supposed to put their responsibilities for the state first, and organize their production activities according to the needs of the society.

Power and interest could only be granted to enterprises after all the state plans were fulfilled, and employee income could only be increased when there was progress made in the development of the enterprises. In terms of actual production, product quality had to be guaranteed and costs could only be reduced, never increased. We summarize the implementation process of the contracted responsibility system in the early 1980s as follows:

However, in order to solve problems such as economic disorder and rapidly increasing prices emerging during the same period, and also to stabilize the national fiscal revenue, the Central Committee decided to discontinue the practice of contracted profits and taxes from 1983 on, a new practice called "substituting tax payment for profit delivery" was put in place. The implementation of this policy was divided into two parts, as shown in Table 1.

Table 1: **Contracted responsibility system in the early 1980s**

Time	Policies
Early 1981	In order to stimulate the enthusiasm of the enterprises on the premise of stable fiscal revenue, Shandong Province, with the approval of the state, put the economic responsibility system into effect in its state-owned industrial enterprises for the first time.
April 1981	Documents such as “Notice on Enhancing Industrial and Transportation Production, Increasing Productivity and Income and Fulfilling State Plans” put forward at the National Industrial and Transportation Meeting, “Suggestions for Problems Emerging in the Implementation of Economic Responsibility System in Industrial Production” in October, and “Tentative Rules” issued in November all approved methods of profit-keeping and responsibility-taking that were formed in the former power-expanding practice. Policy for interest distribution between the state and enterprises, the content of an economic responsibility system, principles, and requirements that have to be abided by were all stipulated.

October 1981	"Suggestions for Problems Emerging in the Implementation of Industrial Enterprise Economic Responsibility System," approved and distributed by the State Council to the State Economic Committee and the State Council System Reform Office, stipulated that the state was to adopt economic responsibility to enterprises. As to the aspect of distribution, three forms were available for them to choose from, that is, profit-keeping, responsibility-taking for profit and loss, and tax imposition substituting for profit sharing.
1982	The State Council approved the experiment of a contracted responsibility system carried out in eight medium and large SOEs including Capital Steel and Second Auto Factory, and agreed to take a further step in the reform of over 36,000 industrial enterprises, that is to implement the policy of "turning in a fixed amount, keeping the extra," thus stimulating the first round contract climax in state-owned enterprises.
Early 1983	A saying "contract induced, trouble reduced" was put forward for enterprises in cities, promoting an enterprises contract system in the urban industrial and commercial industries.

As various forms of reform were tried out on state-owned enterprises to improve their efficiency, China also increased effort on its opening-up process. As early as April and May 1978, the central government sent two delegations to visit Hong Kong and Macau, and some Western countries to learn about their economies. The delegation to Hong Kong and Macau even wrote a report "Report on the Hong Kong and Macau Visit" after they returned to Beijing, suggesting the setup of export bases in Bao'an and Zhuhai, Guangdong and making them bases for export manufacturing, processing, and tourist attractions. In January, 1979, a Hong Kong merchant appealed to the Central Committee, wishing to set up a factory in Guangzhou, to which Mr. Deng Xiaoping responded: "Guangdong, I believe, should be given full rein on such things." This probably could be regarded as the beginning of the development of foreign-funded enterprises in China. Several years after this, in the mid- and late 1980s, the central government issued a series of laws and rules for these foreign-invested enterprises, which included "Regulations on Foreign Exchange Balance of Sino-foreign Joint Venture" issued on January 15, 1986 and "People's Republic of China Foreign-invested Enterprises Law" issued on April 12, 1986, encouraging foreign enterprises to invest in China, and also stipulating other related problems such as product selling, foreign exchange management, and project operating time limit.

Despite this, the 1980s were still more about "reform" and the meaning of "opening-up" was rather symbolic. So we shall get back to our discussion of- SOF reform. The termination of the "profit to taxation" policy in the mid-1980s forced the Central Committee to think about other ways of reform. This is where the contracted responsibility system came into play.

In March 1987, the Fifth Session of the Sixth National People's Congress passed "government Working Report," which proposed to put the focus of the reform for that year on the amelioration of the enterprise operating system. Based on the principle of properly separating ownership and management, various forms of the contracted responsibility system should be carried out. From April 23 to 27, the State Economic Committee, entrusted by the State Council, held a national symposium on the contracted responsibility system. With experience accumulated from provinces such as Jilin, Guangdong, and so on, and enterprises like Capital Iron & Steel Company, and Second Automobile Works Company, it was decided to promote the contracted responsibility system across the country from June that year. On August 29,"suggestions for Deepening Enterprise Reform and Ameliorating the Contracted Responsibility System," issued by the State Economic Committee and the State System Reform Commission, reiterated the principle of "fixing the base, assuring the turning -in amount, keeping the extra, making up for shortage" of the contracted responsibility system and the requirement of considering at the same time the interest of the state, enterprises and employees. On February 27, 1988, the State Council issued another document: "Tentative Ordinance on Contracted Responsibility System for Industrial Enterprises of the Ownership by the whole People," providing further regulations for enterprises to implement the contracted responsibility system.

Compared with the first promotion of the economic responsibility system, the implementation of the contracted responsibility system across the country this time was not met with too much resistance By the end of 1987. 82% of large and medium-sized, state-run industrial enterprises, and over 60% of large and medium-sized state-run commercial enterprises had adopted various forms of the contracted responsibility system. Just as in the countryside, the contracted responsibility system also exerted a very strong stimulating effect By July 1987, the 22-month consecutive all of industrial enterprise profit was over and the yearly fiscal revenue had increased by over RMB 6 billion. By the end of 1988, that is, 20 months after the implementation of the contracted responsibility system across the country, Profit and tax created by within-budget industrial enterprises reached RMB 36.9 billion, which was equal to the total amount of profit and tax during the six years from 1981 to 1986.

As we all know, an important feature of the gradual reform model that the reform is always carried out in one or several areas first. Even within an area, it is first started in a certain way. This was especially the case in the reform process of state-owned enterprises. Reform policy-makers soon realized that the contracted responsibility system could only provide incentives to SOEs, but there was no corresponding constraining system to support it. The defects of the system surfaced when the contracted responsibility system was first tried out in the early 1980s. Enterprises benefited when there was profit but did not take any responsibility when there was loss. Nobody could be blamed for the loss. When the contracted responsibility system was fully implemented, the problem got even worse. So the central government brought forward the factory director responsibility system to monitor the behaviors of enterprises. From August 25 to 29 of 1987, the State Economic Committee, the Organization Department Of CPC, Central Government, and China Trade union jointly held a working meeting in Beijing, discussing the full implementation of the factory director responsibility system, which required that all large and medium-sized, industrial enterprises carry out this new responsibility system within 1987, and all industrial enterprises with ownership by the whole people by the end of 1988. However, we also found that as the former reform measures did not touch the fundamental problems that state-owned enterprises had, there was less and less space for reforms featuring incentives and constraints.

This thought originated from the problems that had occurred in the in the first three-year try out of the contracted responsibility system, During the three years from 1987 to 1990,the considerable fluctuation of the Chinese economy greatly affected the implementation of the contracted responsibility system and accelerated the exposure of the inherent defects of this system.

In addition, as the contracted base profit was counted on the enterprises' performance in the past one or several years, once fixed, it would stay put for the following several years, which would make enterprises with competence reluctant to bring their full potential into play so as to avoid an increased amount of base profit in the next round. Moreover, the contracted responsibility system did not change such shortsighted behavior as "emphasizing consumption while ignoring accumulation." As the contract only specified incentives but not punishments, the enterprises would take no responsibility for any financial loss, which further weakened the constraining power of the contracted responsibility system on enterprise behaviors.

More importantly, the contracted responsibility system further blurred the boundary of enterprise property rights and intensified the interest conflict between the government and enterprises. As a consequence, right-breaching behaviors from both sides occurred from time to time, The implementation of the contracted responsibility system had a precondition: Enterprises all have good reasons to gain and keep some profit, whether the industries they belong to are faced with adjustment or not. Looking from the perspective of the macro-economy, we would find that the no-responsibility-for-loss policy might cause deterioration of the economic structure and thus reduce the efficiency of resource allocation of the society. As the contracted responsibility system had such problems, there was already a lot of discussion about improving it in the first round of its implementation. Many proposals were put forward, for instance, "separating tax and profit," "fixing contracted base on a scientific basis and assessing enterprise performance," "introducing competition' into contract," "implementing contract among enterprises," "risk-mortgaging contract," and so on. But all this had brought no fundamental changes to this situation.

Despite this, the central government did not give up the contracted responsibility system. From May 1991 to March 1992, former director of the State Economic Committee, Lu Dong, organized a survey on large and medium-sized enterprise in different industries and regions, with the support of the China Industrial Economic Association, and published three articles in People's Daily advocating transforming the enterprise operating system so as to invigorate large and medium-sized, state-run enterprises. This was first approved by the Central Committee at the 12th Plenary Session of the State Council. Later, the central government issued policies three times to conduct experimental reforms aimed at improving the internal management and external operating conductions of large and medium-sized enterprises, and transforming enterprise operating systems.

As a supporting rule for the contracted responsibility system, the State Council issued an implementing document for "The Whole People Ownership Industrial Enterprise Law" the

"Operating System Transforming Ordinance, for the whole people Ownership Industrial Enterprises" on July 23, 1992, which covered stipulations pertaining to such aspects as the objectives for the enterprise operating system transformation, the scope of enterprise operating rights, enterprise responsibilities for its profit and loss, and adjustment for products and organization structure. From the second half of1992 on, this ordinance wan put into effect across the whole country. About 8,000 enterprises were selected to conduct this operating system reform experiment. However, as this ordinance was still confined to the reform of enterprise operating models, and had to stepped out of the perspective granting more power and profit, problems that had been haunting SOEs for long were still not completely, no clearly clarified ownership of property rights, and no efficient self-constraint and self-accumulating system had been established. The problem of low economic efficiency and great losses remained quite common, or even deteriorated, in state-owned enterprises.

Up to this point, China's SOE reform had been going for 13 years. Despite the developmental achievements in invigorating the rigor of enterprises, the reform at this stage had not brought the enterprises out of the various circle of "turning active when control relaxed, turning chaotic when getting active, control tightened when chaos set in, and turning inactive when control intensified." As a result, the government policy also fell into a vicious cycle of relaxing and tightening control, and the government had not found a way to promote the sustained healthy development of SOEs.

3. Restructuring SOEs after 1993

In the history of China's economic reform,1993 is undoubtedly a crucial year, and often regarded as a turning point by both domestic and foreign economists. On November 14,1993, the "Central Committee Decision on Problems Emerging in Establishing Socialist Market Economic System," ("Decision" for short), was passed in the Third Plenary Session of the 14th CPC Central Committee. This document confirmed the direction of establishing a socialist market economic system and adhered to the policy of common development and coexistence of a variety of economic elements with the public system taking the dominant role. It advocated the establishment of a modern corporate system which had clearly established ownership of property rights, clearly defined rights and responsibilities, separated administration and enterprises, and scientific management; and was compatible with the market economy via further transformation of the operating system of SOEs. Unlike the previous policies for SOE reform, the "Decision" put the reform of state-owned enterprises into the macro pattern of social reformation, and took into consideration factors such as corporate governance, government governance, price reform, financial system, tax system, and allocation system. It thus indicated that the reform of SOEs had started to shift away from the pure adjustment of interest with the original system structure staying put, to a new period where production relation reform, property rights definition, and enterprise system innovation were the focus.

However, this "Decision" only elaborated on the nature and characteristics of the modern corporate system, but did not offer any concrete pathways for realizing it. So it was more directional than operational. As there were no examples to follow, the time between 1993, when the objective to establish modern corporate system wan first set, and 1998, when the reform made breakthrough progress, was mainly spent on the adjustment of the system and the changing of people's mindsets.

The central government expected to figure out a pathway for establishing a modern corporate system one year after the issuing of the "Decision", that is, in 1994. It even made a four-step plan, which consisted of discussion, preparation, and task assigning and initiation. At the end of 1994, the State System Reform Commission issued a document entitled "Notice on the 30 Enterprise and the One State-controlled Enterprise Contacted by the State System Reform Commission for the Experiment of Modern Contacted by the State System Reform Commission for the

Experiment of Modern Corporate System" to eight provinces, two municipalities, one city with independent budgetary status, eight central government enterprise administration departments, and China Petrol-Chemical General Company, stipulating the working procedures of this experiment. But the implementation of this experiment did not turn out to be as smooth as expected. Here are some of the problems that were encountered:

First of all, due to the lack of theoretical preparation, the issuance of supporting policies for the establishment of a modern corporate system lagged behind. For example, after the issuance of the document entitled "Plans for the Selection of Some Large and Medium-sized SOEs to Try Out the Modern Corporate System," and some other relevant files concerning the eight aspects of the tryout in November of 1994, the central government had planned to issue 12 supporting documents by the first of 1995.However, by October 1996, only five had been issued. The tryout work was supposed to be over by 1996, but it was not finished until the end of 1997.

Secondly, unlike former policies which focused on granting more power and interest to enterprises, this new round of reform, with the objective of establishing a modern corporate system, was no longer an "incremental reform" which would result in a "Pareto improvement" on the whole. Instead, it aimed to resolve some of the more deeply rooted problems in the traditional system. Changing the existing power and interest structure was almost certainly going to cause some contradiction and interest conflicts that had never arisen before, for instance, the issue of losing the status of being state-owned and that of unemployment.

Thirdly, there were also problems with the actual implementation of those policies pertaining to the establishment of a modern corporate system, though they only existed for a short period. For example, there was a leadership debate about who should take a leading role in managing affairs related to the reform in building a modern corporate system: the State System Reform Commission or the State Economic and Trade Commission. After some coordination, it was finally pronounced by the vice-premier of the State Council, Zou Jiahua, on the working meeting for the tryout of a modern corporate system at the beginning of 1994 that the State Economic and Trade Commission was to lead this work.

All of these problems were not foreseen by the central government. To ensure the implementation of this reform, the State Economic and Trade Commission put for-ward another proposal, that is, to select some cities to try out a "capital structure optimization" reform. According to this proposal, the deepening of SOE reform could be achieved from city to city by "increasing capital, conducting reconstruction, treating separately, and allowing bankruptcy." The reform first commenced in 'in 18 cities in 1995. In 1996, the number of cities involved was expanded into 58. By 1997, 111 cities were included. As almost each and every aspect of this reform experiment need huge financial support, the problem of "cooking without the right ingredients" arose'. The serious inflation that hit the Chinese economy in 1994 only made things worse.

Two years after the concept of the modern corporate system was put forward, the government finally understood the internal logic of the modern corporate system and identified a breaking point for the reform of SOEs after various investigations, and with the help of economists. On September 28, 1995, the "CPC Central Committee Suggestion on Making the Ninth Five-year Plan for the National Economy and Social Development and the 2010 Long-term Goal" was passed at the Fifth Plenary Session of the 14th CPC Central Committee, which put forward the so-called reform strategy of "grasping the big and letting to small." In terms of "grasping the big". China apparently copied Japan's big-firm model. For example, in 1996, the central government assigned supporting banks for 300 of the 1,000 major enterprises. Here are some of the related policies: Ensuring the capital source for enterprises by assigning commercial bank headquarters or branches on the provincial level as supporting banks; evaluating and ratifying a reasonable amount of flowing capital for enterprises and changing the short-term loans into one-year loans with a fixed basic interest rate; and enterprises not allowed to make improper use of the loans or default on any interest. These policies provide d enough funds for major enterprises and helped them get by temporarily. However, on the other hand, they postponed the reform of some state-owned enterprises. Some of these policies are still in use today. Compared with "grasping the big," "letting go of the small" was actually a more important breakthrough point for reform at this stage. The reform practices in places such as Zhucheng City, Shandong Province provided the central government decision-makers with important experiences. In 1996, two documents entitles "Some Suggestions on Speeding up the Reform of Small SOEs' and "Suggestions on Freeing and Invigorating Small SOEs" were issued by the State System Reform Committee and the State Economic and Trade Commission, respectively, strengthening the guidance of the government on the reform of small SOEs.

Just as the central government began to understand how to carry out this reform, the fundamentals of the SOEs deteriorated. In 1994, all the state-owned industrial enterprises with independent accounting in 13 of the 39 industries suffered losses, which amounted to RMB 5.858 billion, while in 1997, 25 out of the 39 industries lost RMB 25.886 billion. By the end of 1997, of the 16,874 large and medium-sized, state-owned or state-controlled, industrial enterprises, 6,599 suffered a loss of RMB 66.59 billion.

As the state-owned enterprise loss-making phenomenon had become a serious problem threatening the stability of the society, the central government planned to carry out a more powerful reform on these enterprises. From July 18 to 24, vice-premier of the State Council, Zhu Rongji, visited state-owned enterprises in Liaoning Province, and brought forward the famous reform strategy called "Turning Around in Three Years," that is, to make the majority of large and medium-sized SOEs improve their operations within the following three years. Concrete measures included: strengthening the construction of enterprise management; firmly adhering to the policy of encouraging merger, regulating bankruptcy, laying off and streaming workers to other fields; dismissing unnecessary employees to increase efficiency; and implementing the reemployment project," and various other methods. This is the original form of the so-called "two goals within three years."

In order to help SOEs turn around in three years, the government not only required these enterprises to carry out internal reforms, but also issued quite a few supporting measures to deal with problems arising from the reform. Table 2 shows more details.

Table 2: **Supporting measures for state-owned enterprises to get out of poverty in three years**

Problems	Supporting policies
Heavy debts	Changing debts into stocks. Injecting RMB 270 billion into the four big banks as reserves in 1998. Setting up four asset management companies - Cinda, Orient, Great Wall, and Huarong - to acquire, manage, and dispose of bad assets stripped from the four big state-owned banks in 1998. On July 30, 1999, "Suggestions on Problems Emerging in the Process of Changing Debt into Stocks" was issued by the State Economic and Trade Commission and People's Bank of China.

Placement of employees	On July 24, 1998, the National Endowment Insurance and Reemployment Service Center Construction Working Meeting decided that all the work concerning employee basic endowment insurance of enterprises in the 11 department with basic endowment insurance planned as whole should be transferred to local governments. Meanwhile, enterprises should accelerate the construction of the reemployment service centers. Two documents were issued by the central government, that is, "Notice on the Management of SOE Laid-off Workes and the Construction of the Reemployment Service Center" and "Notice on the Transfer of Provincially Planned and Industrially Planned Enterprise Employee Basic Endowment Insurance to Local Governments," respectively on August 3 and 6. According to the document entitled "Decision on Establishing Employee Basic Medicare Insurance System in Cities and Towns," issued by the State Council, medicare

	insurance system reform was initiated in January 1999. In August 1999, the State Council approved and transmitted "Suggestions on Improving the Three Social Security Lines" issued by ministries including Ministry of Human Resources and Social Security, planning to increase the level of state-owned enterprise laid-off workers' basic cost of living, unemployment insurance, and minimum living safeguard standard by 30%.
Backward technology	In June of 1999, the central government decided to spend RMB 9 billion from the newly issued government bond on loan interest-paying for enterprise technological reconstruction and industrial update. By the end of 2000, the State Economic and Trade Commission arranged 880 government bond projects for major technological reconstruction in four lots. The total investment reached RMB 240 billion, of which RMB 19.5 billion was from government bond and RMB 135.9 billion from loans.

Industry structural surplus	Controlling total production, structural adjustment, shutting down small and unregulated enterprises, eliminating laggard enterprises, and reducting excessive production capacity.
Market disorder	From 1998, the central government put into effect a new smuggling suppressing system of "combined effort, collective disposal and comprehensive treating," carrying out a more powerful strike on the smuggling of major commodities such as oil, plant oil, textile raw materials, cars, and computers.

Upon the all-round implementation of the these measures, on December 11, 2000,it was announced at the National Economic and Trade Working Conference that the state-owned enterprise reform and the objective of turning around in three years' time were both basically accomplished. By the end of 2000, 4,800 out of the 6,599 loss-making large and medium-sized SOEs of 1997 no longer suffered loss. State-owned and state-controlled industrial enterprises realized a profit of RMB 239.2 billion, which was 2.9 times that of 1997. State-run industries in 31 provinces (autonomous regions and municipalities) and 12 out of the 14 major industries stopped making a loss or increased their profit.Fortunately, the central government was fully aware of this and did not stop the reform of state-owned enterprises even after the accomplishment of meeting the set goals. At the beginning of 2001, the state especially emphasized the authorization for the operation of state-owned assets and the elimination of state-owned enterprise administration hierarchy. In March of 2001, the State Economic and Trade Commission and other related departments issued "Suggestions on Examining SOE Internal Personnel Labor and Allocation System Reform. They held another meeting discussing problems concerning the deepening of SOE internal reform, making a comprehensive plan for the reform of personnel, labor and allocation systems.

In the 1990s, the number of laid-off workers due to state-owned enterprise reform soared. Between 1996 and 1997, this number amounted to 15 million.The number remained very high in the subsequent years up till 2000, which made unemployment one of the most eye-catching social problems. To ease the social pressure resulting from this problem, President Jiang Zemin elevated reemployment to an issue concerning the big picture of reform, development and social stability, the improvement of people's living standard and the long-term peace of the whole nation at a national work conference on reemployment held on September 12, 2002. Later on November 18, the State Economic and Trade Commission and some other departments jointly issued the notice entitled "Implementation Methods for the Separation of Major and Sideline, the Restructuring of Sideline, and the Disposal of Surplus Labor in Large and Medium-sized, State-run Enterprises, encouraging large and medium-sized, SOEs to reconstruct and establish market-oriented, legal, economic entities with independent accounting that were capable of being responsible for their own profit and loss.

This was achieved by making use of non major assets, idle assets and effective assets in 44Bankrupted enterprises, so as to reemploy surplus labor and employees of bankrupted enterprises and mitigate social employment pressure. After nearly seven years of high unemployment from 1995 to 2002, the unemployment rate finally dropped to a much lower level. This period could be seen as the time when China’s labor market was beginning to take shape.

One of the principles to establishing a modern corporate system is to “separate administration from enterprises," but this only applies to the everyday operation of enterprises. Although the government should not be interfere with enterprises' behavior of profit maximization, it should not be deprived of its right to benefit as investor and ownership delegate. This touches the issue of state-owned assets management after the modern corporate system is set up. Wu Jinglian put forward a concept called "public assets management commission," which could be regarded as the prototype of the later "State-owned Assets Regulatory Commission." In November of 2002, the 16th Centra Committee of the CPC put forward a management model for state-owned with assets management, the core idea of which was that these assets were "state-owned with the central government and local governments carrying out investor responsibility and enjoying ownership rights and interest on behalf of the state." This new model terminated the traditional model of "state-owned with different levels of local governments in charge of different levels of management." With the state controlling the ultimate ownership, local governments would enjoy full investor interest and have the right to decide whether to sell these assets by auction or just transfer them. Later in March 2003, a new state-owned assets management organization, State-owned Assets Regulatory Commission (SARC), was set up at the First Session of the 10th National Congress to implement the new model. The State-owned Assets Supervision and Administration Commission of the State Council (SASAC) was officially established on March 19, and went into operation on March 26. By 2004, all 31 provinces and Xinjiang Production and Construction Co had their own SARC offices. Later, in order to adapt to the reform of state-owned asset; management system, all the local levels of SARC started a new round of exploration on state-owned assets operating organizations, related laws and rules, operating performance assessment, the salary system, state-owned assets operating budget, and monitoring committee.

On October 14, 2003, the CPC Central Committee Decision on Ameliorating Socialist Market Economic System was passed in the Third Plenary Session of the 16th Central Committee. It was decided to take the share-holding system as the principal from of the public economic sector, which had in fact pointed out a new way for the property rights reform. As a matter of fact, the share-holding system had long been tried out in the reform of state-owned enterprises, but there was still a long way for it to go.

In order to realize the restructuring of SOEs and the adjustment of- the strategic distribution of the national economy, the China Securities Regulatory Commission issued the "Notice on Tryout Reform of Listed Company's Non-tradable Shares" on April 29, 2005. This tryout reform was thus officially started. On September 12, 40companies claimed to have initiated the nontradable shares reform procedure. From then, there would be about 20 companies joining the reform every week. In April of 2006, the China Securities Regulatory Commission asked for public opinion on the "Administration Methods for Listed Company Securities Issuing (Draft)." According to the China Regulatory Commission, resuming the refinancing ability of listed companies is an important step to "separating the new from the old." Only those companies that had finished the reform of nontradable shares for more than half a year were allowed to conduct refinancing, and IPO should be initiated first in those provinces where the proportion of the market value of companies which had gone through or entered the reform procedures had reached a certain level. A series of supporting measures were also in place.

The first word in the phrase of "incremental reform" shows us why the Chinese economic reform got to maintain its momentum. The reform of SOEs was called "stock reform." As it had long been in a situation of groping its way forward, the role that this "incremental reform" played should, therefore, not be ignored. There are two sources for the incremental reform of the Chinese economy: One is foreign enterprises and the other is private enterprises that have grown up as grassroot economic elements of the Chinese economy.

Ever since the process of socialist reconstruction ended in 1956, the development of private enterprises had experienced a period of over 20 years of vacancy. Not until the late 1970s did private enterprises begin to develop in the form of specialist household in the countryside and individual industrial and commercial households in cities and towns. Even in the 1980s, private enterprises in the countryside and towns of some areas still needed the protection of the so-called "red hat," meaning that such enterprises should be set up and operated in the name of collective enterprises. The central government and local governments were also very cautious about the development of the private economy, as can be revealed by their policy of "no advocating, no promoting, and no clamping down." The legal status of the private economy was only acknowledge after the First Session of the Seventh National Congress passed the Constitution Revision Act in April, 1988, which stipulated that the private economy was allowed to exist and develop in a scope within the regulation of the law. It was a supplement to the socialist public economy and the state had to protect the legal rights and interests of the private economy, and meanwhile guide, regulate and monitor its development.

4. Roles of Chinese Economists

If we say that the government has long been concerned with SOE reform and quite a number of policies are issued especially for these enterprises, then in the theoretical circle, particularly after the 1990s, research studies about non-state-owned enterprises have been piling up. As a result, in our discussion of the evolution of China's enterprise reform theories, we shall not be confined to the reform of SOEs only, nor shall we present them in a chronological order. What we shall do is talk about different enterprise reform theories according to different subjects.

Under the planned economic system, enterprises were owned by the state and had long been operating according to the plans made by the state and thus became production workshops for the government. As a consequence, they almost lost all of their dynamics, production enthusiasm, and innovative capability. Even after the "administrative power sharing" reform in 1958, the power to make production plans was only transferred from the central government to the hands of local governments. Enterprises had still not gained their status as independent commodity producers. Therefore, the reform of Chinese enterprises should start from invigorating the production enthusiasm of the enterprises and let them be what they are meant to be.

In 1979, former member of the State Planning Commission and Head of the State Statistic Bureau, Xue Muqiao, pointed out that one of the two most urgent and important problems with China's economic reform was to change the enterprise management system so that they could become dynamic basic operating and management units (Xue 1979). In the same year, economists such as Jiang Yiwei and Dong Fureng published research papers about this very problem in key economic journals.

In June, 1979, Jiang Yiwei published an article entitled "Some Tentative Ideas on Enterprise Focus" in Economic Management. With reference to several different views existing then, helpful forward the concept of "enterprise focus." In his opinion, the economic system that had been implemented at that time (that is, a highly concentrated system) is actually a single and huge economic organization where the state (including the central government and local governments) as the upper level structure of this organization, gives directives directly to its subordinate branch institutions (including enterprises and other economic organizations), which could be regarded as "state focus." Some people say that the management is very centralized, so the local government (provinces and municipalities) should be given more power and serve as basic economic organizations to conduct independently basic economic activities with collective accounting and collective examination, which could be called "local government focus." Jiang also said that the national economic organization should not be regarded as one single economic unit, nor should it be divided into a number of organizations according to different administrative regions. It should instead be divided into different organizations according to different kinds of enterprises such as industrial enterprises, commercial enterprises, and agricultural enterprises. They should be allowed to conduct independent operation and accounting under the leadership and supervision of the state, enjoying rights on the one hand and fulfilling responsibilities to the same on the other hand. This is the so-called "enterprise focus." In his view, commodity production should not be eliminated from socialist society but instead should be developed with great effort. Some of the characteristics that enterprises have derived from the process of commodity production would not be contradictory to socialist principles. On the contrary, it would promote the development of a socialist economy. This article was also published, after revisions, in Social Sciences in China in 1980 with the title of "On Corporate Focus," which had stimulated quite some discussion and gained the approval of the business circle.

In an article commemorating Jiang Yiwei, Zhang Jingfu said that Jiang's enterprise focus theory had made a great contribution to their drafting of The Tentative Plan for Economic System Reform. Although this plan did not use the exact phrase of "enterprise focus," its content was indeed an embodiment of the spirit of "enterprise focus."

In 1979, in the first volume of Economic Research, Dong Fureng wrote an article on the problem of how to delegate the power to the enterprises to operate independently contending that economic units with ownership by the whole people should be able to enjoy independence and have their own comprehensive, independent and strict economic accounting. He also pointed out that on the condition of maintaining and improving the common interest of all working people, employees in each economic organization should be given the right to take part in enterprise operation under the guidance of the same plan and with the consideration of their own interest.

While china's economists were advocating granting state-owned enterprises independent operating rights, an economist from Tokyo University, Ryutaro Komiya, after comparing the development of Chinese and Japanese enterprises, argued that China had (almost) no enterprises (Wu 1993). in the "Sino-Japan Economic Academic Symposium" that was held on May 14, 1985 in Okinawa, Japan. This saying was later widely quoted by Chinese economists.

Early theories on Chinese enterprise reform had two characteristics. One is being empirical. Due to the lack of mature theories and examples on the gradual reform model, the early reform of Chinese enterprises had relied more on actual practices for experience. The other is being policy driven. Theories on the reform of Chinese enterprises were reflected in government policies, laws and rules, which was an important way for Chinese economists to participate in the early reform of Chinese enterprises.

However, there were several debates on the reform of Chinese enterprise among economists of the golden generation. Quite a few of them expressed their own views on the direction and models of this reform. Mainly the debate revolved around two subjects:”plan” and “market.”

For example, in the early 1980s, economists supporting the dominating position of the planned economy blamed the overemphasis of the relation between commodities and money for the macroeconomic disorder. As representative of the reform school, economist Xue Muqaio believed that the reform direction was not wrong. The problem was the reform model used. More emphasis should be placed on placed on the issuing of supporting measures of the state-owned enterprise reform, including the marketization of the price reform and financial reform. However, his opinion was not accepted decision-makers at that time. The 12th CPC National Congress, held in September 1982, still placed the role of plans over that of market.

In the mid-1980s, the market-oriented reform again became a hot topic in economic circles. The incremental reform provided space for the development of the non-state-owned sector. The implementation of a dual-track system stimulated the production of state-owned enterprises. Nevertheless, the incremental reform and a dual-track system also caused a series of problems for the Chinese economy, for instance, the consistent low efficiency of SOEs, corruption among government officials, the lagging of reform of other related systems, and so on. Meanwhile, economists differed in their opinions about how to further promote the reform SOEs. The so-called “adjusting reform school,” represented by Wu Jinglian, Zhou Xiaochuan, Guo Shuqing, Lou Jiwei, Li Jiange, and so on, held that the Chinese economic reform should not be confined just to the reform of SOEs. The setup of a macro-controlling system so as to cultivate a competitive market system and conduct adjustment to the market should also be included. Li yining, representative of the so-called “enterprise reform school,” argued that success of economic reform does not depend on price reform but on the reform of ownership structure and enterprise system. He advocated the combination of the shareholding system and contract system so as to make enterprises responsible for their own profit and loss.

In the mid-1990s, in order to solve the problem of increasing loss-making in SOEs, some economists said the state should inject more funds into the state-owned economic sector, making up for the loss-making on the one hand and increasing the competitiveness of state-own of state-owned enterprises on the other hand. Based on this view, a policy called "capital structure optimization tryout" was carried out in 1995 and it turned out to be a failure. Some other people suggested establishing a modern corporate system through the strategic restructuring of SOEs. According to this view, it was almost impossible to just rely on state fiscal investment to eliminate bad loans formed over a long period and inject funds into SOEs to increase their capital and facilitate their technological reconstruction. Under the circumstances then, it might be more practical to just invest in major state-owned economic projects following a certain order of priority.

In the mid-and late 1990s, research on the reform of Chinese enterprises was mainly concentrated on the establishment of a modern corporate system. This research used the framework of contract analysis and concluded that under the circumstance that the rights of state-owned assets owners did not receive corresponding respect, contracts could not be effectively terminated due to the threat coming from the unemployment caused by enterprise bankruptcy. The state thus was forced to bear the cost of paying for the loss made by SOEs and also to bear the cost of subsidies paid to these enterprises.

In 1995, Qian Yingyi noticed the coexistence of' operating autonomy rights and the situation of appointing enterprise directors by administrative orders in SOEs, and believed that this directly affected the financing structure of these organizations, which was why they raised funds mainly from banks. Therefore, Qian advocated the reform of the state-owned bank system so as to improve its efficiency and set up a new commercial bank system. Yang Ruilong then differentiated state-owned property rights from public property rights and pointed out that the inherent conflict between state-owned property rights and the market economy determined that the government should only grant more power to state-owned enterprises rather than increase their responsibilities. As the government applied multilevel agency model on the management of state-owned assets, different measures had to be taken in different industries in the reform of state-owned enterprises.

Different from the opinion of many other economists that state-owned enterprises in China should implement property rights reform, in 1997, Lin Yifu, et al. indicated that the establishment of a modern corporate system should be focused on the creation of a competitive environment for the marketization of state-owned enterprises. In order to establish a modern corporate system that could invigorate enterprises, special efforts had to be first made in constructing the incentive system, supervision system, and constraint system.

5. Evaluation of China's SOEs Reform

As more young economists received training in Western economic theories in the mid and late 1990s, the research focus of Chinese enterprise reform began to change from policy investigations to empirical studies by using mainstream economic methods. From then, research on SOEs reform also became more empirical rather than policy oriented.

The first remarkable research of this kind was about how to evaluate the influence of enterprise reform on the productivity of SOEs. It was a continuation of their research work of 1992. As domestic economists then were still not used to examining and evaluating the achievement and problems of the reform of the Chinese economy by using empirical methods, the research paper published in Chinese by Xie et al. on the changing trend of Chinese industrial productivity could be said to have developed a school of its own. Xie et al. mainly looked at the changes of total factor productivity (TFP) from 1980 to 1992 in industries such as excavating, manufacturing, and public facilities. According to them, the growth rate of productivity for both state-owned and collectively owned industries accelerated in the 1980s, while from 1988 to 1992, there was an obvious decline of state-owned industrial productivity growth, but the growing momentum for collectively owned industries was not affected. In their opinion, the slowdown of China's TFP in the later years should be attributed to different equipment usage rates, the so-called "beautiful girls get married first" SOE reform, and the unreasonable allocation of resources resulting from the imperfect investment system.

Later, in evaluating China's industrial reform, Zhang Jun and Ji Hong in 1993 reviewed relevant literature on the calculation of the TFP of the Chinese state-owned sector and compared it with that of township and village enterprises in China. They concluded that China's industrial reform did not help save the state-owned sector, but shrank it and thus created a favorable environment for the development of a non-state-owned sector.

In addition, there was still a lot of literature on the changing trend of the financial condition of SOEs. For example, in 1998, Zhang Jun studied data of industries in China after the mid-1980s and pointed out that ever since the beginning of the Chinese economic reform, due to consistent excessive demand and increasing market scale, most of the manufacturing sectors in the 1980s kept good financial records. At the beginning of the reform, the phenomenon of excessive market demand was quite obvious, so the loss-making problem of SOEs did not seem very serious. Thus, when a great many township and village enterprises entered the market and the average profit rate of most of the industrial sectors kept falling, the proportion of loss-making enterprises from 1982 to 1988 still declined. However, the consistent large-scale increase of loss-making in a variety of industries since 1989 was apparently a transitional product of the development of the market structure and industrial organization, which basically reflected the fact that the organization structure of the Chinese industry was heading toward the direction of optimization with intensifying market competition. In 2001, Zhang Jun demonstrated further that the structural change of the state-owned industrial sector profitability in the 1990s was the major reason for the increase in losses, thus the deterioration of enterprise profit rates. However, as this was a structural deterioration, we should be careful when evaluating the performance of the Chinese industries as a whole.

Quite a number of economists conducted plenty of empirical research on the evaluation of the property rights reform of SOEs. For example, Ping Xinqiao et al. in 2003 estimated and analyzed the scale of agency cost of the state-owned enterprise and the reason for its existence by using the maximum likelihood estimation model of Broyden-Fletcher-Goldfarb-Shanno on the data of incentive salary in the "2002 state-owned enterprise restructuring survey". They conclude that the agency cost of Chinese state-owned enterprises was equal to 60%-70% of their profitability potential, which means that agency cost had reduced the enterprise efficiency to only 30%-40% under the current state-owned enterprise system.

In 2006, Bai Chong'en et al. supported the judgment made by Ping Xinqiao to some extent. They investigated the influence of restructuring on enterprise economic and social efficiency, the channel of influence, the difference between state-controlled and non-state-controlled enterprises, and the sustainability of the restructuring effect by analyzing the data of all SOEs and above-scale non-state-owned enterprises. Here are some of their findings. First, enterprise economic efficiency was improved dramatically due to the reduction of agency cost, which could be seen from the dropping of the management cost rate. Second, the process of restructuring resulted in certain social costs but the costs were not very high compared with international experience. Third, the restructuring of state-controlled enterprises had good social effect while the restructuring of non-state-controlled enterprises had good economic effect. Fourth, the effect of the restructuring of enterprises was sustained within a certain period.

In 2006, Hu, Song, and Zheng studied the impact of the diversification of ownership on the performance of enterprises by analyzing data over 700 enterprises in six departments of five cities in China collected by the World Bank, and reached the following conclusions:

- Private shares and foreign shares could exert better effect on enterprise productivity than state-owned shares. In private shares, those shares held by legal entities, or by senior management and employees could exert better effect on enterprise productivity than those held by outsiders.

- In state-owned shares, the number of shares held by entities and local governments was negatively associated with enterprise productivity, while those held by the central government and the provincial governments did not show very significant effect on enterprise productivity.

- In those shares held by legal entities, only privately owned shares had positive relation with enterprise productivity. These findings were very important for the issuing of policies for the privatization process of SOEs.

Talking of the research of the SOEs conducted by the younger generation economists, we have to mention the empirical studies on non-state-owned enterprises they made. Township and village enterprises had such great impact on the Chinese economy at the beginning of the Reform and Opening Up policy that it was said that China has its miracle in the countryside, while the countryside had its miracle in township and village enterprises. In 1994, pure privately run enterprises only accounted for 13% of the total number of non-state-owned sectors, while the proportion of cooperative enterprises, mainly township and village enterprises, reached the level of 74%.

Besides their large proportional representation in the Chinese economy, township and village enterprises also played a big role in the augmentation of the Chinese economy. Weitzman and Xu calculated and compared the TFP of township and village enterprises and SOEs, reaching the conclusion that the TFP of township and village enterprises was almost three times that of SOEs. In 2002, Zhang Jun and Chen Shiyi studied the effective efficiency of the development and the future of township and village enterprises by analyzing the changing trend of TFP, the capital-raising method, the way of making technology choices, and the technological regional differences of township and village enterprises.

Looking from the perspective of property rights, though township and village enterprises were not pure privately run enterprises; they did have some related characteristics of private enterprises. Qian and Roland showed that due to the relatively small scale and the control of local government, township and village enterprises had stricter budget constraints than state-owned enterprises. With power sharing between the central government and local governments, the development of township and village enterprises in China got rid of the control of the central government on the one hand, but was still subject to the control of local government. First, township and village enterprises no longer needed to accomplish any plans, and the state was also no longer their single investor. Secondly, the local government still held shares in these enterprises, and local government still had a big say in the appointment of the enterprise management and their profit distribution.

Short Biography of Mr. Laksamana Sukardi, Former Minister of Investment and State Owned Enterprises for Indonesia

Mr. Laksamana Sukardi has over 35 years of experience in banking, investment, and asset restructuring both in Indonesia and internationally. In 2009, he co-founded Cordoba Capital and Earth Investment Group, private investment firms whose investment activities include green energy companies in Indonesia.

As Minister of Investment and State Owned Enterprises for Indonesia, Mr. Sukardi managed a diverse portfolio of more than US$200 billion, including state- owned companies in mining, oil and gas, transportation, banking and finance (IBRA), plantations, telecommunications, electric power, and other strategic industries. As a career banker from the private sector, Mr. Sukardi's much needed professional and technical expertise in restructuring enabled the country to reorganize and privatize Indonesian state-owned firms.

Mr. Sukardi holds a BS in civil engineering from Bandung Institute of Technology, Indonesia, and has been a past President of the Bandung Alumni Association of 15,000 graduate engineers.

SOEs RERORM IN INDONESIA

Laksamana Sukardi

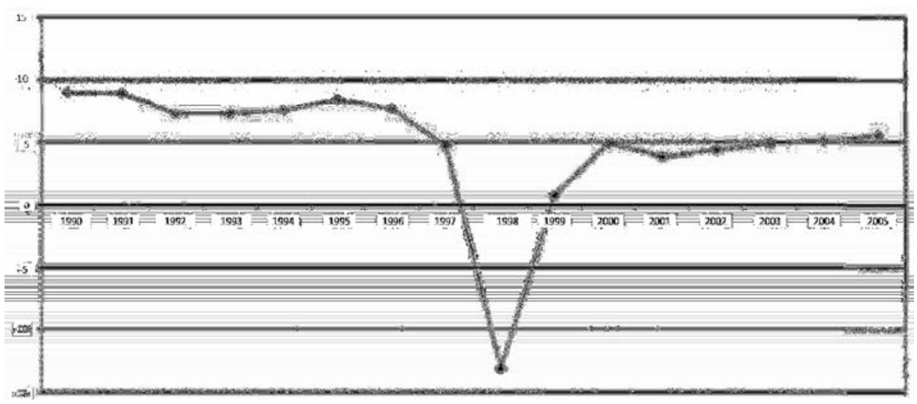
Former Minister of SOEs, Indonesia

1. The relationship between bad governance and SOE vulnerability

Indonesia, with its own characteristics, faced many political challenges, also known as "financial disasters". After 1997, Indonesa was able to achieve impressive results in poverty reduction, high economic growth rate and was a destination for investors. But only few months later, Indonesia was unexpectedly hit by political instability; it was as it was hit from a natural disaster.

The Indonesian economy was heavily affected by top economic advisors working with the government. However, at some point, the economy was also manipulated by some interest groups that we can also call them "mafia". That was a very difficult period which in turn led to very bad governance.

Figure 1: **Indonesia growth rates 1996 to 2005 (annual percentage)**



Source: World Bank Internal Document.

In Indonesia, the banking system was also faced with many difficulties, most notably, the significant amount of outstanding unguaranteed debt from the private sector. In addition are also the issues of non-performing loans and weak supervision of the banking system. The country's weak institutions favoured corruption. The lessons drawn from Indonesia's experience confirm the necessity of market institutions for economic development, and in order to make a smooth transition to market economy, market rules and principles need to be respected, because otherwise, there will be punishments by the market. That was the scenario happening in Indonesia at that period, which led to the serious loss of market confidence. The Rupiah depreciated by 75%, inflation climbed to very high levels between 1996-2005. At the time when Indonesia deeply collapsed in debt, the outlook was so bad that total debt jumped to more than 90% of GDP. At that very moment, market confidence was seriously impaired.

2. Solutions adopted by Indonesia

Luckily, Indonesia suddenly became as a socialist country and the country initiated a debt restructuring policy, amounting to 198 billion USD to restructure the banking system and non-performing loans. IBRA was established, and by which, all companies in Indonesia were placed under IBRA for control and supervision, with the only exception to street vendors. At that time, such a socialist policy was implemented out of the bad experience of Indonesia. A guarantee system for mega projects consisting of more than 20 independent power projects that need to be restructured was put in place, which. We had to restructure debt and place the restructuring process under a tight judicial system. In addition, significant costs were incurred, amounting to 50% of GDP, to recapitalize the banking system. IBRA managed the firms, the Governemnt set out its policies; not only SOEs were put under restructuring, but also other kinds of firms were considered for the matter. In that period, communicating and educating stakeholders about the reform had to be taken, and were not a simple task.

3. The Indonesian experience

What's most important is to be decisive in doing reforms. The Indonesian experience shows, that the more we waited, the higher the costs incurred. To bear in mind that the East Asian financial crisis in 1997 forced us to be decisive, because otherwise, it would have taken us 5 years to recover. One example worth to mention, is that the term for being President of IBRA is very short, and Indonesia has been through 7 Presidents of IBRA. Therefore, it is very important to be serious and decisive and setting in place a good corporate governance system.

It is important to have political will and commitment, and the government needs to take a proactive role in leading this reform. How to guide the exchange, dialogue and reporting with the National Assembly in inacting new legal documents to address these issues? In that period, despite the indebtedness, there was no clear regulation. But Indonesia was thenable to establish legal documents such as the Law on SOEs, Law on Corruption, Corruption Eradication Law, Anti-Monopoly Law and many other laws. This clearly changed everything, because with regulations in place, it would take more time.

The Government created a Financial Service Policy Committee with the responsibility for overseeing the establishment of Indonesian Banking Restructuring Agency and promotion of SOE privatization or equitization. This has attracted the attention of ministries, branches also as from the private sector. However, the challenge remains with a large amount of outstanding debt placed under IBRA but which are external to SOEs. Banks needs to review these outstanding loans, and take responsibilities in monitoring such debt and non-performing loans for these private firms. In addition to privatization and equitization of SOEs, the issue of private debt also needed to be addressed.

4. The Jakarta Initiative Task Force (JITF)

The JITF was launched to carry out the restructuring of private debt. This was a programme supported by the World Bank and has been one of the World Bank most successful programmes in Indonesia. JITF was able to address the restructuring of Indonesian state-owned banks and was a great effort in that period. The organization structure was defined by Presidential decree no. 17/1999. On top, the President holds the most important power, while IBRA is established below in the organizational structure; this is sign of a good governance system. The President was responsible for enacting the laws, decrees and resolutions, while IBRA was responsible to address debt issues. At that time, IBRA President was even more powerful than the Minister of Justice. Of course, there were in place an Oversight Committee, and supervising bodies from the World Bank and the IMF. A dedicated Ministry was also established, the Ministry of SOEs, in addition to IBRA, and the Jakarta Initiative Task Force (JITF) was built together with many other initiatives.

5. SOE restructuring in Indonesia

Due to the fiscal pressures, Indonesia conducted the equitization of SOEs and the Ministry of SOE received approval from the National Assembly. Budget revenues were limited, as were mainly drawn from the IMF loans. We lost market confidence and we needed to take important steps to restore that confidence. Donors and financial institutions, such as the IMF, World Bank or ADB provided support and committments through bilateral agreements to support our process of re-establishing market confidence which consisted of a blanket guarantee which was initiated once State-owned banks were equitized and privatized.

Such a process requires a gradual implementation. It is also important to equitize or privatize at the right moment. When market value is too low, demand is weak, the amount of proceedings collected from equitization is also significantly reduced. And there were many other challenges due to the loss of market confidence. In my experience of being Minister of SOEs, at some point, my trips visiting the CEOs of international companies around the world was so difficult because it became as if an answering machine was set up with "please press 0 if dialing from Singapore, please hang up if dialing from Indonesia."

It is important to stay determined in attracting investors. At that time, Indonesia almost disappeared from the radar of international investors. A blue chip company was selected, whose despite the low price of that moment, it was still set to be sold. The sales program was able to attract attention from investors who started to get curious of the changing situation in Indonesia, and so interest led to participation. Indonesia was able to step by step to sell the companies, and at good prices indeed. This has been a good strategy implemented by Indonesian government to re-establish Indonesia's position on the radar of investors and gaining back their interest. As Minister of SOEs, I was often criticized for selling such companies at that very specific moment, but choosing the right companies to sell on the market also requires careful selection and choosing the right timing. For BCA, an important large bank of Indonesia, important international investors were invited to Indonesia. Internal discussions with the government on how to attract large international investors and banks such as Standard Chartered Bank, Bank of Holland and other banks. The participation of these important banks raise interest in the sales program and automatically other investors were drawn to the sale. Thus, it is never too late to sell, but it is very important to create the right incentives to attract "early bird" investors.

What is also equally important is defining the book and market value of SOEs. While banks - investors - come with very low offers of only 1/10 of market value, such offer should be considered as early positive signs.

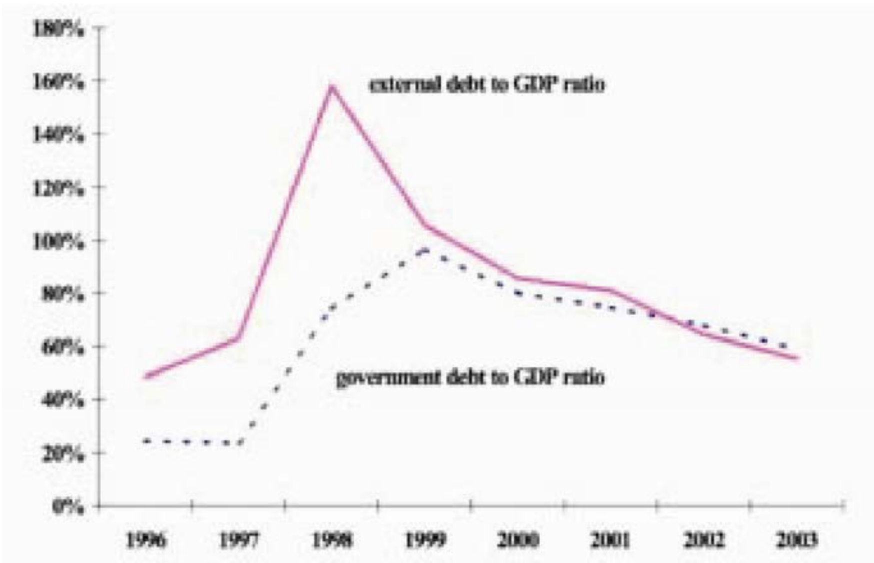
Next, to jumpstart the market confidence, promoting good governance and ensuring a check and balance system through the creation of an Oversight Committee and an Corruption Eradication Committee, Ombdusman and transparency committees is of utmost importance.

The fight against corruption is very important. The law enforcement authorities of Indonesia have arrested and sent to jail several former ministers and former senior government officials for corruption in their mandate. This has conveyed a very clear message by the Indonesian government on its fight against corruption in order to protect and ensure good governance.

6. Progress and achievements

At the begininning of 2010, the situation was much improved: Indonesia was now able to develop a monetary and foreign exchange rate, control inflation and restore market confidence and this has led to a slowdown in private capital outflows and a recovery in private capital inflows. With these impressive achievements, investors started to return to Indonesia and the Indonesian economy was back to its growth trajectory. The debt to GDP ratio was improved and the IMF blanket gurarantee was removed. Many State-owned firms and banks were privatized.

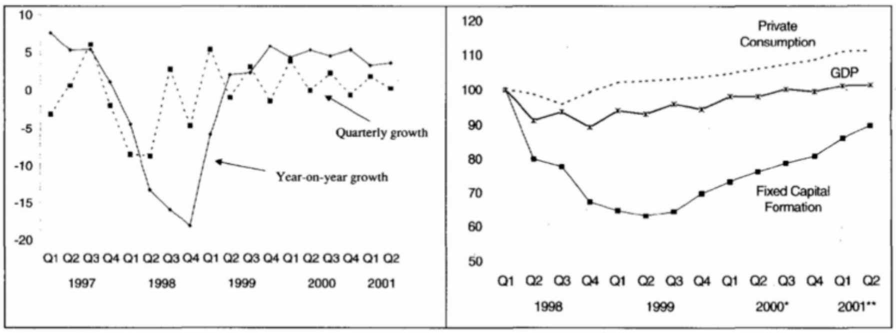
***Figure 2:* Government and external debt as a share of GDP (%/GDP)**



Source: BPS, Bank Indonesia, MOF, staff calculation.

One of the very important missions of IBRA was to establish a deposit guarantee agency for Indonesian people. Indonesia was no longer dependent to the IMF support and was able to build up policies in the "post-IMF" era..

Figure 3: **Positive GDP growth driven by domestic demand**



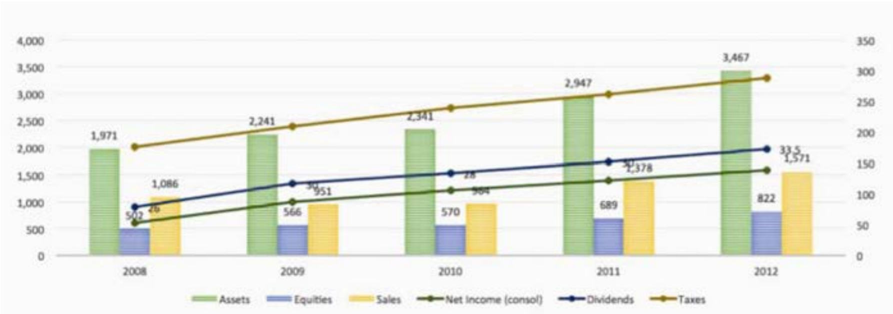
Source: CBS

7. Lessons drawn

A strong legal framework to support the reform of SOEs is required, including regulations on State management, capital market regulations, Law on Enterprises, Law on SOEs, etc. SOEs were governed by the Law on Enterprises, until the Parliament approved a more appropriate and detailed legal framework which was the Law on SOEs, which lay out a very solid framework for Indonesia to start the process of privatization and equitization of SOEs. This law specifies all aspects related to the management of SOEs.

Once again, it should be emphasized that good governance is key, as there are multiple actors, including ministries and branches, participating to the SOE reforms. Therefore, with more than one host ministry participating to the process, it is important that rules, responsibilities and powers of different parties are clearly laid out, ie. which ministry shall be responsbile for the restructring or reform of a maritime SOE? For the banking sector, the Law on Enterprises have clearly set out all regulations. It is important that there is clear division of reponsibility and authority of government agencies, executors and supervisors. Next, good governance requires the creation of committees as mentioned above, such as the Committee for Privatization which was established by Presidential decree. Setting in place a check and balance system, as stated in the Law on Enterprises, such as the establishment of independent audit firms, or a privatization or equitization committees. A candidate to the management board or Committee on SOE Equitization cannot be employ in any SOEs and members of these committees will rotate rather than staying permanent in one single committee. Regarding the reform of firms in the banking system, a person who violates the Law on Enterprises cannot hold managing positions in any banks. Indonesia established the Ministry of SOEs, representing the Government as stakeholder in SOEs with 60% share, and therefore holds voting rights and participation rights to the Board of Directors meetings. The role of the Government as stakeholder of SOEs is now clear. The Ministry of SOEs acts as proxy for the governemnt and has its own voice, despite not being the only decisive voice in M&A, transfer or sale decisions. If a company merger is beneficial, then the Ministry of SOEs will revise the structure to sell the company. In such case, the Ministry only acts as a normal stakeholder in an SOE, without any decisive power with regard to the company assets. Such a reform contributed to the collection of tax, capitaliation, and profitability. SOEs that became privatized or equitized companies are now very successful and able to compete on open market. These are results of good corporate governance. Some SOEs operate via contract with the Government to provide public services such as transportation, subsidies to fertilizers; these are all responsibilties of SOEs but these SOEs will have to operate on a more transparent basis: how much profit, how much costs, all of which are regulated by the Law on SOEs.

Figure 4: **Performance of SOE 2008 - 2012**



Regarding the ownership of SOEs: In some SOEs, the State accounts for some 51% or 60% of ownership. With the reduction of State ownership, benefits even increased. The contribution to GDP has been stable and even increasing. Profits continued to rise despite the SOEs have been privatized or not. For example, 20 of the SOEs are now listed companies and some are no longer State-owned because they have been fully privatized. These 20 firms contribute to 26% of the market capitalization and only accounts for 4% of companies listed on the stock market. BCA has now a market capitalization of 27 billion and joined the list of 200 largest global enterprises. Papa Mina is also ranked in the list of top 500 companies by Forbes magazine. All banks privatized under IBRA such as Danamon, Negara, etc... Privatized firms all have their market prices increased.

Figure 5: **Market value of Indonesian privatized banks**

III. ENHANCING INTERNATIONAL COMPETITIVENESS: INDUSTRIAL, AGRICULTURE AND RURAL DEVELOPMEMT

Short biography of Richard F. Doner, Emory University

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ECONOMIC REFORM FOR INCLUSIVE AND SUSTAINED DEVELOPMET: EXPERIENCES FROM SOUTHEAST ASIA[1]

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1. Introduction

Vietnam's impressive record of economic growth and poverty alleviation since the initiation of *doi moi* some three decades ago has resulted in new challenges. As the country has only recently surpassed the national income level of $1,000 and thus moved from low- to lower-middle-income status, its leaders are now facing the tough job of sustaining growth and making it more equitable. Analysts are already warning that failure to undertake further

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1. The paper has benefited from comments by participants during presentations to the Conference on Economic Reform for Inclusive and Sustainable Growth: International Experience and Lessons for Vietnam, Hanoi, March 25, 2014, and to the Vietnam Academy of Social Sciences, March 26, 2014; and from discussion with Prof. Eddy Malesky. The paper also draws on "Quality Infrastructure and the Middle-Income Trap: Preliminary Analysis and Research Proposal" paper presented for the International Workshop on the "'Middle Income Trap' in Southeast Asia," National Graduate Institute for Policy Studies (GRIPS), Tokyo, March 28, 2014; and on Doner and Ricks (2013).

reforms may lead the country to "encounter the early appearance of a middle-income trap" (Tran 2013: 29). [1]

The fact that development in one stage leads to new challenges should not be a surprise. Analysts have recognized that even successful countries typically "grow into trouble" (Temple 2003), and that policies and institutions appropriate for one level of development are often insufficient for the next. This is not to deny the timeless value of certain core principles, such as the necessity of competitive pressures on enterprises and the role of human capital. But experience has demonstrated the necessity of going beyond generic prescriptions to specify the kinds of policies required for different development objectives.

Writings on the middle-income trap often go one step further by warning that different goals and policies themselves require new and different institutions. But they provide little sense of what makes an effective institution; even more critically, they are usually silent on the difficulties of creating effective institutions. And yet we know that while institutions are central to the development process, effective institutions do not simply emerge because they are in principal needed, i.e. because rational actors create institutions to capture gains from grade. Creating effective institutions is itself a tough job - a collective action problem typically requiring long time horizons and significant resources (Bates 1995).

Drawing on empirical material from elsewhere in Southeast Asia, this paper explores the challenges of crafting effective

1. There are, of course, a number of views on operationalizing the middle-income trap. These include: national per capita GDP as % of the U.S. remains at 20-55% over 50 years, or for 28 years or more. By the former measure, only 13 of the 101 countries achieving middle-income status by 1960 achieved high income by 2008 (see Palanivel 2014, p. 3). Vietnam's per capita GDP rose from XX in to

institutions facing Vietnam. The next section (II) provides a general framework for analyzing development policy and institutional challenges. Drawing on this framework, Section III outlines the challenges facing Vietnam through the comparative lens of the middle-income trap and addresses the question: Why is a full-blown middle-income trap, or a potential one, as is the case for Vietnam, a *trap*? What, in principle, are the obstacles to continued and more inclusive growth? Section IV applies this framework to challenges and opportunities in rubber, a product for which Vietnam has become one of the world's largest producers and exporters. Specifically, the paper briefly reviews key features of Malaysian and Thai efforts to upgrade the production of natural rubber and rubber products. The hope is that lessons from these two countries can help move Vietnam's rubber industry toward more sustained and inclusive growth. Section V summarizes key findings and proposes further research on a particular institution important for upgrading local enterprises: public testing and research centers.

2. Development Challenges, Institutional Capacities, and Institutional Creation

Development Challenges: It is now generally accepted that "development" is composed of many different policy tasks that often differ from each other with regard to the difficulties of accomplishing them. Drawing from various scholars, we can identify five dimensions through which to assess the difficulty of development or reform tasks (Table 1). [1]

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1. See for example Naim (1994); Nelson (1999); Pritchett and Woolcock (2004); Grindle (2004); Doner (2009); and especially Doner and Ricks (2013).

Table 1: **Policy Task Typology**

	Number of Policy Participants	Time length of Implementation	Information Requirements	Distributional Consequences	Visibility
Easier	Few	Short	Non-technical. Non-site-specific.	Costs borne by many, benefits enjoyed by few. Costs felt immediately, benefits more slowly	High
More Difficult	Many	Long	Technical. Site-specific.	Costs borne by few, benefits enjoyed by many. Costs felt more slowly, benefits immeidately	Low

Number of participants required: How many actors - such as government agencies, party branches, or practitioners - are required to implement a policy? Smaller groups are better able to share information and coordinate their activities. As the group grows larger, the problem moves beyond simple coordination to one that requires significant institutional capacity. Other things being equal, the more complex the implementation chain and the more actors required, the more difficult the task.

Length of time for implementation: If a policy can be implemented overnight or within a few days, then debate about the policy is moot. But if a policy takes many months or even years to implement, debate may be renewed each budget cycle and obstacles become annual; policy "champions" may have retired or been removed as a result of policy shifts; funds may no longer bed available; and the importance of the policy may have lessened in the face of new pressing questions and/or a weakening of the original pressure for the policy shift.

Informational requirements: How much technical knowledge is required to implement a policy? How much detailed information is required? How site-specific or time-specific is the knowledge required to carry out a policy? Other things being equal, the more technical, detailed and context-specific the information, the more difficult the task.

Distributional consequences: Who wins and who loses from different policies? How small is the group of winners? How broad is the group of losers? How quickly do winners gain and losers give up benefits? Following the logic of group size in collective action (Olson 1965), a policy is easier to implement if a relatively small group receives immediate benefits and a more diffuse group bears the costs over a longer period of time. Conversely, when the benefits of a new policy are spread widely through society but the costs are borne by a small group, policy promoters will likely face strong opposition to their efforts. For example, changing classroom teaching methods in order to enhance learning would primarily benefit children and parents. Teachers' unions, on the other hand, might suffer from stricter standards and would thus likely organize to oppose such changes. The political constraints of coalition size are fundamental to understanding the source of "political will" for any policy project or task.

Visibility: A highly visible policy change is very tangible, high profile, or both. Tangible tasks are composed with bricks and mortar that can serve as both a source of rents and a clear focus of constituent attention. Such reforms will thus be easier to implement. As Nelson (1999: 19) notes, "Most people are more impressed with a vigorous school-building program than with organizational changes to improve supervision or the introduction of national examinations to assess the performance of schools and teachers." In addition, visibility, such as the construction of a school building, makes it easier to monitor those implementing the project. In contrast, quality improvements such as changing classroom teaching practices, are much more difficult to monitor as they are invisible to the casual observer. Monitoring is, of course, an important component of institutional capacity.

Institutional Capacities: Formulating and implementing development policies are typically collective action problems. As such, they require institutions, and the more difficult the policy to implement, the greater the institutional capacity required. Such capacity has at least three core components:

Consultation: Effective institutions provide opportunities for ongoing exchanges among key actors. In doing so, it facilitates actors learning about each other's preferences with regard to goals and mechanisms for achieving those goals.

Credibility: Effective institutions facilitate actors' belief in each other's willingness and ability to comply with stated preferences and courses of action. Doing so requires credibility in terms of the capacity to provide rewards for compliance with decisions and to impose sanctions for failure to comply.

Monitoring: The enforcement of credible commitments presumes that parties to an agreement have access to information about each other's behavior, and such information requires monitoring. As Ostrom notes, "Without monitoring, there can be no credible commitment…" (1990:45).

Institutional Creation: The fact that institutional capacities vary across and within countries, as well as over time, suggests that effective institutions do not emerge simply because they are needed for development. *Variation in institutional capacities is, above all, a function of the pressures and opportunities facing political leaders*. Threats, whether immediate crises or longer-term dangers, combined with the ability to meet those threats, are key. Put differently, greater claims on resources due to external and domestic political threats, combined with fewer available resources to satisfy such claims, will push regimes to develop stronger institutions. What does all this mean for Vietnam as the country attempts to move from "simple" GDP growth to a process that is more inclusive and sustainable?

3. Vietnam's Development and Development Traps

Development Performance - Strengths and Weaknesses: Vietnam has enjoyed several decades of consistent growth, as well as significant success in reducing poverty and reaching millennium development goals.[1] However, GDP growth has slowed from 8.1% in 2002-2007 to 5.7% in 2008-2013 (VELP 2014: 2). In addition, inequality has worsened not only in terms of income but also measured by less equal access to education and health. The growth slowdown can be attributed in part to problems in the global economy. But equally important has been the nature of Vietnam's growth trajectory or, more specifically, the degree and nature of *structural changes*.

In principle, development involves a number of structural shifts:

from reliance on a small number of industries to a more diversified production structure

from rural to more urban concentrations of labor and productive activities

from agriculture to industry

from informal to informal labor

from less to more productive (skilled) labor

from lower- to higher-value added activities

1. GPD growth averaged around 7.% annually from 1990-2010, and poverty fell from around 70% of the population in the late 1980s to 10..6% in 2010 (Tran 2013: 27). Success has been recorded in employment generation, health, education and gender equality. Problems remain in HIV/AIDS, water and sanitation and environmental sustainability, and equality on urban-rural and ethnicity (VELP 2014: 1).

from fewer to more linkages among components of value chains

Vietnam has clearly done well with regard to the first three types of structural change, resulting in diversification, also known as *extensive growth*.[1] The economy has expanded into a number of new, globally competitive sectors, with exports as a percentage of GDP growing from 26% in 1960 to 70% in 2010 (Tran 2013: 27). This diversification has been largely limited to petroleum, natural resources and related products – food processing, rice, tea, coffee, rubber, wood and fishery products – and labor-intensive manufactures, including garments, footwear, and electronics.

Although impressive and a largely necessary stage, diversification is input-driven in the sense of being based largely on natural resources and on the mobilization of labor and capital. Although they have grown in number and expanded in production volume, Vietnam's new sectors exhibit weaknesses in productivity, linkages, and formality. Put differently, the country is weaker in *intensive growth.*

Overall *productivity* growth over the past 10 years appears to have contributed to less than a third of GDP growth in Vietnam, with the level and growth of productivity in agriculture the lowest in the ASEAN region. During 2003-13, productivity growth accounted for about only one third (29%) of GDP growth in Vietnam.[2]

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1. For a general discussion of extensive vs. intensive growth, see Imbs Wacziarg (2003), who argue that an economy's sectoral concentration falls, i.e. the economy becomes more diversified, roughly through middle-income levels, after which further development involves greater growth in fewer sectors. As applied to Vietnam, See VELP (2014:1). As applied to Thailand, see Doner (2009).

2. Vietnam's productivity growth was lower than that of China, India, Indonesia, Philippines and Thailand (50-55%). It also lagged historical experiences of industrialized economies, where TFP accounted for 50-75% (EIU online database, cited in Palanivel 2014). On agricultural productivity, see Nguyen Do Anh Tuan (2014).

The *linkage* problem has both upstream and downstream dimensions. Higher tech exports by multinationals are largely labor-intensive assembly operations which derive few of their (upstream) inputs from local producers. Natural resources sectors, for their part, often involve little if any downstream transformation into commodity-based manufactured goods. This weak development of the entire value chain results in lower levels of value added.

Finally, Vietnam's very large and growing percentage of *informal* workers - a process one study labels as "de-formalizing" (VELP 2014:1) - runs counter to the shift from informal to formal employment assumed to be characteristic of development.[1] Growing levels of informality often lead to a number of problems.[2] First, it can reinforce skill shortages. As informal jobs typically involve low capital investment and thus little productivity-enhancing equipment, college-educated workers miss out on the chance to gain skills and experience and as even the experienced see their skills deteriorate. Second, since informal workers are typically not committed to a particular firm, informality discourages employers from investment in training and thus fosters even greater reliance on low-skill activities. A third problem is the potential for the growth of subcontractors engaging in unethical business practices that trigger complaints from foreign clients and labor protests. A fourth problem is inequality. To the extent that informality discourages skills development, it reduces the supply of skilled labor and raises the skill premium, thus fostering income inequality in the labor market. And as is now well known, inequality tends to foster political instability, shorter growth

1. A 2010 study (Cling et al) claims that 82% of employment in Vietnam can be defined as informal. This includes not only those in the traditional informal economy, but also those self-employed in formal sectors, such as manufacturing, trade, construction and accommodations. See also Arnold (2013).
2. The following discussion draws from ILO (2012); Packard and Nguyen (2013, p. 54); and Doner (forthcoming 2014).

durations, weaker public goods provision, and populist demands for measures that do little to promote sustainable growth. Finally, high levels of informality, by virtue of the fact that informal workers often do not pay taxes, limit state capacity to provide public goods, such as education and training.

How does the framework presented in Section II help to account for Vietnam's successes *and* the challenges it confronts in promoting inclusive and sustainable development. A complete review of the policy shifts contributing to Vietnam's impressive growth since *doi moi* is neither necessary nor possible within the limits of this paper. The key point to note is that the initial stages involved reforms that are less difficult relative to the challenges now facing Vietnam.

Reforms for Extensive Development:

The central component of the reforms undertaken up to now has been *the reduction of barriers* to factor and product markets. The government has improved access to foreign exchange, reduced bureaucratic and legal obstacles to enterprise registration, improved access to agricultural markets and inputs for families (rather than cooperatives), and increased access to new sources of financing through liberalized FDI rules, and to global markets, through both increased FDI and WTO membership in 2007 (Perkins and Vu 2009).

Without minimizing the foresight required, obstacles to, and significance of these reforms, it is important to note that they are largely 1st generation reforms that are *relatively* easy (Table 2). That is, they were decided and implemented by a relatively few top decision makers acting "with the stroke of a pen." They came into effect fairly quickly and are relatively generic, i.e. they followed fairly clear templates that do not require those implementing to possess extensive technical or site-specific knowledge. They resulted in fairly visible consequences, such as the tangible growth in new firms, both Vietnamese and foreign, in employment, exports and foreign exchange earnings. Finally, they yielded significant gains without imposing equally significant costs. This distributional virtue seems to have reflected two factors: the reforms have been relatively *gradual*, a feature that seems to have been critical for allowing small firms the opportunity to build up experience and capital and thus avoid getting swamped by new market forces (Hayton 2011: 9); and the reforms did not significantly cut into the operations of powerful interests, especially the state enterprises / General Corporations.

Indeed, because the reforms since *doi moi* were enacted with great political sensitivity, they postponed a number of more difficult-to-implement measures. One, noted above, was state enterprise reform. Although the SOEs were transformed into General Corporations with the ostensible goal of functioning like Korean *chaebol,* they differ from the Korean enterprises in that they are public, not private; and further, even unlike their Chinese counterparts, they are under little if any pressure to export or to serve downstream exporters (Perkins and Vu 2009; Dapice et al. 2008, 47-48).

In addition, property rights in land for individual Vietnamese citizens, especially small farmers and firms, as opposed to large, especially foreign firms, remain inadequately specified due to the fact that "local governments may take back… land any time for reasons such as development of infrastructure, industrial parks or even golf courses." (Tran 2013: 27; Perkins and Vu 2009: 24). Third, Vietnam's physical infrastructure remains seriously undeveloped (Perkins and Vu 2009: 26). Fourth, the country's social infrastructure and related resources necessary for technology absorption and development are weak. Most critically, education, including in science and technology, is "in crisis" (Perkins and Vu 2009: 35).

Table 2: **Extensive vs. Intensive Development Tasks**

Development Policies	Number Policy Participants	Time length of Implementation	Information Requirements	Distributional Consequences	Visibility
Extensive - Easier: - Ease access to foreign exchange / financing - Easier enterprise registration -Ease access to agric. markets and inputs - Less state control over foreign trade	Few; most can be achieved by "stroke of a pen"	Relatively rapid	Low	Mostly winners, gains rapid. Some reduction of state control but minimal limitations on state enterprises	Fairly high
Intensive - More Difficult: Physical infrastructure (roads, electricity)	Moderate	Moderate	Low	Moderate-high: state vs. private? Inter-provincial conflicts[1]	High

1. Perkins and Vu 2009.

Property rights: land	Few-moderate; depends on decentralization	Rapid	Low-moderate	High	High
Education and technical training	Many	Long	High	Moderate-high; e.g. state loses control over universities[1]	Low
Agricultural extension	Many	Long	High	Low	Moderate
Testing centers	Many	Long	High	Low	Moderate
Research and development	Many	Long gestation periods	High	Lots of potential winners, but initially costly and specific returns uncertain; options for rent seeking	Low, at least initially

1. At least as of 2009, universities did not have autonomy to promote faculty professors (perkins and vu 2009: 36, fn 44).

The fact that two unfinished tasks - physical infrastructure and property rights in land - are critical for further extensive growth reminds us that Vietnam is still a low-income country requiring further development of factor and product markets (Tran 2013: 28). At the same time, the country's weakness in social infrastructure reflects the importance of implementing policies that will help Vietnam "make a smooth transition up the technology ladder and from dependence on the domestic market to reliance on exports not just in labor intensive sectors where it now clearly enjoys a comparative advantage world-wide, but in the more complex and higher technology sectors" (Perkins and Vu 2009: 8). Indeed, the consensus is that Vietnam, having shifted from subsistence economy into more diversified and export-oriented activities, now needs to move into more sophisticated and higher value-added activities (Palanivel 2014).

Reforms for Intensive Development: It is all fine and good to call for policy reforms that contribute to development characterized by more robust domestic linkages, higher value added, and greater innovation. But to be effective, such advocacy must be based on several considerations: the difficulties of policies contributing to more intensive growth; the institutional challenges involved; the risk of partial reform traps; and, relatedly, the importance of pressures on political leaders for further institutional development.

Difficulty of innovation and technology: Acknowledging the need for greater innovation and technology in Vietnam does not assume domestic farms and firms must come up with radical new innovations and inventions. We are speaking rather of the need to absorb, adapt, and disseminate knowledge and practices new not to the world but to the farms and firms themselves. But even the ability to move up the value chain by using existing technology is fraught with market imperfections and failures, such as long gestation periods subject to unpredictable and path-dependent learning processes, uncertain demand, lack of complementary inputs, and poaching of skilled personnel by competitors. As a result, competitive pressure from superior imports is rarely if ever sufficient to overcome such problems (Rodrik 2007, 107).

Addressing the challenges of enhancing firm and farm capabilities requires broader packages of incentives and support, including enhanced technical and vocational training, extension services, testing and standard services, as well as ongoing competitive pressures. Such packages pose difficulties well beyond the uncertainty and risks characterizing any new investments. They require going beyond a broad-brush, one-size-fits-all agenda to address specific policy reforms aimed at the particular challenges in specific countries, in particular sectors, at particular development stages.[1] As seen in Table 2, their information requirements are higher; they require the involvement of multiple parties in extended implementation chains; and they poses tough distributional challenges.

Institutional Strength: Responding to these policy challenges requires significant institutional strengths. The importance of this issue for Vietnam is reflected first of all in the call for "new reforms characterized by high-quality institutions" that include not just better property rights and corporate governance, but also more transparent policy and better quality of bureaucrats and technocrats (Tran 2013: 28). Indeed, it is not clear, at least to me, that reform until now has involved any widespread institutional reforms, especially in the areas of innovation and technology. But a further piece of evidence in support of the need for institutional strengthening is what seem to be pockets of institutional strength in agriculture, such as in rubber where, as discussed below, Vietnam's productivity levels have improved significantly.

Traps and Partial Reforms: Most writings by economists on the middle-income trap, whether full-fledged or, as in the Vietnam case, "precocious," call for new policies and capabilities. But to the extent that they speak of politics at all, they simply lament the lack of political will to make their sector or country more innovative

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1. The importance of selective interventions for the growth of the East Asian Newly Industrialized Countries is now widely recognized (e.g. Palanivel 2014; Rodrik 2007). The challenge is to ensure that such interventions are combined with competitive pressure.

(e.g. Somchai 2012: 16). In fact, drawing on political economy writings, we can identify factors that undermine the will and capacity to undertake new policies and to build new institutions. One is a *success trap.* This is a situation in which initial policy reforms lead to growth that essentially takes the pressure off political leaders to undertake subsequent reforms. A second is a *partial equilibrium trap* in which groups that gain from initial reforms block subsequent changes that can undermine their previous gains (Hellman 1998).

A third is what might be labeled a *disarticulation trap*. Here the focus is on fragmentation of interests and institutions, often resulting from initial reform and growth - especially export growth, which impedes subsequent shifts. In terms of interests, one often sees fragmentation

* between domestic firms on the one hand, and multinationals, including their suppliers, on the other

* among different segments of value chains (up-, mid- and downstream segments)

* between formal and informal workers

This fragmentation has important, negative consequences for the provision of goods and services necessary for further growth. For example, MNCs, especially as they engage in "group offshoring" and thus without strong linkages to domestic firms, can provide whatever training they need in-house and thus have little interest in contributing to public or even sectoral education and training. The existence of a large informal workforce reduces a state's fiscal capacity and thus its ability to finance needed public goods.

Interest disarticulation contributes to institutional fragmentation. Without any great stake in the provision of public or sectoral goods, MNCs largely abstain from active participation in local business associations, thus undermining a key voice for broader shifts. Similarly, high levels of informality preclude the possibility of a cohesive, encompassing voice for labor able to engage in productive consultation on issues regarding productivity and benefits. And finally, the lack of linkages within value chains tends to translate into a state bureaucracy in which agencies promoting exports are disassociated from those allegedly promoting higher value added and technological upgrading.

Pressures on Leaders: Given the obstacles to reform noted above, what would induce political leaders to undertake the kinds of institutional strengthening needed for further changes? Answering this question requires identifying pressures and opportunities facing leaders. More specifically, threats, whether immediate crises or longer-term dangers, combined with the ability to meet those threats, are key. Other things being equal, leaders will support reform when they face claims on resources due to external dangers and domestic "contentious politics," combined with fewer available resources to satisfy such claims, will push regimes to develop stronger institutions.

To be sure, this argument does not explain all of Vietnam's reform performance.[1] Explaining Vietnam's reform initiatives requires acknowledging a sort of reform spillover in that the impact of earlier changes contributed to reform through the 1990s: the incremental retreat from collectivization, the expansion of private plots, and the emergence of a contract system built on early, less-noticed moves to private plots in the north (Kerkvliet 2005).

Nevertheless, looming crises and the threat of significant losses, or the absence of such pressure, constituted the core driver for policy change. Vietnam's shift from a command economy to initial reforms in the early 1980s was clearly a response to various threats regarding food shortages, concerns over aid, a trade embargo, and Khmer Rouge raids. The subsequent shift to *doi moi* in the mid-1980s was moderate and incremental. This reflected the

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1. Unless noted, this discussion draws on Doner (forthcoming 2014). Note that the focus here is on motivations for, rather than modalities or mechanisms of reform. On gerrymandering as a mechanism for SOE reform, see Malesky (2008).

achievements of initial reforms, along with generous Soviet support. Intensification of *doi moi* in the late 1980s occurred only with the collapse of the Soviet Union and loss of broader socialist support. The resulting loss of access to cheap inputs for agriculture and the SOEs exacerbated internal economic problems, such as inflation. These pressures pushed the leadership not only to undertake significant policy changes, but also to initiate complementary institutional reforms, ranging from moderate shifts in property rights to support for business associations.[1]

These same incremental steps also contributed to a *weakening* of reform efforts. Greater autonomy without state support for technology-related investments led the General Corporations to pursue noncore activities, to rely on credit and protection, and to avoid "the more uncertain task of technological upgrading and becoming internationally competitive" (Beresford 2008, 232, 227-228).

But underlying the lack of government pressure for better performance was the fact that earlier urgency was replaced by "a sense of complacency and satisfaction with the status quo" (Dapice et al. 2008, 2). In addition to the success of prior reform efforts, this satisfaction was a function of the relatively moderate pressures facing Vietnam up to 2008. Owing to an earlier "minicrisis" in 1996, Vietnam avoided some of the worse impacts of the Asian crisis by its imposition of controls over trade, investment, and financial flows (Leung and Riedel 2001, 19). More recently, it has not suffered from significant foreign exchange shortages. Despite the country's significant fiscal and trade deficits noted above, foreign exchange has been financed by large capital inflows, which rose from US$9.4 billion in 2006 to US$15.7 billion in 2007, amounting to 15.4 percent and 22.7 percent of GDP (FETP 2008, 5).

1. Perkins and Vu (2009: 2) note that early initiatives at hard budget constraints in late 1980s were motivated by need to control inflation, not to improve industrial enterprise performance. The constraints were relaxed as inflation ceased to be a problem.

Vietnam has also benefited from high prices for its commodity exports—crude oil, marine products, rice, coffee, rubber—which dominate its list of largest export earners. Finally, Vietnam seems not tohave made use of WTO accession to impose greater discipline on domestic firms, as was the case for China (Noble et al 2005; Perkins and Vu 2009).

This section has put forward three general arguments. First, policy reforms designed to move firms, sectors and countries beyond extensive growth to more intensive, knowledge-based development involving domestic linkages and higher value added are more difficult to implement than earlier, first-generation reforms. Second, implementing difficult policy shifts to enhance local capabilities requires institutions capable of extensive consultation among key actors, more credibility, and effective monitoring. Finally, as reflected in the Vietnamese case, undertaking reforms and building effective institutions requires that political leaders feel significant pressures to do so.

To further illustrate these points, the following section explores reforms in two of the world's leading rubber producers, Malaysia and Thailand.

4. Institutions and Pressures for Upgrading in Natural Rubber

Rubber in Vietnam

Vietnam's Impressive Performance: A focus on natural rubber (NR) is useful because both its successes and looming challenges exemplify the broader issues inherent in Vietnam's efforts to achieve more inclusive and sustainable development. The country's achievements in natural rubber are truly impressive; indeed, a leading trade journal has called Vietnam's NR progress "astounding." On a purely quantitative level, the area under NR cultivation expanded from 190,000 hectares in 1985 to 740,000 in 2010; production rose from 52,500 metric tons to 750,000 metric tons; and exports jumped from 35,500 metric tons to 783,700 metric tons over the same period. [1] Equally impressive has been the industry's qualitative growth: By 2013, Vietnam's NR industry has overtaken India to occupy the #1 global position in NR productivity. All of this has resulted in Vietnam's moving to 3rd place in global NR production, following Thailand and Indonesia, with Malaysia #4.[2] Rubber has become Vietnam's third largest agricultural commodity export, behind rice and coffee (Tran 2009).

Institutions: Not surprisingly, this growth was in large part a function of state initiatives in both policy and institutions, including the Agricultural Diversification Project (1998-2006), the 2008 Feasibility for Rubber Smallholders, technical assistance to smallholders from the giant Vietnam Rubber Group and the Rubber Research Institute of Vietnam in areas of planting material, clones, and techniques (Tran 2009). Such support has become increasingly important as the role of smallholders relative to large state-owned or private plantations has risen from under 10% in 1985 to 47% of cultivated area in 2011(Tran 2009; "Astounding progress…").

The Challenges and Stakes of Upgrading: A key challenge now is to upgrade the NR industry. This refers not just to improving yields and related productivity features of NR cultivation, but also to increasing value added both in terms of developing new, more valuable types of NR and moving downstream by expanding the production of rubber-based manufactured goods, such as tires, autoparts, footwear, toys, and medical gloves. It is especially in processing NR as an intermediate input (midstream) and in rubber-based manufactures(downstream) that Vietnam has much to learn from Malaysia's successes and Thailand's difficulties. Development in these segments is necessary as even the most successful upstream producers are at risk from the ongoing price volatility of the global NR market (Figure 5). The political fallout from such price volatility were seen in large-scale protests by Thai farmers in the wake of price declines in late 2013 (Doner 2013).

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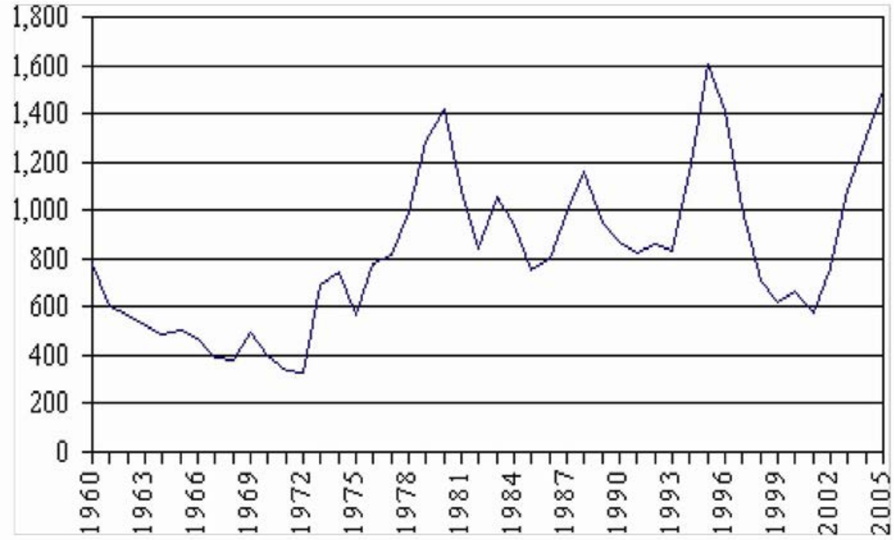
1. "Astounding progress in natural rubber output," Rubber Asia - Silver Jubilee Issue 2011: 251-252).
2. Rubber Asia (Jan-Feb. 2014: 119; March-April 2014: 120).

Figure 5: **Market Instability**

Rubber price, Singapore RSS 1 fobinbales, 1960-2005



Source: UNCTAD secretariat (Data UNCTAD Commodity Price Bulletin).

NR in Malaysia and Thailand - Comparative Performance:[1] Both of these countries are world leaders in NR, although they have excelled in different parts of the value chain. Thailand is the world's largest producer and exporter, having taken over from Malaysia in the mid-1980s. But Malaysia has been the leader in midstream and downstream segments.

Upstream: Thailand has been especially successful in the upstream sector: The country is the world's leading producer and exporter of NR, with production capacity of 3.1-3.2 million tons/year. Most of this production has occurred in the South, which accounts for around 11 million rai (2.7 million hectares) out of a total area of around 17 million rai, followed by the Northeast with 3

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1. Unless noted, this is a very abbreviated discussion drawn from Doner and Abonyi (2013).

million, the East with 2 million and the North with 600,000 rai. Two factors are especially important in explaining Thai upstream success, especially as Thailand began producing rubber some 20-30 years after Malaysia, the traditional leader. One is the country's impressive ability to improve yield. A second is Thailand's success in expanding production area into the Northeast and the North. Malaysia's NR output declined due in part to falling yields and in part to increasing land devoted to the cultivation of oil palm. The country is attempting to raise yields through innovations such as high-yielding clones, automated tapping systems, and low-intensity tapping.

Midstream: Malaysia has been the leader in a number of midstream activities, such as the creation of technically specified ("block") rubber, the development of rubber processing capital equipment, and the transformation of NR from a commodity to a "specialty polymer" through development of specialty, epoxidized natural rubber chemically modified to produce higher value added with significant environmental sustainability benefits. Thailand quickly copied Malaysia's block rubber innovation but has remained focused largely on the more traditional and more-difficult-to standardize smoked sheets. The Thais tend to rely on foreign-made capital inputs, and have invested little in specialized rubber products.

Downstream: Natural rubber is a key input into a number of important manufacturing sectors, ranging from tires, to hoses, to threads, to condoms and gloves. Thailand has performed well in a number of downstream areas. It is the world's number one producer of condoms, a very significant exporter of rubber gloves, and well ahead of Malaysia in tire exports. But Thailand lags Malaysia in some important areas. Malaysia leads not only in medical glove production but also in related technological innovations. It was Malaysian government researchers, working with local firms, who developed the product and process innovations needed to respond to protein allergies that threatened to destroy the industry. Based on these innovations, the country established a national label - the

"Standard Malaysian Glove" - that involves high standards for barrier protection and elements believed to cause allergic reactions. To the extent that such innovations have come to Thailand, they have often done so through Malaysian firms setting up operations in Thailand. Malaysia has also expanded its production of engineering applications for natural rubber, such as high-damping natural rubber bearings for the seismic protection of bridges and buildings. Malaysia's performance contrasts with Thailand's failure to promote rubber-based manufactures with significant potential, such as elastic and rubber bands, construction equipment, road materials, medical products, mattresses, toys, and tractor tires. And while Thailand is the world leader in condom production and produces large volumes of gloves, these are largely the work of multinationals,[1] whereas the indigenous Malaysian firms are the core of the country's dominant glove industry. The result is that rubber-related technology development has been a function not of multinationals but of initiatives by Malaysian firms and state agencies.

NR in Malaysia and Thailand - Institutions: The relative strengths of the two countries are reflected in the institutions that "govern" (i.e. coordinate) the rubber value chain. In Thailand's upstream segment, government agencies - such as the Office of Rubber Replanting Aid Fund (ORRAF), the Rubber Research Institute of Thailand, the Ministry of Agriculture and Cooperative's Agriculture Extension Services - helped smallholders (who account for the majority of Thai rubber production) with new, high-yielding clones, optimal planting techniques, fertilizer use, and marketing.[2]

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1. "The extent of technology transfer from foreign investors has …been limited. Research and development activities are few and there is a lack of laboratories equipment as well as manpower for product quality inspection…Dearth of R&D in rubber product industry. Labs necessary for R&D, product and raw material testing are still lacking…(The industry)...also suffers from lack of supporting industries." (Somsak 2009: Intro - 5).

2 During the industry's early development, Bridgestone also provided extension services to improve the quality of inputs to its tires.

Government agencies have also contributed to the industry's growth by sponsoring organizations, such as farmers' cooperatives and central markets, that have helped expand farmers' access to information and bargaining power, and have thus facilitated good margins and fair returns to farmers. Malaysia's earlier progress in NR cultivation and yield was due in large part to similar institutions. These included the Rubber Research Institute of Malaysia (RRIM), the Federal Land Development Authority (FELDA), the Rubber Industry Smallholders Development Authority (RISDA), and the Malaysian Rubber Development Corporation (MARDEC).

In midstream and upstream segments, Malaysia's superior performance reflects much stronger institutions than those found in Thailand. There is no effective, high-level oversight body for the Thai rubber industry, despite various "Master Plans" and calls for a National Rubber Authority or a Rubber Products Institute. Instead of a coherent lead agency, Thai rubber policy is managed by multiple and often competing. ministries. As one industry official noted, "Thailand is the only country with two rubber plans: One from the MOAC and one from the MOI." There are also are also multiple types of farmer cooperatives representing different rubber-related government agencies. And finally, there are coordination problems and differing interests within the private sector. Overall, the Thai Rubber Association, representing upstream interests is the most influential. Exporters are also active and influential. Neither of these two is especially focused on linkages with and upgrading of downstream rubber products firms. The politically weakest of the private sector associations, representing domestic Thai producers of rubber manufactured goods such as tires, is the group pushing the hardest for linkages and support for technology upgrading.

Malaysia's rubber-related institutions (i.e. "national innovation system") are much stronger.[1] A key player is the overall coordinating

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1. These institutions have, however, been weakened in the past few years due to personnel shifts, privatization of a key institution, challenges from new rivals, increased emphasis on palm oil, and the ageing of rubber farmers.

agency, the Malaysian Rubber Board, formerly the Rubber Research Institute of Malaysia. The Malaysia Rubber Development Corporation (MARDEC) worked closely with both the RRIM and various private sector entities.[1] Key players in the development of Malaysia's successful medical glove industry have been a public-private entity, the Malaysia Rubber Export Processing Council (MREPC), as well as a well-coordinated association of glove producers, the Malaysian Rubber Glove Manufacturers' Association (MARGMA). Finally, all of these agencies operate under or are in some way responsible to a powerful ministry that is fairly insulated from political manipulation: the Ministry of Plantation Industries and Commodities. This contrasts with Thailand's much more politicized Ministry of Agriculture and Cooperatives.

NR in Malaysia and Thailand - Political Pressures and Institutional Differences: The differences in performances and corresponding institutional strengths are a function *not* of some inherent Thai-Malay differences in culture or technological aptitude. They are instead the result of different pressures on political actors.

Thailand: Consider first the origins of Thailand's strengths in the upstream segments of NR - cultivation and marketing - represented by agencies such as ORRAF and other parts of the Ministry of Agriculture and Cooperatives. Natural rubber has historically been strategically important. The Thai government hoped that better rubber production would help to weaken widespread communist insurgency in the South. Also, global development institutions, such as the World Bank, wanted to ensure a stable, growing supply of rubber as an important raw material. Finally, the millions of smallholders (not large estates) who produce the majority of Thai rubber constitute a significant political force, especially when rubber prices fall, as was the case in the 2013 protests.

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1. For a superb description of a key institution, see J.C. Rao's (2013) study of MARDEC.

Given these upstream strengths, why would Thailand lag Malaysia in midstream and downstream segments? One factor is Thailand's ability to make effective use of Malaysia's innovations and investments. A second is the country's attractiveness as an investment site for foreign producers of downstream products such as tires, condoms and gloves. But perhaps the most important consideration is the robustness of Thailand's (upstream) NR production to China, the world's largest consumer of natural rubber. In sum, Thai leaders have been under little if any pressure for innovation and expansion by local midstream and downstream producers. Instead, as what one official labeled a "political crop," rubber policy in Thailand is sometimes the focus of conflicts among and within political parties.

Malaysia: The situation has been somewhat different in Malaysia. The country's initial moves to improve yields in the 1950s and 1960s reflected the fact that Malay rural smallholders have been key constituents of the United Malays National Organization (UMNO). Malaysia's development of technically specified ("block") rubber was a response to concerns that competition from synthetic rubber would wipe out Malaysia's NR production, especially in light of increasing demand for SR from the auto industry. This would not only have severely hurt Malay smallholders; it would also have destroyed a key source of Malaysia's foreign exchange earnings. Indeed, former Prime Minister Mahathir noted that in the 1960s and early 1970s, the government checked global NR prices before settling on its annual budget. And a senior Malaysia Rubber Board official stated that rubber and rubber product exports "saved us" after the 1997 Asian Financial Crisis.[1]

But Malaysia's development has generated new threats in rubber. As the economy has diversified, including an expansion of

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1. Mahathir comments were made during a speech at the International Rubber Technology and Economics Conference, Kuala Lumpur, October 10, 2013. MRB quote from author interview, Kuala Lumpur, July 27, 2010.

oil palm cultivation, Malaysia's own production of NR has fallen, thus threatening the key intermediate input for downstream producers, especially glove manufacturers. In the face of growing vulnerability, the government is thus under pressure to improve NR yield, to develop new, higher value added NR products, such as specialty rubbers, and to expand and deepen downstream, rubber-based manufactures.

5. Conclusions and Implications

This paper has argued that Vietnam needs not only to recognize the different kinds of difficulties posed by move inclusive and sustainable growth, but also to craft institutions with the capacities to address these challenges. But the paper has also argued that such institutional capacities typically emerge not simply because they are "needed" as efficient responses to market problems, but because leaders experience a combination of political or security pressures and the need to generate resources to address these pressures.

If the paper's framework has real value, it should prove useful in analyzing specific development challenges, policies and institutions. Given Vietnam's need to increase strengthen domestic linkages, to increase local value added, and to do so at high levels of efficiency, a key challenge is strengthening the technological capacity of local firms and workers. Cross-national experience suggests that public or sectoral *testing and research centers* constitute an important institutional mechanism for such development.[1] An in-depth analysis of such centers in Vietnam, especially in a sector such as rubber, where there are many opportunities for linkages with downstream industries, such as autoparts, toys, and footwear, would thus be a valuable contribution to the country's understanding of the challenges and opportunities it faces three decades after the launching of *doi moi.*

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1. On the significance of these centers and suggestions for research, see Doner (2014).

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Short Biography of Thangavel Palanivel, Chief Economist for Asia and the Pacific, United Nations Development Programme (UNDP)

Thangavel Palanivel is the Chief Economist for Asia and the Pacific, United Nations Development Programme (UNDP), New York. Before joining this position in March 2010, he was a Senior Advisor and Team Leader at the UNDP Asia-Pacific Regional Centre in Colombo, Sri Lanka, and at the Regional Programme in Kathmandu, Nepal and provided technical and policy advisory services to countries in Asia and the Pacific region on pro-poor economic policies, macroeconomic modelling and forecasting, economic shocks such food, fuel and financial crises, economic & poverty assessment, and formulation of national development plans/poverty reduction strategies. During 2002-10, he has also coordinated activities of the UNDP Asia-Pacific Regional Macroeconomics of Poverty Reduction and Regional MDG Initiative.

Prior to joining UNDP in 2002, he has worked at the United Nations University (Tokyo, Japan), University of Pennsylvania (Philadelphia, USA), and Institute of Economic Growth (Delhi, India) for several years. He holds a doctorate in Economics and has more than 20 years of research, programme management and policy advisory support experience. He has published three books and several research articles on development issues in journals and other publications.

AVOIDING THE MIDDLE INCOME TRAP: INTERNATIONAL EXPERIENCES AND LESSONS FOR VIET NAM

Dr. Thangavel Palanivel

UNDP Chief Economist for Asia and the Pacific

1. The concept of Middle income trap

Concept

The term ‘middle income trap’ refers to countries which transformed themselves from low-income into middle income status and then unable to move into high-income status within a reasonable period of time. In the past 4-5 years, the term became very popular and there have been many research conducted by economists from the World Bank and other institutions which focused on the context of apparent growth slowdowns in many Asian economies, such as Malaysia, India, etc.

How governments respond to a rapid slowdown will depend on its causes. One cause could be a macroeconomic shock - e.g., the 2008 global economic crisis; another could be structural in nature, i.e., the so-called middle income trap (MIT).

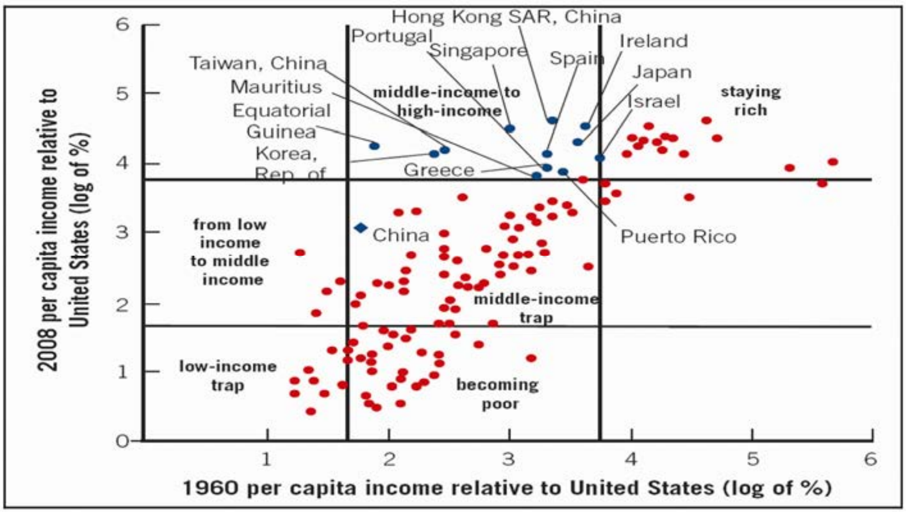
How to identify whether a particular country is in or not in the middle-income trap

Some scholars (e.g., Woo 2012) define that a country is trapped in the middle income group if its per capita income as a ratio of the

US per capita income remains at the level of 20-55% over a 50 years period. Some others (e.g., Filipe et al.) determine that a country is in the lower-middle-income trap if it has been in that group for 28 years or more. Similarly they define that a country is in the upper-middle-income trap if it has been in this income group for 14 years or longer.

Some 50 years ago, there were 101 middle-income economies, but in 2008, only 13 escaped the middle-income trap to become high income. Accordingg to the WB, countries as Israel, Portugal, and Spain graduated from middle to high-income status. Similarly, some Asian economies such as Hong Kong, Singapore, Japan, and Korea were also able to do the same. However, ADB has a slightly different definition, what matters is how these economies have caught up the high income level of the United States in the past 60 years. Some countries demonstrated an impressive catch-up, however, most countries still fall behind the US income level. Latin American countries have been declining since the 1960s.

Figure 1: **Countries per capita income in 2008**

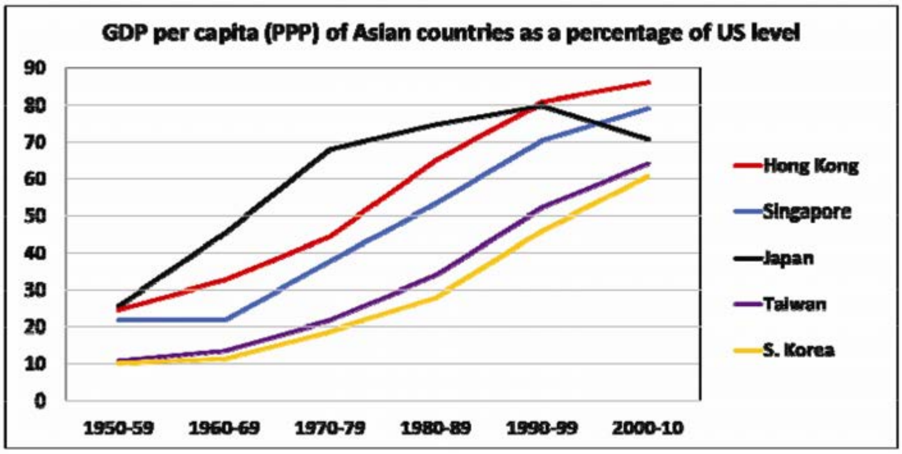


Source: World Bank.

2. Common features of five Asian economies that successfully escaped from the trap

Five Asian economies almost caught up with the income level of the US include the Singapore, Japan, Korea, Hong Kong, and therefore, have successfully escaped the middle-income trap.

Figure 2: **Income per capita of top 5 Asian economies**



Sources: The First Update of the Maddison Project database.

Common features of economies that escaped from the middle income trap

• The first common feature of economies that escaped from the MIT such as Japan, South Korea, and Taiwan (China) was the rapid & sustained growth with equitable income distribution between 1960 and 1990.

• A second common characteristic was the strong exports push through selective interventions such as export credit and duty-free capital goods import for exports which resulted in high export growth.

- A third common feature was a dynamic agriculture and rural development (in an initial period) which supported the industrialization process.

- A fourth common characteristic was a strong emphasis on education. Historically, only some non-Western economies such as Japan, Korea, Taiwan, and Singapore established policies and institutions to encourage (or even force) skills, technology and knowledge.

- Fifth, experiences of the Asian Tigers also suggest that escaping the middle-income trap is a function of structural transformation through diversification into a greater number of products, as well as movement into higher value-added products over time in a gradual and sequencing manner.

- Sixth, these economies also had rapid demographic transition resulting in the 'demographic dividends' - declining dependency ratio, large working age population, and high level of domestic savings and investment rates.

- Productivity growth also played a key role in Asian Tiger economies. While high domestic investment (over 20% of GDP) and a rapidly growing skilled labour force accounted for 2/3 of the growth, productivity accounted for the remaining one third of economic growth.

- Finally the effective but somewhat authoritarian and technocratic elite ensured macroeconomic stability, intervened in capital allocation, and managed complex & flexible labour market policies.

Table 1: **Levels of inequality are generally low in the economies that escaped from the middle income trap**

Economies that escaped from MIT		**Economies currently not in the MIT**	
Countries	Gini coefficient	Countries	Gini coefficient
Austria	26.0	Bulgaria	28.7
Belgium	33.0	China	42.4
Denmark	24.0	Hungary	29.3
Finland	27.0	India	33.6
Greece	34.0	Indonesia	34.3
Ireland	34.0	Mozambique	46.4
Israel	39.0	Pakistan	31.1
Italy	36.0	Poland	34.2
Japan	24.9	Sri Lanka	39.2
South Korea	32.0	Viet Nam	36.0
Norway	26.0		
Portugal	38.0		
Spain	35.0		
Sweden	25.0		
Average	**31.0**	**Average**	**35.5**

Moreover, effective State administration also plays a very important role. These are 8 common features characterizing these economies, but due to research limits, we have only focused on present available data.

In countries trapped in MIT, their GINI coefficient is approximately 48-50. The GINI coefficient in these countries are relatively high, and for some, even higher than 20 years ago. While among the four countries that escaped MIT, in addition to some European countries, there is also Korea, with a GINI coefficient relatively lower. Similarly, countries as India and China do not seem to have fallen into the MIT and show a relatively low GINI coefficient.

Structural transformation is key in catching up. There are four stages of structural transformation, and most countries are in the second or third stage. For example, Vietnam is in the second stage, therefore will need to move up to the third stage in the next 10 years in order to sustain growth. Some indicators worth mentioning include the share of technology exports in the total manufactured exports. Singapore, Hong Kong have relatively higher share of high-technology exports (50%), or Korea (approximately 30%). Latin American countries mainly export commodities based on their abundant natural resources with low technology content.

Next is the level of investment in R&D. This is extremely important in guiding the structural transformation of the economy. Economies that are in the MIT do not invest much in R&D, for example, Latin American countries invest very little in R&D - less than 0.5% of GDP, while other countries invest more than 1% GDP for R&D activities.

In terms of government administration, some economies have inadequate public governance, high level of corruption.

3. Is the recent economic slowdown in Asia due to such trap - structural (not cyclical) factors?

Strong growth in Asia in the past decade was the result of the first generation of reforms such as trade liberalization, financial liberalization and privatization. Growth in many Asia Pacific economies has slowed down considerably in the past 5-6 years. Not only China, India, but other countries as Vietnam also experienced declining growth. Growth declined by 2-3 percentage points compared to the previous 9-10% growth rate. These countries have lost their demographic opportunity. Most of the decline in GDP growth rate in Asia seems to be due to a decline in productivity growth. Compared to the period before and after the global financial crisis, from 2002 to 2007 and from 2008 to 2013, many countries as China, India, and Thailand all displayed declining total productivity growth. Other factors also contribute to the decreasing GDP in these economies. Another important aspect is that sustainable development requires that part of productivity growth to contribute human capital investments. Many countries as China, India and other countries in the region as Malaysia, when compared to countries as Brazil or South African countries, have relatively low public investment for education. However, there also exist many inconsistencies related to public investment efficiency and productivity in education.

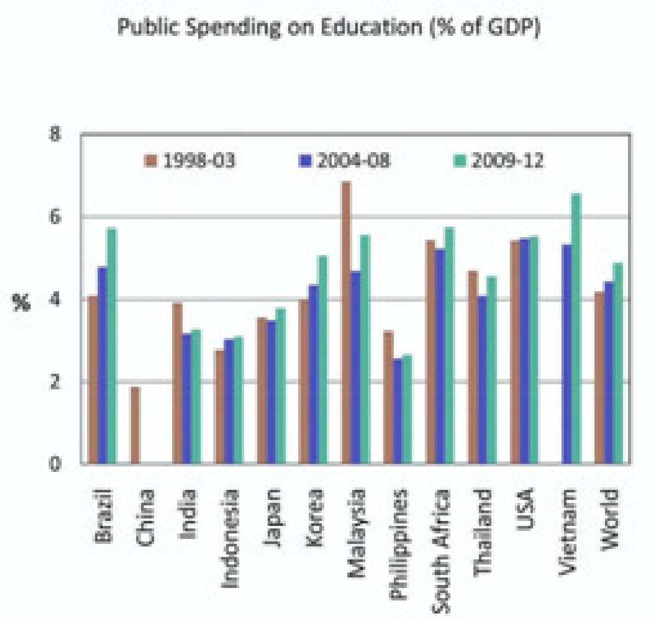
Promoting productivity through increasing investment in human capital and innovation is the way forward. However, a second generation of institutional reforms did not occur which might increase competition and foster innovation.

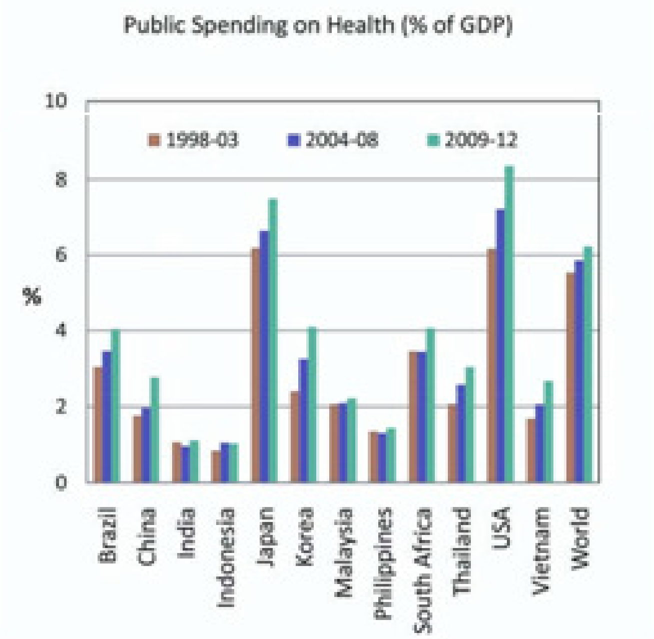
Some of the key dynamics (such as ‘exports-led growth’ and ‘demographic dividends’) which have supported Asia's rise well so far are now evolving and might undermine its future growth. Growth in developing Asia has slowed down considerably in the recent years. Asia is likely to settle at about 5-7 % in the medium term compared to 8-10 % before the crisis. Structural transformation is a key for catching-up/ avoiding the MIT.

Table 2: **Four structural transformations**

Stage	**Product specialization**	**Growth driver**	**Development outcomes**
1	Primary Products	Abundant land and cheap labor	Low income trap
2	Labor Intensive simple Manufacturing	Low Cost Labor led simple manufacturing products/exports	This will enable countries to graduate from low into lower MIC group
3	Hi Tech Manufactures	Capital Intensive and productivity led technically sophisticated products/exports	This will enable countries to graduate from lower MIC into upper MIC group
3	Services (high level)	Innovation led knowledge based economy	This will enable countries to graduate from upper MIC group into high income group

Figure 3: **Investment on human capital in Asian emerging economies**





4. Lessons for Vietnam

Vietnam successfully moved up to achieve the middle-income status few years ago. According to ADB, it usually takes 40-42 years for a country to escape the MIT. As a consequence, since Vietnam only recently joined the middle-income rank, there is no need to worry too much. However, without a clear orientation and early plannning, avoiding the MIT in the future may become much more difficult later on. Here, Viet Nam has successfully shifted from a subsistence economy into diversified manufacturing. After 10-15 years, how can Vietnam switch to higher value services? This is a prospect that requires careful thoughts.

In the last two decades Viet Nam has achieved significant structural transformation. It is the right time for the country to make further structural upgradation into the sophisticated manufacturing and high value services. Innovation-conducive policy framework and business environment is key in this regard.

Secondly, initial analysis shows that the increase in productivity seems to be much lower than neighboring countries such as Thailand, China, etc. During 2003-13, productivity growth appears to account for about only one third (29%) of GDP growth in Viet Nam. This is lower than that of China, India, Indonesia, Philippines and Thailand (50-55%).Viet Nam needs therefore to enhance its productivity levels.

Third, unlike the past, strong export-push will be difficult now under WTO system; however, it is still promising for countries like Viet Nam. Regional integration with other countries as ASEAN+ China, India - middle-income countries, represents great opportunities if Viet Nam is able to integrate to higher value added components in the value chain. Countries as Japan, Korea, Singapore have relatively flexible economies that Vietnam may consider learning from. FDI will help Viet Nam to get technology transfer, capital goods import, foreign training, etc. Economic integration and the ASEAN Economic Community respresents an opportunity in terms of new markets, raising productivity growth, and technological upgradation. Japan in the 1950-60s and Asian Tigers in the 1970-80s all adapted sector-specific industrial policies. Careful selective interventions may be considered; a flexible labor market policy that focuses on job creation and an appropriate minimum wage fixation .

Viet Nam also needs to consider reforms to upgrade its human capital base. It needs to focus on the quality of education and increase innovation. In this context, policies and institutions must be established to encourage skills, technology and knowledge. Viet Nam has made large investments in resources for education. However, the quality of education is an aspect that requires further attention, especially in the higher education system to promote innovation and competition. This is a foundation that requires us to reflect on which policies to implement that can support innovation and reforms.

Economic growth is recently accompanied by a widening inequality and rising emissions in Viet Nam. In this regard, it is critical that Viet Nam look into the development model of countries like South Korea in moving towards an inclusive and green development path. Despite the fact that inequality in Viet Nam is yet not too high, however, it is important to promote productivity in agriculture or flexible rural development. Finally, as Viet Nam strongly integrates itself with the world, it also needs to focus on its resilience capacity.

Short biography of Dr. Nguyen Do Anh Tuan, Institute of Policy and Strategy of Agriculture and Rural Development (IPSARD)

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Employment record: (i) 9/2013 - present: Vice Director General, Institute of Policy and Strategy of Agriculture and Rural Development (IPSARD); (ii) Jan 2011 to Sep 2013: Director, Center for Agricultural Policy (CAP) of Institute of Policy and Strategy of Agriculture and Rural Development (IPSARD); (iii) 2006 - 2010: Researcher, IPSARD…

AGRICULTURE AND RURAL DEVELOPMENT IN VIETNAM: VISION AND ACTION

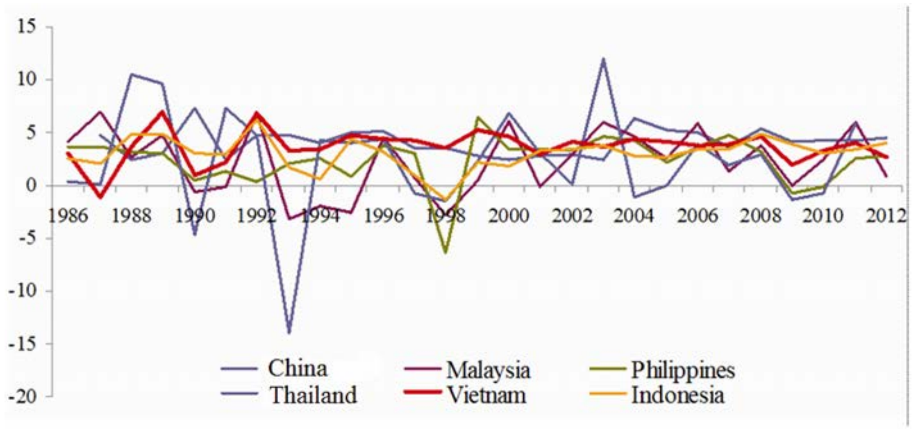
Dr. Nguyen Do Anh Tuan

Institute of Policy and Strategy for Agriculture and Rural development (IPSARD)

1. Review of agricultural development in Viet Nam

In the past, agriculture has long been considered the pedestal of the Vietnamese economy. If compared to other countries, Viet Nam experienced quite a stable agricultural growth. Vietnamese agriculture contributes to the maintaining of macroeconomic stability, especially by creating food at low price, ensuring low inflation also as ensuring that wages are maintained low in order to attract private domestic and foreign investments.

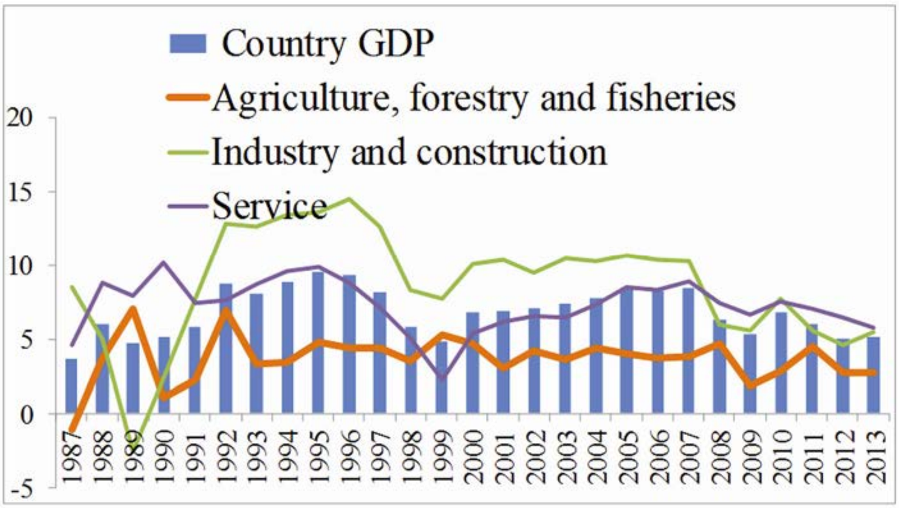
Figure 1: **Constant and Stable Agricultural Growth**



Source: ADB, 2013.

According to these figures, each time the economy declines, agriculture provides some stimulus so that the economy can rebounce, especially the agricultural stimulus in the initial period of *Doi Moi,* when subsidies under the socialist regime were removed and industrial services were declining, we started to assign land, allocate quota to households, thus creating very strong incentives for development. On the other hand, Viet Nam beganits market liberalization, agricultural development, at least to ensure food security for that period and started to export as way of supporting the economy when Viet Nam had insufficient foreign currency for imports.

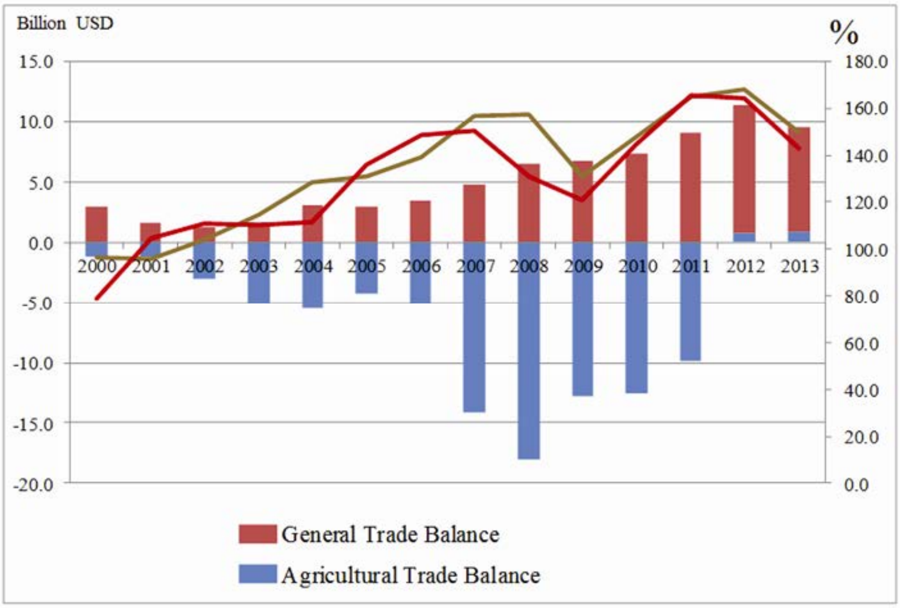
Figure 2: **Growth by Sector (%, compared to 1994 price)**



Source: General Statistics Office (GSO).

In addition, the agriculture sector in Vietnam: has a very strong competitive advantage, being the only sector with export surplus: meaning that total exports minus total imports of production inputs in agriculture also as direct imports of some agricultural, forestry and fishery products, yields a positive surplus, while the majority of industries and services always yield a negative figure. Only recently, these sectors were able to show little improvement, showing minor positive figures, but which are mainly due to exports of large FDI firms, such as exports of electronic components by Samsung.

Figure 3: **Agriculture: The only trade surplus sector**



Source: GSO, MARD.

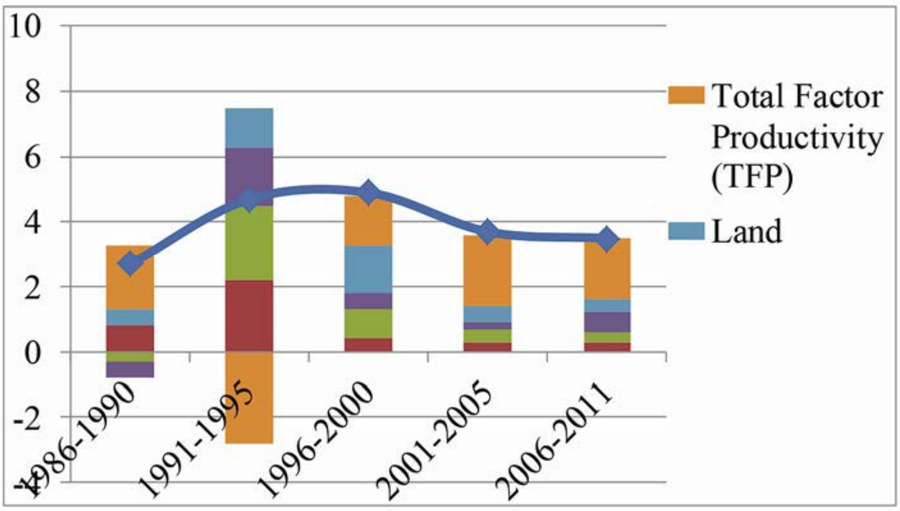
2. Current problems and challenges in Viet Nam

In 2007, Viet Nam was not a high growth economy, with very weak business environment, yet Viet Nam was able to rank sixth in the world in attracting FDI, showing that at that particular moment, Viet Nam was extremely attractive in the eyes of foreign investments and the business community. Rural agriculture is the foundation of economic development as it provides enough food for the whole population, contributes to poverty reduction, employment creation, social stability and provides resources and inputs for industrialization. In brief, in the context of natural resources in Viet Nam being depleted, with average cultivate land per capita among the lowest in the world; frequent natural disasters and diseaseses; complex market fluctuations; low level of investment on agriculture - current level of only 6-7% of total social investment capital; weak technological level; poor infrastructure; incompatible macroeconomic policies in agriculture, especially the high valuation of domestic currency which is harmful for exports;

yet, agriculture is the only sector with positive trade surplus. The driver for agricultural growth in the past period mainly relied on policies promoting and liberalizing the people to participate in agriculture production, by assigning land to households and liberalizing the market. With the available promoting policies, Viet Nam was able to establish a strong team of farmers compared to other countries, very hard working and innovative. Once there is motivation, they make use of all internal strengths, all natural resources and technology available, even domestic technology. This has brought about good production growth, poverty reduction, employment creation, income creation, improvement of rural development, control of inflation and economic stability.

However, the bottlenecks remain in the high level of production but of poor quality. We mainly export raw materials, and too much exploitation of natural resources. Agricultural growth began to decline starting from 2012-2013, down to only 2.6-2.7%/year. This represents a threat for the social security in the coming years, especially when issues related to land, especially the stability of land use and land property rights remain unclear so that farmers can accumulate and concentrate land for higher level of production.

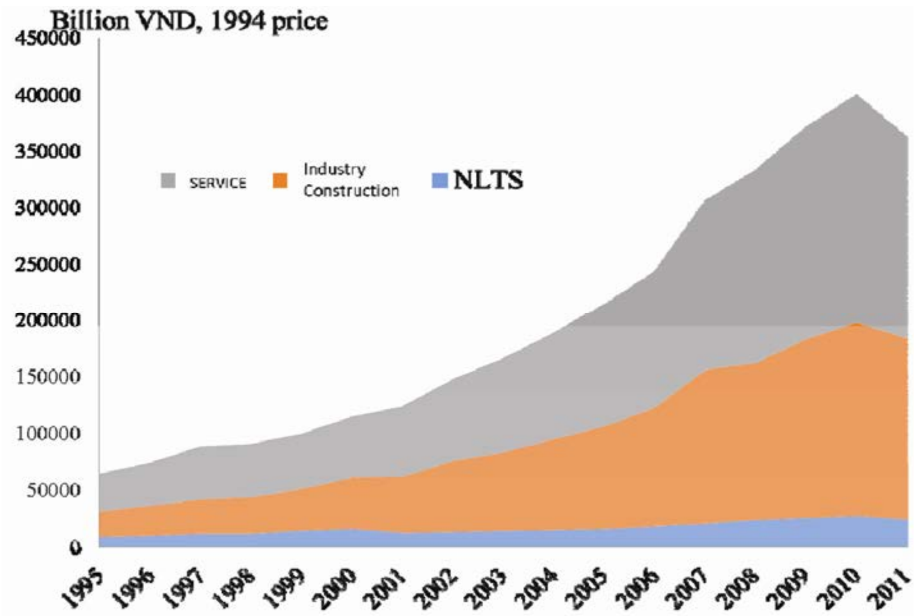
Figure 4: **Agricultural growth was slowed down (%/year)**



Source: CAP calculations based on data from GSO.

Technological development remains weak; agricultural tools and equipments remain expensive and of poor quality; outdated infrastructure; linkages between farmers - farmers, farmers - businesses remain weak. On the external side, Viet Nam still has issues related to natural disasters, an undeveloped market, an economy in decline, weakening demand and purchasing power. Price of agricultural export products in 2012-2013 fell significantly. Supporting industries for agriculture remain weak and investments are low. What worked in the past, such as land, labour, continue to contribute well, however recently, their level of marginal contribution has been declining and now it all relies on research and development and technology. While investment on R&D and technology is very low, if we are unable to create breakthroughs, then it will be very difficult to recover growth for the agriculture sector.

Figure 5: **Social Investment Capital**

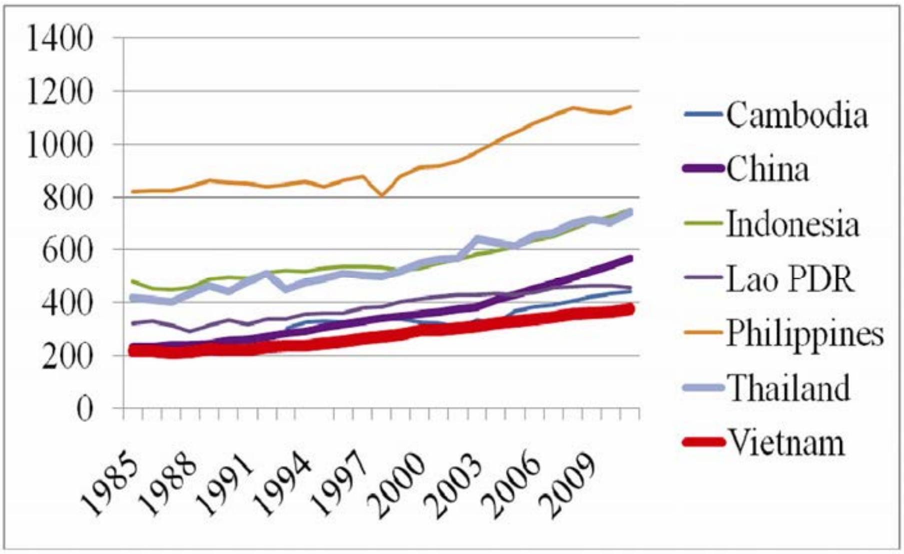


Source: GSO.

Social investment increases in absolute terms but falls in relative terms, from 13% down to only 6% in the recent period. Labour productivity of Vietnamese agriculture is very low compared to other countries in the region. One of the reasons is that in addition to the low level of growth which fails to compensate for the new workforce in agriculture, there is the reason that land is widely dispersed, small and fragmented, unable to link to the creation of a value chain of higher value added.

Figure 6: **Low Agricultural Labor productivity**

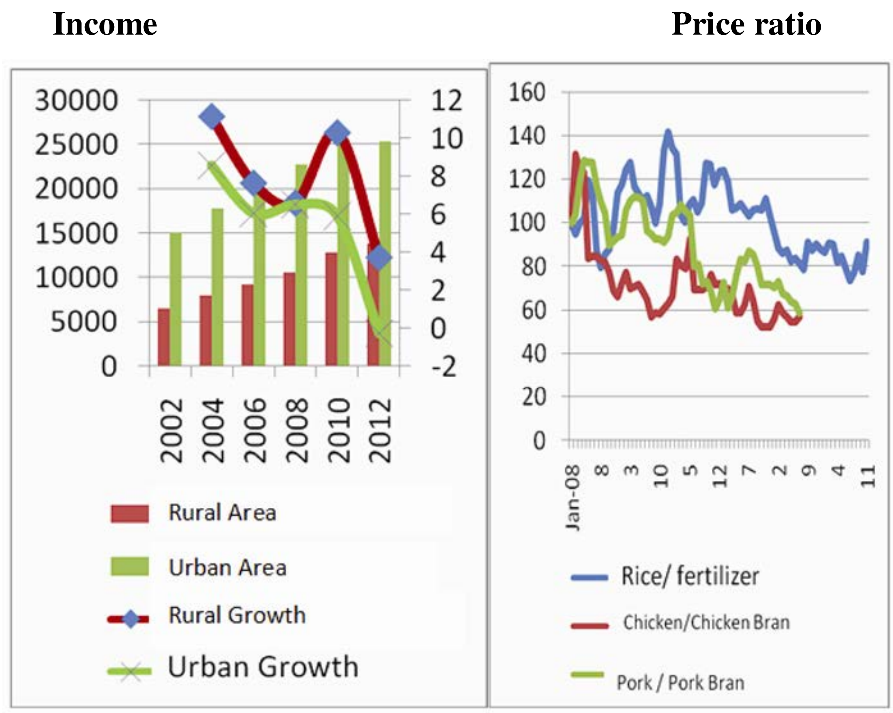
(Unit: USD / employee / year, 2000 prices)



Source: WB.

Average income per capita of the rural population has been declining. Growth slowdown was in part due to the shrinking spread between input and output prices: input price increased more rapidly while output price did not increase, thus affecting people's life. Income inequality between households seems to be rising, with income differentiation between rural - urban areasmaintained at approximately 1.7-2 times. But in rural areas, there is a clear distinction between the group of highest income level and group of lowest income level, with a difference between these groups increasing by 6-8.3 times between 2002 and 2012.

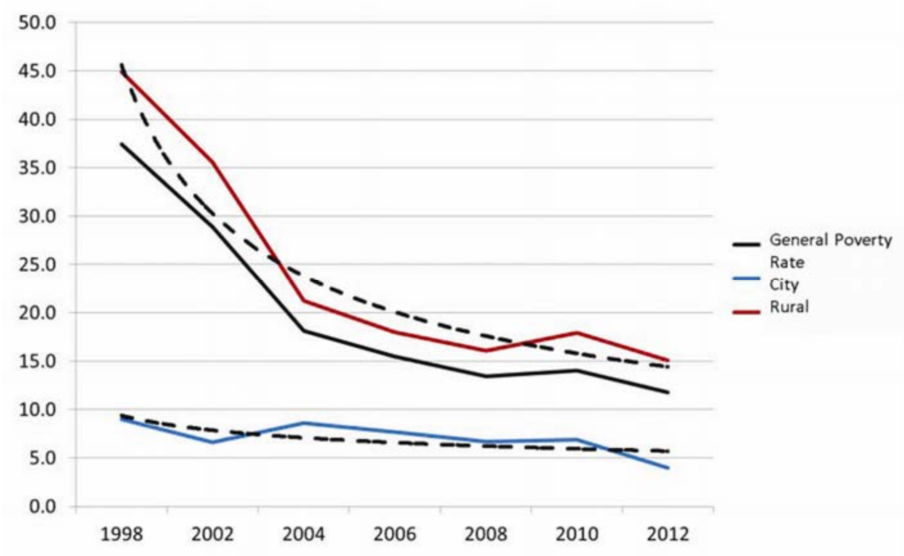
Figure 7: **Income per capita / year and growth rate (2010 price)**



Source: VHLSS and Agroinfo.

Poverty rate: poverty rate has been declinining but at lower speed during recent years, with bottlenecks in agriculture in particular and in the rural economy in general, especially in a context of economic decline.

Figure 8: **Poverty rate (%)**



Source: VHLSS.

A series of issues in terms of environment pollution, destruction of natural resources, risks related to climate change continue to take place. In 2013, despite some national competitivity index, the business environment was improved compared to 2007, but the country's foreign investment attraction now only ranks 13th. Adding to these are issues faced in agriculture, such as large production at poor quality, low competitivity, low value added, macroeconomic instability, low income, rising inequality, slowdown in poverty reduction that represents a threat for socio-political stability, environment degradation, depletion of natural resources, disputes in natural resources exploitation, are all making it difficult for urban industrial sector to take land from the agricultural sector as it previously did in the past. Macroeconomic indicators from mid-2007-2012 show clear changes in the Vietnamese economy attraction, despite the macroeconomic instabilities and stagnation of rural and agriculture development.

3. New opportunities and challenges in agriculture

In terms of demand, the market will require products of higher quality, safe, environment friendly, and with the changing human and social values and changing pattern of food consumption, the market is aiming towards products of higher value and nutrition. This is a big challenge that we can take as an opportunity to change our agriculture sector.

Second, as a new market, we have the giant Chinese market when their income growth and rapid urbanization creates a huge demand for food products. The ASEAN Economic Community that hopefully will be established by 2015, and the signing of TPP also open up important new markets for Vietnamese agricultural products.

In terms of production, Viet Nam has a chance for scientific and technological development, and using the existing investment capital available for economic restructuring which can give priority to agriculture. This was already mentioned in the project for economic restructuring in general also as the project for agriculture sector restructuring.

Challenges include competition in accessing natural resources, higher labour costs in the future, climate and weather risks, and biosecurity risk. In agriculture, the vision for the coming period focuses on sector restructuring which has implications on both policies and institutions.

4. Actions to be taken

First of all, it is important to select sectors with competitive advantage, and not selecting sectors using the model used previously in which all sectors are driving sectors. Sectors with competitive advantage are those with production conditions and capacity, large scale production, production market advantage, able to establish a value chain, organize supporting infrastructure and accompanied services, with technological standards, new value added activities, in particular in refined and deep processing, and in market access, establish transportation and logistics services, product distribution, marketing and payment services. Here, agriculture needs to be linked with all other sectors in the economy and not being stand-alone as it used to. Only then, we can expect to create specialized areas and industrial clusters linking from production to preservation to processing and to the final consumer. This is the agricultural value chain proposed in the project for agriculture sector restructuring approved by the Prime Minister by Decision n. 899 on June 2013 and it is expected that this will enable the creation of value chains serving as inputs of high quality, right price, organized on large scale production, using the appropriate techniques, mechanization and irrigation efficiency, with good efficiency after harvest, processing that also includes deep processing, trade traceability, food hygiene and marketing services. The production area can be organized in cooperatives and farmers cooperatives. The after harvest area can organize close linkages between businesses, such as firms providing training, credit, inputs and cooperatives, in which farmers can contribute capital and land to participate in business management and profit sharing.

In terms of innovation on sector management, the focus is that the State only plays a structural role and supporting the production and services of farmers and firms. Regarding the management of the State, the State focus on planning, setting strategies, handle negotiations, setting standards, setting regulations, but this also requires the participation of people and firms. The provision of public services will be gradually transferred to public-private partnerships, from key infrastructure, major irrigation management, training, research, agriucultural facilitation, market information, quarantine, ensuring market and environment, promoting the participation of firms and communities in all decisions taken by the State. The improvement ofState management is extremely important. We used to setting strategy in one direction while planning was done in another direction. Policies fail to follow a long term strategy, often planning and strategy contradicting each other. It is important to ensure connectivity between strategy and policies, from master planning to concrete planning in order to ensure stated objectives and ensuring the process of monitoring and assessment for adjustments and interventions.

In terms of investment restructuring, it is important to increase investments for agriculture. With limited budget constraints, we need to find ways to attract private investments to develop public-private partnerships. Before, Viet Nam only focused on the production segment, but now it needs to also focus on the processing and after harvest segments while giving priority to marketing, science and technology, risk management and quarantine. In terms of public investment, in order to improve public investment, we used to only focus on the plantation stage, but now we need to change focus to establish the supporting agricultural, forestry and fisheryinfrastructure, export-oriented processing, science and technology development and ODA capital mobilization on areas that private investment is unable to invest. Investment management needs to be focus, finish, with regional/sectoral linkages, with a monitoring and evaluation system and socialization.

In terms of private investment, most important thing is creating the favorable conditions, with the legal frameworks, procedures, standards and policies that can ensure equality betweeen public and private firms. In agriculture, present level of private investment is too low, therefore needs support and stimulus, especially issues related to the production site, preferential credit, credit extension, increased loans so that the agriculture can contrbute more to the public-private partnership on investments in infrastructure and agricultural value chains.

In terms of science and technology innovation, this requires the strong participation of the private sector so that they can participate to research activities, and are given the opportunity to carry out funded research projects, receive grants for technological support by the State, to import technology for research purpose and technological transfer.

In terms of rural institutions restructuring, it is important to scale up the production, integrate to the value chain as way to build up specialized farmers, unlike to the small, fragmented farmers who used to produce products that they have no idea of the markets where their products will be sold, or whether these products are of acceptable quality or not. It is important to increase the land area assigned to farmers, provide them with incentives for farmers to accumulate land. Institutions should also be able to create favorable conditions for changing employment, especially through the development of services to create and attract employment and labour.

In terms of businesses and cooperatives, there should be the development of industry associations, in which the managing committee should feature the participation of firms, farmers, and State representatives in order to participate to the process of policy making and implementation of State-funded projects.

In terms of rural community development, changing people's living and promoting grassroots democracy are important aspects that require attention. Community development should be able to open up opportunities for farmers in rural areas. The present market for non-agricultural products mainly features craft villages, small household businesses, therefore they should be provided assistance to register into formal rural businesses. The informal labour market should be formalized by creating favorable conditions for people to buy health insurance, social insurance, setting up unions as way to provide information and supporting channels to workers. The existing formal labour market should be upgraded to higher skill levels, with a particular focus on labour export as demand for labour in foreign countries are substantial while the domestic labour market remains with many challenges.

SESSION THREE

TAPPING THE POTENTIAL OF GLOBAL AND REGIONAL INTERGRATION FOR INCLUSIVE AND SUSTAINABLE GROWTH

Short Biography of Dr. Vo Tri Thanh, Vice President of the Central Institute for Economic Management (CIEM)

Dr. Vo Tri Thanh is currently the Vice President of the Central Institute for Economic Management (CIEM). He holds a Master degree in Economics and a PhD degree in Economics both from the Australian National University. Dr. Vo Tri Thanh has undertaken extensive research and provided consultation on issues related to trade liberalization, regional economic integration, financial development and macroeconomic policies. His other areas of interests include institutional reforms and economic development.

WINNERS AND LOSERS IN INTERNATIONAL ECONOMIC INTERGRATION: SOME THOUGHTS

Dr. Vo Tri Thanh
Deputy Director
Central Institute for Economic Management (CIEM)

1. The impacts of integration: What we really know

Economic integration, under common understanding, creates three types of impact. First, trade liberalization is very good, a win-win game where all players are winners, with improved welfare for all trading partners. Second, according to most research, such as Dani Rodrik's study 10 years ago, globalizers often seem to be winners, which is translated into better growth and social welfare. Third is the positive impact on poverty reduction. Trade liberalization helps to better exploit comparative advantages (labour, natural resources for poor countries) and more efficient resources allocation, which in turn leads to higher growth and lower poverty incidence. These are often repeated by economists and are common to find in any book on economics.

However, the reality is much more complex, specifically in some of the following points:

Meaning of "winners and losers"?

The meaning of "*winners and losers*" entails many implications, considering the relationship between countries, or within a specific country and between different groups of individuals. "Gains" must be viewed both under absolute and relative terms. For example, according to many calculations on TPP and Viet Nam, in relative terms, Viet Nam's percentage of exports on GDP is highest, but in absolute terms, the percentage is too small compared with other countries. Next is the political factor and interest. There are strong interest groups and vulnerable groups, therefore it requires different kinds of support for anti-globalization and international integration.

How to measure the level of economic integration (to assess the degree of integration)?

Supporting trade liberalization and institutional reforms is not a simple task. Therefore, measuring the level of integration to assess the degree of integration is not easy. There are some quantitative approach to measure total trade/GDP, while some other measurements calculate based on tariffs. The challenge is that there is standard model to evaluate and measure non-tariff barriers - most important barriers to trade liberalization and economic integration. International integration nowadays is much more complex than it was in the past, as integratoin now not only cover trade of goods but also trade of services, labour, capital and cooperation programs and linkages. Especially in East Asia, the area which does not like using the term FTA but use Comprehensive Partnership instead. As a consequence, FTA is only a very important part of Comprehensive Partnership. Since integration per se is already complex, then the evaluation of its impact would be even much more complex.

*Interaction between **integration** and **domestic reforms***

Practice and research[1] have shown that if integration is not accompanied by institutional reforms, then trading partners would not be able to extract most of the benefits. Therefore in Viet Nam, in April 2013, the Politburo issued a new resolution on comprehensive integration (Resolution n. 22-NQ/TW dated on

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1. Cf. research study on Vietnam's WTO integration by Roland -Holst et. al., 2002.

10/4/2013), which also covers security, defense and culture. Trade liberalization is increasingly associated with policies behind the border, and is considered one of the most complicated and difficult issues during TPP negotiations, as the majority of areas under TPP negotiations are not on the border itself but the policies behind it, government spending, competition, SOEs, intellectual property rights (IPR), and even economic issues of the domestic economy.

One of our research (at CIEM) conducted with the University of Copenhagen in the beginning of 2000 in assessing the impact of US - Vietnam Bilateral Agreement (BTA) and WTA shows that without institutional reforms, then 80% of benefits from trade liberalization will fall into the hands of Vietnam's trading partners and not of Vietnamese people or the country. Another study by a reknown economist, Winter (2003) suggests that the impact on welfare may be positive or negative, depending on different channels: relative prices, flexibility of production factors such as labour market, capital market and budget capacity.

Short-term and long-term impact

First, integration may brings "real" positive effects to the economy but also pose the threat of "low wage trap"/"trade liberalization trap" in the long run. If we continue to rely on cheap labour, Viet Nam will fall into the low wage trap and will not be able to set the foundations for higher value creation in the value chain and set the premises to overcome the middle income trap.

Second, the unhealthy financial system with the movement of capital flows, especially short-term capital flows and the business cycle, will bring risks of a financial crisis, which would affect the poor and vulnerable people the most.

Third are uncertainties in the future due to the emergence and restructruring of China and India. At the EADN - East Asian Development Network, an American economist observed that, with the rise of China and Inda, predicting the flows of goods, services and capital has become very difficult. With the unclear movements of these flows, then income distritbution between nations and between different groups of individuals in each country is also very unclear. These are all very important issues. Therefore, in Vietnam, we focus on situation analysis at sectoral or micro level to support research at the macro level or studies based on models such as GiTec, a general equilibrium model to assess the overall impact of integration. Only the combination of these 3 results can help to predict and be more certain abou the impact of integration, particularly for the vulnerable groups.

2. Some ideas for narrowing the development gap in ASEAN

For ASEAN countries, the ASEAN Economic Community will be created in December 2015. At that same period, ASEAN leaders will sign an agreement named Regional Comprehensive Economic Partnership (RCEP), a free trade agreement between ASEAN and 6 partner countries (China, Japan, Korea, Australia, New Zealand and India).

Basically, this is the idea of a more integrated ASEAN, with improved quality of life and narrowed development gap between nations. Currently, ASEAN is preparing for a post-2015 vision as the ASEAN Economic Community (AEC) and RCEP will be a continuing process beyond 2015. The ASEAN Vision post-2015 has not yet been approved by country leaders, however, there are two ideas that ASEAN leaders will come very close, including the ADBI initiative that we are involved with the study. The first idea is that ASEAN 2030 will have a vision called RICH. Specifically, R (Resilience), I (Inclusive), C (Competitive), and H (Harmonious) - harmony between economy, society and environment. The second idea was presented by the Institute of South East Asian Studies (ISEAS) at the ASEAN SOM Conference, which stated that ASEAN will become highly competitive, with good resiglience, inclusive development, global and highly responsible…

Personally, I think that ideas on how to narrow the wealth gap within ASEAN need to be based on the following core pillars:

First of all is the liberalization of trade, investment and services as way to open up opportunities, trade liberalization should be associated with institutional reforms in Vietnam because this creates opportunities for business and people to work and make businesses.

Second, is to create favorable conditions for trade and investment through reduced transaction costs (in production networks and value chains); as well as increased connectivity to facilitate easier access to opportunities and at lower transaction costs. Studies have shown that the most important barriers and transaction cost for trade of goods not only lie in isseus at the border, not only tariff-related issues but instead are non-tariff barriers and issues related to facilitated trade liberalization and connectivity. The main purpose is to decrease transaction costs, an extremely serious issue for East Asia - region with unique production networks in the world, with 60% of traded goods are intermediary, semi-final goods to developed countries as Japan, the US and the EU. Therefore, how to minimize transaction and networking costs is fundamental.

A third aspect is the cooperation for improved capacity for efficiently exploiting new opportunities. For example, ASEAN has an initiative of ASEAN integration to support CLMV countries (Cambodia, Laos, Myanmar and Viet Nam). Many consider Viet Nam as a stronger and more developed country and needs to be out of this group and join the VIP group instead (Viet Nam, Indonesia and Philippines). But I personally think that from a financial capability point of view, Viet Nam still ranks among CLMV, but for its important position in ASEAN, it may join the VIP group of countries.

3. Lessons learnt from poverty reduction in Viet Nam

Since almost 30 years that Doi Moi was launched, the nature of the reform is the expansion of choices for people thanks to economic integration. Until now, Viet Nam was able to achieve a relatively high growth, despite the slowdown in recent years. Viet Nam has been among the leading countries in the implementation of the Millennium Development Goals on poverty reduction. From a nearly 70% of Vietnamese people living below poverty in the 1980s, the poverty incidence has now fell to below 10%. But Viet Nam continues to face many other challenges. Only in poverty, there has been emergence of a “hardcore” poverty, thus extreme poverty. This is a very difficult issue to address, especially in mountainous, remote areas and areas with high concentration of ethnic minorities. On the other hand, the emergence of a new group of poor such as garmers whose land was collected, migrant farmers and workers in the informal sector in urban areas. At present, income is not the only indicator, despite its importance in measuring poverty, and this indicator has been expanded. For example, in urban areas, we also consider access to basic services, political rights of migrants and landless farmers who are forced to migrate. These factors contribute to a multi-dimensional view on poverty, from poverty line, poverty measurement to an understanding of poverty.

There are four important lessons drawn from the Vietnamese success with poverty reduction.

First, poverty reduction cannot be achieved if growth is too low, but such growth also needs to be associated with employment creation. The challenge for Viet Nam is now, on one side, Viet Nam has to address employment in unskilled jobs, such as textile and garment, leather and shoes; but on the other side, if Viet Nam continues to stay in these production stages, it risks of falling into a low wage trap, low income trap and cheap labour trap.

A second lesson is that macroeconomic instability is unacceptable because it cannot help the poor. The poor are mostly vulnerable when the economy is unstable, with high inflation. Therefore, stabilizing the macroeconomy is an extremely important pre-requisite for successful and sustained poverty reduction. This is particularly true for Vietnam when the poverty rate is below 10%

but the near poor group has expanded into a large group. The problem for Viet Nam is, facing with instability and high inflation, Viet Nam needs to tighten its policy to stabilize the economy, but this will reduce employment opportunities and slowdown growth. So the new challege is to seek macroeconomic stability in a turbulent period with instabilities and crisis, while minimizing costs of this stabilization process and associated social costs. That is the reason why UNS Cab implemented an Inclusive Monetary Policy.

The third issue is that integration means creating opportunities, but whether the people are able to access those new opportunities depend first and foremost on the information and infrastructure available, which explains why infrastructure development is so important. According to the World Bank, in infrastructure linkages, for example in rural agriculture what is important is not not building dams and dikes for largest impact on employment creation and poverty reduction in rural areas, but it is R&D activites and service extensions.

And the final lesson is closely related to macroeconomic studies. Viet Nam has implemented a variety of targeted programs for poverty reductions, such as Program 135, job creating programs, targeted poverty reduction in mountainous and remote areas, especially programs supported by the State and the international community. The biggest challenge from these programs are their sustainabilty once these budget support and support from NGOs decrease, is for Vietnam to continue with the implementation of the policies as mentioned in this sections.

Short Biography of Dr. Shahid Yusuf, George Washington University

Shahid Yusuf is Chief Economist of the Growth Dialogue. Dr. Yusuf has written extensively on development issues, with a special focus on East Asia and has also published widely in various academic journals. He has authored or edited 24 books on industrial and urban development, innovation systems and tertiary education. His five most recent books are: *Development Economics through the Decades* (2009); *Tiger Economies under Threat* (co-authored with Kaoru Nabeshima, 2009); *Two Dragonheads: Contrasting development paths for Beijing and Shanghai* (co-authored with Kaoru Nabeshima 2010); *Changing the Industrial Geography in Asia: The Impact of China and India* (co-authored with Kaoru Nabeshima 2010); and *China Urbanizes* (co-edited with Tony Saich, 2008).

Dr. Yusuf holds a Ph.D. in Economics from Harvard University, and a BA in Economics from Cambridge University. He joined the World Bank in 1974 as a Young Professional and while at the Bank spent more than 35 years tackling issues confronting developing countries. During his tenure at the World Bank, Dr. Yusuf was the team leader for the World Bank-Japan project on East Asia's Future Economy from 2000-2009. He was the Director of the *World Development Report 1999/2000, Entering the 21st Century*. Prior to that, he was Economic Adviser to the Senior Vice President and Chief Economist (1997-98), Lead Economist for the East Africa Department (1995-97) and Lead Economist for the China and Mongolia Department (1989-1993). Dr. Yusuf lives in Washington DC and consults with the World Bank and with other organizations.

EVOLVING GLOBAL VALUE CHAINS AND THEIR POLICY IMPLICATIONS FOR VIET NAM

Dr. Shahid Yusuf
Growth Dialogue
Washington DC

The first wave of industrialization in East Asia demonstrated the growth potential inherent in technological catching-up when combined with high levels of investment and an export orientation. The prowess of Japan and the four Tiger economies created a model that more than three decades later has thoroughly permeated thinking on development and remains the touchstone for all late developing economies. First China and more recently Vietnam, have borrowed and adapted the East Asian growth recipe, and following the launch of Vietnam's *DoiMoi* reform strategy in 1986, Vietnam emerged as a *fast follower* steadily improving its performance through the 1990s and in the process gaining membership of the elite club comprised of the world’s fastest growing countries. Between 1990 and 2010, Vietnam’s GDP grew at an average rate of 7.1 percent per annum, with the burgeoning export sector a significant contributor. The acceleration of trade was assisted by Vietnam’s participation in a number of multilateral and bilateral trade agreements - including the USBTA (2000), AFTA (2001), and WTO (2007). Trade and through it, the increasing participation in global value chains (GVCs) for a number of manufactured products, is likely to remain one of the key drivers of growth in East Asia, and for Vietnam. The purpose of this note is fourfold: (i) to briefly describe the role GVCs play; (ii) to examine how the chains are evolving in the regional context; (iii) to indicate how this could impinge upon Vietnam's exports and growth prospects; and (iv) to discuss the policy implications.

1. Expanding trade and its fragmentation

The dismantling of trade barriers and falling transport costs, were largely responsible for the rapid growth of global trade through 2007.[1] They were the result of containerization, advances in ship design and propulsion technologies, investment in port infrastructures, and improved trade facilitation. The financial crisis of 2008-9 and the slow recovery from recession by the leading OECD countries, has caused trade to increase by a meager 2.3 percent per annum between 2008 and 2013. Looking ahead, the WTO expects, merchandise trade to rise by 4.5 percent in 2014; however, as China is likely to grow more slowly over the medium term and developed economies could remain sluggish, it is doubtful that the past 2:1 ratio between global GDP growth and the increase in trade will be soon restored. With more countries - advanced and developing - seeking to hitch their economies to the engine of trade, competition particularly in the more commodified segments of the global market, will be severe. The major incumbents, Vietnam and other East Asian exporters among them, have an advantage over newcomers, nevertheless they will have to raise their game if the want to retain their share in existing highly contested product markets or upgrade and diversify into areas promising higher returns. In a wide range of products, the successful traders will need to better exploit the potential of existing value chains oremergent value chains tilting towards markets in the South. A brief overview of GVCs can help to explain their salience and their future role.

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1. Trade as a share of global GDP rose from less than one fifth in mid 1980s to one third in 2012. WTO (2013) http://www.wto.org/english/res e/bookspe/ wtr13-1 e.pdf

2. Production unbundling and the rise of GVCs

GVCs owe their beginning to the fragmentation of manufacturing activities that commenced in the 1980s. This initiated the offshoring of the labor-intensive elements of production from advanced countries mainly to a small number of industrializing economies. Thus commenced a process of vertical specialization that has served to embed manufacturing activities across East Asia. The geographical dispersion of the textile and garment industry, which spearheaded the migration of production across the Pacific, was reinforced over time by trade agreements that sought to restrict imports into the advanced countries by assigning export quotas to developing nations. For example, a series of multilateral and bilateral agreements, contributed to a scattering of production across the developing world as leading East Asian exporters to the West first exhausted their own quotas and then began establishing production platforms in countries not subject to quotas or with quotas to spare[1]. Thus a cotton garment sold at a Wal-Mart store in the U.S. can trace a circuitous path from its origins in a field in Texas, spinning and weaving operations in Korea, its design in Germany, the cutting, trimming and making (CTM) of the garment in Vietnam, and its final packaging and shipping in yet another location (Rivoli 2005)[2]. Garments are but one example of the disintegration of the production process into a large number of piecemeal tasks. The most highly fragmented industries are: TV

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1. This is how Bangladesh, Mauritius, Sri Lanka, Central American and African countries among others, became producers of garments. When East Pakistan became the independent nation of Bangladesh, it received half of the quota that had been assigned to Pakistan.
2. PietraRivoli, Travels of a T-Shirt. http://www.amazon.com/The-Travels-T-Shirt-Global-Economy/dp/0470287160.Ghemawat and Nueno (2006, p.2) describe how a "down jacket's filling might come from China, the outer shell and fabric from Korea, the zippers from Japan, the inner lining from Taiwan, and the elastics, label and other trim from Hong Kong. Dyeing might take place in South Asia, stitching in China, followed by quality assurance and packaging in Hong Kong."

and communications equipment, motor vehicles, basic metals, electrical machinery, and footwear, textiles and leather goods.

It is no surprise therefore, that intra-industry trade and trade in intermediate products are growing faster than trade in the aggregate and that the fragmentation process has also encouraged greater intraregional trade. As Baldwin (2012) points out, GVCs tend to be regionally oriented,[1] with some products crossing nation boundaries a number of times as they move along the value chain. In the aggregate, 60 percent of trade is in intermediates[2] and the import content of exports had risen to 40 percent in 2010, with the trend line pointing to a 60 percent share by 2030.[3] For developed economies, between 56 percent and 73 percent of all trade is in intermediate products and they comprise three quarters of the imports of China and Brazil (Miroudot and others 2009;[4] Ali and Dadush 2011[5]). Over 70 percent of European trade in 2010 was intraregional, 53 percent of Asian trade and almost one-half of exports from North America were to members of NAFTA. It is not surprising that this makes it hard to determine with much precision, the domestic value added in any one country along the chain that a product traverses[6]. In addition to fragmentation, trade flows that

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1. Baldwin (2012) http://www.cepr.org/sites/default/files/policy insights/Policy Insight64.pdf
2. However, only 27 percent of intermediates produced are exported as against 44 percent of final products. The reason being that 60 percent of manufacturing GDP worldwide takes place in large relatively closed economies: the US, China, Japan, Germany and India. Baldwin and Lopez-Gonzalez (2013) http://www.nber.org/papers/w18957
3. Lamy (2013) http://www.voxeu.org/article/looking-back-moving-forward
4. http://www.oecd-ilibrary.org/docserver/download/5kmlcxtdlk8r.pdf?expires=1395004549&id=id&accname=guest&checksum=C1F34F9AE8746305E321B5EE8AB631C3
5. http://ideas.repec.org/p/oec/traaab/93-en.html; http://www.voxeu.org/article/rise-trade-intermediates-policy-implications
6. All trade data is from the WTO unless otherwise specified.

once heavily favored the North are becoming more evenly balanced between the North and the South. By 2020, the WTO projects that North-North, North-South and South-South trade could be approximately equal.

3. Global Value Chains and Production Networks

The recent history of trade in manufactured commodities is inextricably bound up with the emergence and elaboration of value chains and globe spanning production networks. Most of these are orchestrated by trans national corporations (TNCs). The global dispersion of the garments production can be traced to the advent of lean retailing in the United States and while other factors played a role, retailers and branded producers and marketers based in the U.S. were the drivers of the process.

Four factors made lean retaining almost inevitable. First was the vast proliferation of products e.g. varieties of clothing, toys and consumer electronics, that retailers (and now e-retailers) found that they needed to carry as buyers became more affluent, style conscious and discriminating, advertisers more ingenious, and new entrants made the market far more competitive. Second, the drastic compressing of product life cycles as buyers began to demand and to expect a frequent refreshing of fashions and models meant that carrying large quantities of a perishable products was highly risky and could lead to stock outs and loss making, discounted sales. Hence, anticipating demand and tailoring purchasing decisions as well inventories, rose in the scale of priorities. This imperative was facilitated by a third development, which was the spread of technologies that enabled retailers to track sales of individual items identified by their bar coded, stock keeping units (SKU) at the checkout counter, monitor inventory within and among stores and replenish items that were in demand from centralized distribution points. Wal-Mart was in the vanguard of the lean retailing revolution and the parallel advances in warehousing and inventory management[1]. It remains in the forefront of efforts to diversify suppliers thereby driving down costs and maximizing flexibility of supply[2].

Fourth, computerization (and electronic data interchange, EDI, and Universal Product Codes), distribution centers, and new IT tools have systematized the collection of detailed information on sales, improved forecasting of demand and served to streamline inventory management[3]. But IT, which steeply reduced communication and transmission costs, and better logistics also facilitated the efficient management of far-flung manufacturing activities, the offshoring of production, starting with low tech commodities and the efficient sourcing of products from multiple firms linked to the retailer by long electronic threads. Thus the functionally integrated global value chain as currently understood was born and global production networking took wing. Undoubtedly other factors also played a part, such as trade liberalization noted above, big strides in logistics and the deepening of industrial capabilities in a number of East Asian economies where governments were eager to seize opportunities as they emerged. Absent these developments, globalization would have been anemic indeed. But the American consumer, innovative US based retailers operating in a large and unusually competitive market, and the advent of

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1. Other firms, such as JC Penney and Sears were also active. Wal-Mart's use of cross docking, which minimized the time goods resided in warehouses was a significant innovation. http://www.usanfranonline.com/wal-mart-successful-supply-chain-management/;

   http://www.ame.orgwww.ame.org/sites/default/files/target articles/04-20-3-Crossdocking.pdf. More recently the use of RFIDs has contributed to increased efficiency.
2. Abernathy and others (1999).http://global.oup.com/academic/product/a-stitch-in-time-9780195126150;jsessionid=4B09B835B39F1CB47F15CE701C52DE90?cc=us&lang=en&
3. See Gereffi and Christian (2009); and the comment by Robert Baldwin (2012) http://www.economist.com/economics/by-invitation/guest-contributions/supply-chains-changed-growth-model/print

facilitating IT, were the forces that articulated and energized value chains. Moreover, how the chains evolve, will strongly influence the shape of the industry in the future.

According to Michael Porter (1985),[1] the value chain represents "a sequence of related and dependent activities that are needed to bring a product or a service from conception, through the different phases of production, to delivery to final consumers and after sales services, and finally to disposal or recycling." The GVC is complemented by the global production network, which is constituted of "specialized independent enterprises, capturing complex relationships between firms that are of systemic nature ... It reflects the fragmentation of activities in some value chains", a result of technological modularization that permits the separation of design and other knowledge intensive or downstream activities from the production process and also allows for the decomposition of production itself into specialized operations performed by independent producers in geographically removed locations (UNIDO 2004, p. 5-6). Inevitably GPNs and GVCs overlap with one GPN contributing to several value chains as contract manufacturers frequently do. However, the distinctive characteristic of a GPN is that it comprises of a constellation of tiered supplier firms[2] headed by a flagship retail buyer/brand leader e.g. Wal-Mart, C&A, Hugo Boss or Nike, a contract manufacturer e.g. Flextronics or Foxconn, or a supply chain manager such as Li & Fung[3] that

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1. http://www.ifm.eng.cam.ac.uk/research/dstools/value-chain-/
2. Top tier firms can be technologically more sophisticated and maintain their own small scale GPNs and distribute their orders among a number of lower order firms, which in turn can do business with a number of suppliers belonging to other networks. Relationships in GPNs can be vertical, horizontal and diagonal.
3. Based in Hong Kong, Li &Fung, is a one stop shop for retailers such as Target, designing garments organizing production through subcontracts with suppliers throughout East Asia and shipping them to buyers mainly in developed countries. Two thirds of the trading company's business is in garments. Recently the company's business has been hit by the downturn and by retailers preferring to deal directly with full package suppliers and ODMs.

determines its organizational architecture, strategic direction, and governance.

The utility of the GVC is that it enables lead buyers or suppliers with an encompassing view of the chain to determine who creates value, how much, where it is distributed along the value chain, and how such value can be enhanced through suitable innovation and/or investment. Relatively low-tech commodities (toys, consumer electronics, garments, food products, some auto parts) subject to codified production processes, fall in the domain of 'buyer driven supply chains' because here the retailer or branded firm can conduct arms length transactions with numerous independent suppliers that are able to produce and deliver according to the specifications[1]. Producer driven supply chains involve the manufacture of more complex products (e.g. autos, computers, mobile devices) requiring closer linkages among firms with affiliates of the lead firm serving as key suppliers.

Successful networks have shared at least three characteristics. First network participants have benefitted from technology transfers of all kinds that have raised productivity, response time to changing market demand, and time to market, thereby bolstering the collectively shared profitability of the network. Such technology sharing includes process innovations that reduce wastage and raise quality; the introduction of products new to a firm; functional innovation that modifies the product mix; a repositioning of a supplier within a value chain in recognition of changing comparative advantage; and perhaps most importantly, the germination of innovation capacity that serves to avoid industrial locking in.

Second, the network is anchored to a number of clusters of producers in advantageous locations, where "thick" labor markets

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1. The buyer driven chain is optimized for sectors where design and marketing are of paramount importance and entry barriers arise from the fixed costs incurred in building the infrastructure for gathering market information, designing, advertising and electronic supply management systems.

permit a pooling of industry specific skills that reduces commuting and job search costs, and leads to technological spillovers. The local agglomeration gains reinforce those derived from the overarching global scale of networking activities, in particular when a cluster acquires a host of input suppliers and encompasses a larger segment of the value chain.

Third, the most effective networks from the perspective of both lead firms and countries hosting clusters, are ones where participating firms have been able to progressively upgrade, specialize, innovate, and move up the value chain from basic assembly operations of mainly imported parts, to becoming full package suppliers, to own design manufacturers (ODMs), and finally joining the elite group of own brand manufacturers (OBMs). As Yeung (2008, p.94)[1] observes, "value chain specialization entails a more strategically focused role played by the global lead firms in the upstream (R&D) and downstream (marketing and distribution) segments of the value chain, leaving much of the manufacturing portion of the value chain to its international strategic partners and supply chain managers."

Developing countries, Vietnam among them, have all started out as assemblers undertaking the simplest and most labor-intensive operations by exploiting their low wage and rental costs and by offering tax exemptions and subsidized utilities. The fast learners (followers),[2] which were able to build manufacturing

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1. Yeung, Henry Wai-chung (2008), Industrial Clusters and Production Networks in Southeast Asia:

   Global Production Network Approach.In IkuoKuroiwa, and MunHeng Toh.*Production networks and industrial clusters: integrating economies in Southeast Asia.* Singapore: ISEAS Pub.

2. See Mathews (2006), http://docenti2.unior.it/docdb/doc obj 20909 01-06-2011 4de5f41f2a386.pdf; Wunker (2012)

   http://www.emeraldinsight.com/journals.htm?articleid=17019364; some doubt as to whether fast following is a viable strategy. http://www.innovation excellence.com/blog/2010/07/01/innovation-who-should-you-fast-follow/

capabilities, have in time and with the help of clustering, become full package suppliers. Such firms have proliferated throughout East Asia. In the middle-income East Asian economies, a number of firms have advanced to the ODM stage - in Malaysia, Thailand, and China for example. However, OBMs with global brands remain a rarity in much of Southeast Asia (Taiwan has a few e.g. ASUS, Acer, and HTC) although they are taking off in China.[1] Becoming OBMs and creating their own global value chains, is the challenge for the leading firms in the industrializing countries and is probably the surest avenue to increase the domestic value added and to avoid lock- in into industrial activities with limited growth prospects. This calls for a building of capabilities (technological innovation etc.) in a number of areas: not just in manufacturing but also in a range of services which complement manufacturing and have GVCs of their own.

Richard Baldwin has noted the transformative effects of the "second unbundling" for trade and development and believes that the impact of digital technologies and public policies could be felt for some time. Disintegration of manufacturing has meant that tasks are parceled out to participants in the value chain and the trade is in the form of tasks. Moreover, gross exports are much less relevant than the domestic value added in the performance of tasks. The GVC based trade regime has raised the profile of the TNCs and it is estimated that 80 percent of gross exports take place in TNC production networks.[2] This has led to a diffusion of higher production standards (e.g. ISO 9000 etc.) and a process of functional upgrading, with a convergence towards international levels of productivity in industries faster in the machinery and equipment subsectors and less rapidly in textiles and clothing.

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1. Only firms from Japan and Korea are represented in the top 100 brands in 2013, http://www.interbrand.com/en/best-global-brands/2013/top-100-list-view.aspx
2. UNCTAD (2013), http://unctad.org/en/pages/PublicationWebflyer.aspx?publicationid=588

Overall, greater participation in GVCs is correlated with higher rates of growth.[1]

A key point that the measurement of tasks has brought to light is the contribution of many services to manufacturing e.g. finance, logistics, insurance, marketing, advertising etc. These clearly complement manufacturing; they can be critical to the competitiveness of manufactures; and they can enhance the value adding tasks performed within a country. In fact between 20 and 30 percent of value added by manufacturing is contributed by services and trade in services comprises one third of global trade.[2]

A second key point that has been underscored by the analysis of GVCs is the importance of imports; when firms are performing specific tasks, vertically integrated production of most manufactures within a single country is the rare exception, and the bulk of trade is in intermediates. Thus a successful exporter needs to be an efficient importer, allowing raw materials and semi-processed goods to enter with the minimum of transaction costs and impediments from barriers of any sort.[3]

4. GVC trends and implications

The GVC world is dynamic. A number of developments are in the works that are affecting participants new and old and other changes are in store. Five deserve special attention.

a. As noted above, the growth of trade has slowed and it is uncertain if this is a temporary flattening of the pace of growth or one that could persist as a consequence of the diminishing potential growth rates of advanced economies. A saturation of markets for

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1. UNCTAD (2013), http://unctad.org/en/pages/PublicationWebflyer.aspx?publicationid=588
2. Cattaneo and others (2013), http://papers.ssrn.com/sol3/papers.cfm?abstract id=2248476
3. Cattaneo and others (2013), http://papers.ssrn.com/sol3/papers.cfm?abstract id=2248476

some light manufactures could affect certain traded items much more than others. Garments, footwear, toys, and leather goods, are more likely to face a slackening of demand and their GVCs could be under greater pressure. It can be argued that incumbents such as Vietnam and its neighbors would have an advantage in that they are entrenched and have benefitted from years of learning. Maintaining cost competitiveness without sacrificing quality will be key. Most potential entrants are likely to be from Sub Saharan Africa and those will be at the very bottom of the food chain.

b. Whether the growth of trade slows or not, the trends point to an increase in South-South trade which will require a partial reorientation of GVCs, which are basically aligned along a North-South axis with the lead firms mainly headquartered in the North. Existing GVCs would be catering more to customers in developing countries and if so, the products mix, its sophistication, the amounts sold in individual markets and marketing channels would change. Increased South-South trade could also create opportunities for South based lead firms and for GVCs operating entirely in the South. Firms from China, Malaysia and Thailand have already begun establishing value chains in Asia, Africa and Latin America and eventually if South-South trade flourishes, others e.g. from Vietnam could follow.

c. A number of factors are leading to the consolidation of some supply chains with the consolidation of production in fewer locations. Trade liberalization and the elimination of quotas have reduced the incentive to fragment. The costs associated with fine segmentation, dispersion of production and its monitoring have induced lead firms to depend more on fewer trusted suppliers who also benefit from scale economies. For assemblers of automobiles and electronic equipment, the proximity of suppliers that can deliver just-in-time (JIT) and also participate in the research and design of components highly complex components involving non-codifiable knowledge, is an advantage. For them shorter production chains and clustering is increasingly optimal. Research by Fally (20

1 2)[1] based on I-O data shows that as the production of goods, even standardized ones, becomes more complex and technologically sophisticated, their production becomes less vertically fragmented. Local content rules also promote such clustering.[2] At the same time the risks associated with depending upon a single supplier or for components and parts from suppliers in one country have been highlighted by floods in Thailand, the havoc wreaked by the Fukushima tsunami and by inter-country political tensions, which threaten to disrupt supplies. Further in the future, rising energy costs, will argue for a greater degree of vertical integration and an easing of fragmentation.

d. The automation and digitalization of manufacturing processes, the ease with which products can be customized, a shortening product design cycles, and the scope for producing swiftly and efficiently in small lots, could potentially bring about a vast change in the scale and complexity of production networks. Intelligent, flexible and additive manufacturing with the help of new materials, could transform the production of a vast number of items in daily use including garments, footwear, travel accessories, leather goods and a variety of metal and plastic products - many produced in Asia. Capital and skill intensive technologies are fast developing that would permit the transfer of production back to the advanced countries bringing them close to the final market and to the centers of research and design. If these technologies do in fact mature rapidly, some East Asian countries, Vietnam included could confront a weakening of the crucial labor cost advantage and would need to compete on the basis of innovation as well. A third industrial revolution, if it is followed by a partial *rebundling* of production, would result in a shrinking of GVCs and less trade in intermediates.

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1. Fally (2012), http://www.voxeu.org/article/has-production-become-more-fragmented-international-vs-domestic-perspectives
2. Sturgeon and others (2008), http://joeg.oxfordjournals.org/content/8/3/297.abstract

e. Perhaps equally consequential for GVCs is the diminishing share of manufacturing in GDP - most markedly in the advanced countries but also in middle and low-income countries. Worldwide, the share fell from 29 percent in 2000 to 16 percent in 2010, while the share of manufactures in merchandise trade went from 75 percent in 2000 to 69 percent in 20 1 0.[1]Meanwhile the share of services in global trade was 19 percent in 2012, however, if calculated with reference to value added, services accounted for a third or more of the traded amount.[2]Could this share rise and if so how would it affect GVCs and the participation of East Asian countries? Services value chains tend to be shorter with the exception of transport and storage, and the advanced countries retain a strong lead in the production and export of services - in fact their comparative advantage is increasingly in this sector. East Asian and other developing countries have long tended to protect their services industries with the result that productivity and competitiveness is low. Greater consumption of services and a lessening of the (physical) material intensity of these services in advanced countries and also in middle income countries such as China, would lead to changes in the exports from Southeast Asia and the way in which participation in GVCs impinge upon these economies.

5. Vietnam and the GVCs

The liberalization of Vietnam's trade followed by the large flow of FDI, have resulted in a rapid growth of manufactured exports - a 21 percent per annum increase in value between 2000 and 2009. The share of manufactures in exports rose from 43 percent in 2000 to 60 percent in 2010. But it remains well below that of neighboring countries such as China, Thailand, and Malaysia. Services comprise a minuscule share of exports - mostly tourism and transport. Vietnamese based producers have successfully

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1. World Development Indicators 2012.
2. http://www.wto.org/english/res e/booksp e/wtr13-1 e.pdf

integrated into some of the key GVCs of the region in the process displacing some production in China and Thailand for example. Vietnam has also emerged as a fierce competitor of producers throughout Asia. As is to be expected, the bulk of Vietnam's merchandise exports fall in the low-tech labor-intensive category that accounts for a relatively small share of global trade. Vietnam's top manufactured exports are footwear, apparel, electrical machinery, furniture and bedding, leather goods and food products in particular seafood. Among them, the fastest growing items are electrical machinery, furniture, and general machinery - and their share of total exports is increasing.[1] These items involve the processing of imported intermediates that are cycled through North-South value chains controlled by TNCs many of which have established subsidiaries in Vietnam.

Vietnam's exports rose by 15.4 percent in 2013 to $132.2 billion[2] and it is diversifying into products that were among the fastest growing global exports. This includes high tech products such as office machines, pharmaceuticals and optical instruments; medium tech products such as ships and boats, and fertilizer; and low- tech products such as jewelry. While Vietnam's share in these product categories is still small, longer run growth prospects will depend upon an increase in the domestic value added in the principal standardized products such as furniture and food products[3] (through increased technological sophistication, backward and forward integration and by harnessing domestic services), and with the help of diversification into new product categories and their GVCs. A viable GVC linked export strategy must go hand in hand with a range of policy initiatives that improve

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1. UNIDO (2011), http://www.unido.org/news/press/viet-launched.html
2. http://en.vietnamplus.vn/Home/Trade-activities-expected-to-register-10-percent-growth/20141/45265.vnplus
3. A few branded products are already established in the regional market: e.g. Vinamilk beverages, PhuQuoc fish sauce and Trung Nguyen coffee. Vietnam Industrial Competitiveness Report 2011.

Vietnam's competitiveness, the volume and quality of skills, infrastructure and logistics, and innovation capabilities.

A few performance indicators can highlight the areas demanding attention. The WEF Competitiveness Report for 2012-2013 ranked Vietnam 75th a small improvement over the 77th place it occupied in 2006.[1] The World Bank's Doing Business Survey for 2014 ranked Vietnam 99th and identified investor protection, resolving insolvency, tax payment, getting electricity, and starting a business as areas requiring the most attention.[2] The World Bank's Knowledge for Development Index showed that Vietnam had improved its ranking from 113 in 2000 to 104 in 2012, however, the supply and quality of technical and scientific skills remains weak, the research infrastructure is undercapitalized, highly compartmentalized with few industry linkages and R&D spending is low by regional and international standards.[3] Lastly, the Logistics Performance Index constructed by the World Bank showed that Vietnam's score rose from 2.96 in 2010 to 3.0 in 2012 from a maximum of 5.[4] This is an encouraging development as logistics plus trade facilitation is critical to the efficiency of a trading nation and to its standing in GVCs. Among developing economies, Vietnam's participation in GVCs was at a middling level in 2010: Its export integration was 48 percent with the upstream component larger than the downstream component. This compares with an integration rate of 82 percent for Singapore, 68 percent for Malaysia and 52 percent for Thailand. In other words, there remains plenty of scope for further exploiting the potential of GVCs.

Much more detail on Vietnam's economy and export sector can be found in the reports that are referenced and other publications. Suffice to say, the literature on the recent developments in GVCs

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1. http://www3.weforum.org/docs/CSI/2012-13/GCR Rankings 2012-13.pdf
2. http://www.doingbusiness.org/data/exploreeconomies/vietnam/
3. http://en.wikipedia.org/wiki/List of countries by research and development spending; www.uis.unesco.org/...2008/Presentation_VietNam.ppt.Dang DuyThinh, NISTPASS, Vietnam
4. http://data.worldbank.org/indicator/LP.LPI.OVRL.XQ

and Vietnam's participation in global supply networks suggests that Vietnam's trade performance could be improved through a further embedding in GVCs however, policies need to ensure that Vietnamese industry does not become locked into low-level assembly activities and instead actively upgrades into higher value tasks. Thin industrialization - as in Pakistan and Bangladesh for example - increase the risks of countries languishing in lower middle-income traps. Taking maximum advantage of GVCs calls for policy actions along the following lines.

6. Better trading in a networked world

It goes without saying that macroeconomic stability, appropriately calibrated exchange rate policies, a sound business environment furnished with effective market institutions, and attractive incentives for FDI, serve as the foundation for the development of tradable activities - and entry into GVCs. East Asian economies are sensitized to these requirements and to varying degrees have met these requirements. Vietnam also continues to make progress.

In addition, Vietnam's rapid growth within the networked GVC framework calls for initiatives in five areas:

First, the fragmentation of production and the trade in intermediates demands the creation of seamless regional production networks so that goods at varying stages of production can circulate with the minimum of delay and subject to the fewest impediments in the form of tariffs or other transaction costs. At the current juncture, large gains would accrue to all the participating Asian countries from Asia- Pacific economic integration through a comprehensive Trans Pacific Partnership (TPP) and a Regional Comprehensive Economic Partnership (RCEP). The annual gains from the instituting of a high standard trade architecture based on deep liberalization could exceed $1.3 trillion by 2025.[1]

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1 Petrie, Plummer and Zhai (2012) http://www.iie.com/publications/pb/pb12-16.pdf

Second, one of weak links in Vietnam's supply chain and in several other Southeast Asian countries, is the infrastructure - hard and soft (Portugal-Perez and Wilson 20 1 2).[1] Inadequate land transport and port infrastructures and weak security increase costs, eat into narrow margins and discourage buyers. Inadequate and erratic power supplies are the bane of producers many of which must seek alternative and expensive own sourced power. HSBC's infrastructure index for Vietnam shows an improvement from 0.28 in 2000 to 0.37 in 2012 (Korea was rated 1.04), however, studies conducted by the World Bank indicate that high transport costs along the principal internal corridors, the poor quality of transport and logistic services, and the underutilization of cheaper waterborne transport are serious bottlenecks.[2] Strengthening supply chains for leaner times demands urgent attention to these inputs. Behind the border trade facilitation and supply chain integrity/security, is a related bottleneck. Outmoded customs procedures many requiring manual form filling pose one set of problems. Cumbersome regulations that are inconsistently applied and delays in customs clearance are some of the others. The OECD has estimated that documentation alone absorbs 7 percent of the value of internationally traded goods annually. In Vietnam, shippers have to expend an additional $100 million annually in inventory charges because of delays at customs. Protecting trade secrets and minimizing the entry of counterfeit components worry producers of high tech

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1. http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/ 2010/04/05/000158349 20100405094717/Rendered/PDF/WPS5261.pdf; The costs imposed by Brazil's infrastructure weaknesses are noted in Sturgeon and others (2013)

   http://www.cggc.duke.edu/pdfs/CNI Brazil GVC Report Final 2013-09-05.pdf

2. http://www.worldbank.org/en/news/feature/2014/01/07/efficient-logistics-a-key-to-vietnams-competitiveness; http://www.worldbank.org/en/news/feature/2014/01/07/facilitating-trade-through-competitive-low-carbon-transport-the-case-for-vietnams-inland-and-coastal-waterways

components and luxury goods. Thus digital economy and secure connectivity issues are additional concerns.[1]

The mechanics of reforming trade facilitation and the regulatory environment are relatively straightforward; the socio-politics of reform can be forbidding. Delay will make it harder for Vietnam to meet its export targets and reduce the trade deficit. The World Bank reports and other publications (e.g. Grainger 2007)[2] spell out the desirable policy reforms: the challenge is implementation.

Third, light manufacturing has been viewed as a low-tech, unskilled labor-intensive activity, surviving on an abundant supply of predominantly female labor and subject to high turnover. But that may be changing. Industries such as textile and garment manufacturing and toys for example, are undergoing a technological renaissance and the more competitive firms will be those that harness new design, production and IT technologies, match these with a more skilled workforce and introduce process (as well as product) innovations so as to increase productivity and lessen waste. The leading top tier firms are already moving in this direction but for the rest, a sea change is required in hiring, compensation and in-house training practices. But these alone will be insufficient in the absence of public and private initiatives to set up effective vocational training facilities that inculcate a base level of skills, building on an adequate foundation of primary and mid-level schooling. Climbing up the value chain, entering the ranks of ODMs and OBMs and achieving the government's targeted rate of 7 percent growth will be impossible if the quality of Vietnam's workforce is not improved and firms do not take steps to retain qualified workers. A Mckinsey report concludes that a 50 percent increase in labor productivity is the desirable target.[3] Leading

1. https://csis.org/publication/enhancing-value-chains

2. http://worldcustomsjournal.org/media/wci/-2008/1/customs and trade facilitation from concepts to implementation.pdf

3. Mckinsey (2012), http://www.mckinsey.com/insights/economic studies/taking vietnams economy to the next level

producers of garments such as China and Turkey have successfully built up the infrastructure of vocational and design institutions and supporting research facilities, increased their spending on R&D, and tightened their links with global retailers. If Vietnam and some of its neighbors want a larger piece of their targeted supply chains, they need to do as much if not more on skill development and the building of innovation capabilities especially if they see their medium term industrialization remaining tied to the fortunes of light manufactures and processing activities[1].

Fourth, recent and multiplying incidents of damage to supply chains caused by extreme weather (e.g. Thailand in 2011) are a warning of the increasing risks from climate change that need to be addressed. Better and more accurate data sets and algorithms to arrive at well-grounded supply chain risk assessments would be one step. Adaptation at the country level but also globally is another, through a variety of initiatives. As Leverman (2014, p.29)[2] observes, "a diverse but reliable supply net (could be) more favorable than relying on one source, even if that transportation route seems cheaper, at first sight."

Fifth and finally, as the UNCTAD (2013) report observes, the large role played by GVCs calls for a more dynamic view of industrial development on the part of individual countries and the creating of "mutually beneficial co-development partnerships with lead firms in the GVCs" that can increase the stickiness of countries for foreign investment and induce cluster formation. [3] A better understanding of power relationships within GVCs can contribute to the effective use of competition as well as other

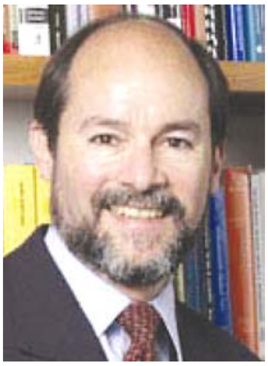
1. See Fernandez-Stark and others (2011). Leading firms from Turkey and Sri Lanka have established offices in a few western cities so as to be closer to their buyers and to work with them on design and product development.
2. http://www.nature.com/news/climate-economics-make-supply-chains-climate-smart-1.14636
3. UNCTAD (2013, pp.177-78) http://unctad.org/en/publicationslibrary/wir 2013 en.pdf

incentive policies to offset the asymmetric distribution of power among lead firms and their suppliers.

These five areas for policy intervention do not by any means exhaust the totality of export/GVC related issues that Vietnam and other countries in the region will need to tackle during the coming decade.[1] Increased South-South trade, a continuing shift in the composition of trade towards services, the rise of GVCs led by firms in developing countries, will also demand responses. However, the above five will be high on the list of near-term priorities for policy action.

1. Gary Gereffi and his colleagues at the Duke Center for Globalization, Governance ands Competitiveness have thoroughly explored the issues by sector and with respect to selected countries. http://www.cggc.duke.edu/projects/gvc.php

Short biography of Prof. Robert Z. Lawrence, John F. Kennedy School of Government at Harvard University



Robert Z. Lawrence, senior fellow since 2001, is the Albert L. Williams Professor of Trade and Investment at the John F. Kennedy School of Government at Harvard University. He was appointed by President Clinton to serve as a member of his Council of Economic Advisers in 1999. He held the New Century Chair as a nonresident senior fellow at the Brookings Institution and founded and edited the Brookings Trade Forum. Lawrence has been a senior fellow in the Economic Studies Program at Brookings (1983-1991), a professorial lecturer at the Johns Hopkins School of Advanced International Studies (1978-1981), and an instructor at Yale University (1975).

He has served as a consultant to the Federal Reserve Bank of New York, the World Bank, the OECD, and UNCTAD. He is the author of more than 100 papers and articles on topics in the field of international economics, particularly on global integration, trade in the Middle East, and the impact of trade on the labor market. He is also the author or coauthor of several books.

VIETNAM AND THE TRANS-PACIFIC PARTNERSHIP: OPPORTUNITIES AND CHALLENGES

Prof. Robert Z. Lawrence
Harvard Kennedy School
and the Peterson Institute of International Economics

If Vietnam is to sustain its economic growth as a middle-income emerging economy, it must implement policies that enhance its global integration and advance its domestic economic reforms. The Trans Pacific Partnership (TPP) has the potential for doing both. The TPP should help remove the obstacles that Vietnamese exports face in some of the world's largest economies. It would also facilitate the operation of Vietnam's domestic trade regime, and help it attract more of the global supply chains that are now relocating from China. If the TPP agreement succeeds in crafting rules that make the markets of its participants more open and contestable, it couldalso provide an anchor for the domestic reforms of state-owned enterprisesthat are needed to make Vietnam a more market-oriented economy. But these outcomes are not assured. The specific provisions of the TPP will matter. Vietnam needs to make sure that the potential benefits from the agreement will outweigh the concessions it will inevitably have to make. In addition, trade agreements can only offer opportunities; they cannot guarantee results. Ultimately the degree to which Vietnam actually benefits from the agreement will depend on whether the government and firms of Vietnam actually take advantage of the opportunities the agreement provides. Accordingly, in addition to negotiating the agreement, complementary policies need to be adopted.

In this presentation I will first describe the global forces that are leading to the negotiation of deep, mega-regional trade agreements such as the TPP. Then I will consider the contribution the TPP could make in boosting Vietnam's international trade and investment performance and stimulating its economic growth. Next I consider the potential role of the TPP as an anchor for domestic reform. I then provide some comments on some of the key aspects of the agreement, and conclude with some cautionary observations relating to the challenges it presents.

1. The global context

An observer of the current global trading system could reasonably draw two contrasting implications from the experience of trade negations of the past decade. The first is that the multilateral system is at an impasse. The combination of decision-making by consensus and a highly diverse and heterogeneous membership with powerful and large emerging economies makes it very difficult to include all members in a single undertaking. Not only has it been difficult to get agreement on traditional issues such as meaningful reductions in tariffs and farm subsidies, but it has also not been possible to obtain agreements that require developing countries as a groupto implement rules that constrain their domestic economic and social policies in new areas.At Cancun, for example, it proved impossible to obtain the required consensus to launch negotiations on three of the Singapore issues -- competition policy, investment and transparency in government procurement. The WTO has also repeatedly passed resolutions rejecting the expansion of its remit to include commitments on labor and environmental standards.

Yet many developed and developing countries are seeking to pursue zero for zero tariff reductions together with deeper integration through regional and mega-regional agreements in precisely the areas that have been roundly rejected by the WTO as a whole. The European Union and Japan have been actively negotiating deeper agreements with each other and with numerous other partners. Despite a lack of enthusiasm for trade agreements for much of its first term, the Obama administration has now embraced FTAs with considerable energy. Thecomprehensive US FTAs with Columbia, Panama and South Korea were passed in 2012 and the United States in now an enthusiastic participant in the TPP as well as its negotiations with Europe in the Transatlantic Trade and Investment Partnership (TTIP). Japanhas also now joined with Canada and Mexico as recent additions to the eleven nations including Vietnam that are negotiating the Transpacific Partnership (TPP). The scope and depth sought in the TPP and TTIP agreements are considerable and far beyond anything contemplated at the WTO. Their agendas call for agreements that not simply eliminate tariffs, but accomplish extensive liberalization in investment and services, place new rules and disciplines on subsidies, state own enterprises and aim to achieve greater regulatory convergence and coherence.

The forces propelling both of these developments are strong. On the one hand, as large emerging economies become increasingly important, it has become more difficult at the WTO to either ignore them or to coerce them into signing agreements they deem against their interests. Prior to the Uruguay Round it was relatively easy for the developed countries to simply exempt developing countries from obligationswhen these countries were unwilling to sign. In the Uruguay Round, by buying off some countries with concessions (such as the elimination of the Multi-Fiber Arrangement quotas that protected textiles) and putting pressure on others to go along, it was possible to induce developing countries to sign an agreement that contained intellectual property rules to which many were opposed. But that time has now past and since Cancun it has become clear that the emerging economies not only can say no, but when they do, achieving agreementwith a single undertaking becomes impossible.

On the other hand, as ShahidYusef has described in his presentation for this conference, the forces driving deeper integration have also become stronger. The combination of liberalization, improvements in technology, logistics and telecommunication have increased the possibilities of reaping additional economic gains from economic integration through establishing and improving the operation of global value chains. Multinational corporations are thus leading the way to help take full advantage of these opportunities by seeking new rules and more effective governance. Many countries seeking the growth and employment these companies can provide are willing to oblige. In addition, in many advanced countries, representatives ofthe major political forces (labor, environmentalists, and enterprises) all seek "a level playing field" in which their foreign competitors are subject to similar rules. Hence, in addition to the pressures that are coming from the functional requirements of operating global value-chains, there are political pressures for agreements that include rules for labor and environmental standards, and competition policy.

2. The potential advantages of TPP for Growth and Trade

Ever since it adopted its *doi moi* policies, Vietnam's growth, export and inward FDI performance has been impressive. Moreover, the current global environment offers additional opportunities for improvement. In particular, because of the appreciation of the Yuan and rapid increases in wages, labor costs are rising in China, As a result some of the global supply chains that were concentrated along the Chinese coast are now moving to new locations both within China as well as to other Asian countries. In addition growth in large emerging economies such as China and India has led to the emergence of a middle class that offers new market opportunities.

In order to sustain its economic growth as a middle income emerging economy, Vietnam needs to be able to participate more fully in these global supply chains with a view to sustaining its export growth in industries in which it has traditionally performed well. In addition, it need to as encourageboth foreign and domestic firms to use Vietnam as a location for the production of more technologically sophisticated products.

But success in this regard is not guaranteed. Success in exporting requires access to foreign markets and a domestic environment that provides firms with access to key inputs at competititve prices, as well as administrative and logistical systems that facilitate their production activities. But tariff and non-tariff barriers in labor intensive and agricultural products - Vietnam's traditional export products -- remain relatively high in both developed and developing countries. Moreover, there is considerable evidence that especially with respect to its domestic tariffs, customs regime and domestic regulatory system, Vietnam continues to impose costly constraints on its exporters. In addition, Vietnam is not the only country seeking to attract the global supply chains. It has strong competition from numerous other Asian economies such as Bangladesh, Cambodia, and Myanmar, Indonesia, the Philippines, Malaysia India and Pakistan.

The TPP can help Vietnam meet these challenges. . Once fully implemented, it would eliminate almost all tariffs and many of the non-tariff barriers faced by Vietnamese exports of agricultural and industrial products in the markets of the participants. In addition, Vietnam's domestic tariffs are the highest among the TPP participants, and eventually these would all have to be eliminated for the exports from other TPP members. This would in turn lead to lower product prices for Vietnamese consumers as well as cheaper input prices for Vietnamese producers. The TPP would also help Vietnam take other measures to facilitate trade.

The most sophisticated model of the impact of the TPP is that undertaken by Petri at. al.[1](2012). These authors have tried to capture not only the gains from trade that accrue as the direct result

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1. Petri, Peter A., Michael G. Plummer and Fan Zhai, *The Trans-Pacific Partnership and Asia-Pacific Integration: A Quantitative Assessment*, Policy Analyses in Internaional Economics Number 98, Washington DC: The Paterson Institute for International Economics, November 2012

of reducing tariffs but have also gone to considerable lengths to capture other channels for trade gains that operate through enhancing product variety, increasing productivity and generating trade in new products. In addition, the authors have attempted to model the gains that are likely to occur through increased foreign investment as well as those that will be generated by improvements in regulations and the reduction of non-tariff barriers. All told, they conclude that by gaining tariff free access to large markets such as USA and Japan and by reducing non-tariff barriers, Vietnam will see larger percentage gains in GNP and faster export growth than any other TPP member. They conclude, for example, that if the TPP is adopted, by 2025, Vietnamese GDP would be 13.6 % higher - this is more than twice as large as the next largest increase - of 6.1 percent for Malaysian GDP - and much larger than additional GDP growth of 0.4, 1.4, and 2.2 percent projected for the US, Peru and Japan respectively. Similarly, Vietnamese exports would increase by 37.3 percent as a result of TPP, far larger in percentage terms than the increases for Japan 14.0 (percent) and Malaysia (12.4) and the United States (4.4 percent).

By joining the TPP, Vietnam would also automatically achieve an advantage over most of the other Asian countries with whom it competes in export markets and efforts to attract foreign direct investment. Malaysia would be the only other Asian country at a similar level of economic development that would be able to match the market access to the US, Japanese, Canadian, Mexican and Australian markets that Vietnam would be able to offer exporters. Even if eventually, other Asian countries were to join the TPP Vietnam would have gained an important first mover competitive advantage.

3. TPP and Domestic Reform

Moreover, the TPP will not only have great breadth of coverage -it is expected to have 29 chapters - but in each area, itwill be much deeper and the rules more demanding than the agreements which Vietnam have signed thus far. A major US goal in the TPP is to establish a template for what the US government refers to as a "high-standard, 21st century agreement". This includes comprehensive coverage, extensive liberalization of services and investment, strong rules for the protection of intellectual property, efforts to improve and streamline regulations, as well as impose disciplines on the operation of state-owned enterprises. Petri et. al. have compared the provisions that are likely to emerge with those in the agreements that have been signed by the ASEAN members, and they conclude that in all respects the TPP will be much deeper.

There is a widespread recognition that Vietnams's economic performance is currently being adversely affected by the role that State Owned Enterprises (SOEs) play in the economy. Institutional reform of SOEs is for example, one of three *breakthroughs* that are sought in Viet Nam's ten year Socio-Economic Development Strategy (SEDS, 2011-2020) and there are currently plans to privatize a large numbers of these firms. SOE's often receive preferential treatment via low-cost government capital, exemptions from normal regulation and taxation, and favorable procurement contracts. The SOE chapter in the TPP has the ability to help Vietnam change some of these practices since it is likely to call for "competitive neutrality between SOEs and private enterprises" and to require a high degree of transparency in SOE operations, including their financial structure. In particular, if the rules impose a hard budget constraint on the operation of SOE's this could in turn help alleviate some of the pressures on the financial system. In addition, if there is competitive neutrality, privately owned domestic and foreign firms would bring competitive pressures to bear on the SOE and speed up their restructuring.

Vietnam can of course take measures to reform the SOEs unilaterally, but it could be preferable to undertake these measures in the context of deep trade agreements, if the benefits from the agreement outweigh the costs of giving up some domestic policy autonomy. Adeep trade agreement can involve costs by dictating both the pace and some of the terms of the reform process. But it can also facilitate this process by acting as a commitment device and thus anchoring domestic reforms and making them more credible. Agreements can also facilitate the domestic politics of reform by mobilizing export interests on the side of change.

In this regard, the Chinese experience in its accession to the WTO is instructive. At the time China was negotiating entering the WTO there were strong internal debates within China between those interested in stimulating market reforms and those in favor of more conservative policies. The reformers were skillfully able to use the demanding terms set by the United States and other WTO members for China's accession to strengthen their hand, and thus to accelerate the movement towardsa more market oriented economy. This did not happen to the same degree when Vietnam entered the WTO, but the TPP would provide Vietnam with a similar opportunity.

Similarly, there is a widespread recognition that Vietnam needs to place more emphasis on the environmental impact and sustainability of its economic policies, and again, the TPP's privsions in this regard could be used to facilitate the adoption of domestic measures in this area.

4. Specific Issues in TPP

The TPP is currently still under negotiation, and ultimately, whether or not Vietnam should sign the TPP will depend on the details of its specific provisions. There are many controversial but important issues with respect to the rules of intellectual property, the digital economy, Vietnam's treatment as a non-market economy, exemptions and or longer phase in periods for less developed members of the agreement. The number of issues under consideration is very large, and in the time allotted to me, I do not have time to discuss them. But I should note that ultimately, the benefits that Vietnam will derive from the agreement will depend on its ability to achieve favorable treatment in the rules and other provisions. As the saying goes, "the devil lies in the details."

Let me, however, give just one example: Vietnam is a major exporter of garments and therefore has a considerable interest in the precise rules of origin for apparel that will be included in the TPP. Typically, the rules in US agreements have required a triple-transformation - i.e that the yarn, the fabric and the assembly all originate in the countries that are party to the agreement. Even with such restrictive rules, Vietnam would benefit from the elimination of tariffs on apparel for its exports to the US. But it would derive even more benefits, if the rules permitted the use of third-country fabrics. While the US is unlikely to agree to such rules, Vietnam has pursued a second best strategy and sought liberal treatment for cases in which the fabric requirement is suspended because it is not being produced in the countries that are party to the agreement - the so-called short-supply rule. This would allow it to reap even larger benefits.

My advice in this respect is twofold and obvious. Firstly, the negotiators need to be extremely diligent and careful when it agreeing to the specific terms of the agreement and secondly, ultimately the question of whether the agreement is actually in Vietnam's interest cannot be answered before the precise terms of the agreement are concluded.

5. Concluding Comments

Concluding the TPP will not automatically give rise to benefits. It is very important that Vietnam take advantage of the opportunities it creates by implementing complementary policies that enhance its competitiveness by investing in human, physical and institutional capital. The shift towards higher levels of value-addition to escape the middle - income trap requires improving worker skills, technologies, and undertaking measures that encourage entrepreneurship. It may also require overcoming the political resistance of those who are unable to adapt to a reformed economic system.

Finally, I should end on a note of caution. The successful conclusion of the TPP negotiations and its implementation is by no means certain. The political situations in both Japan and the United in particular provide reasons for concern. In Japan, for example, there are doubts about the political feasibility of agreeing to market-opening especially in agriculture. In the United States, while President Obama has supported an agreement, has met with resistance from members of congress on both his left and his right. Nonetheless, even if at worst the TPP negotiations do not succeed, to the degree that it enhances the debate about the policies Vietnam needs to undertake to improve the competitiveness of its economy, participation in the negotiations will have made a positive contribution towards formulating its reform strategy.

CONCLUDING SESSION

THE WAY FORWARD
AND CLOSING REMARK

CLOSING REMARK

Nicholas Rosellini
UNDP Deputy Assistant Administrator and
Deputy Regional Director for Asia and the Pacific

Excellency, Vice-Minister of Foreign Affairs, Mme. Nguyen Phuong Nga

Professor Nguyen Quang Thuan, Vice-President of the Viet Nam Academy of Social Sciences

Distinguished participants, ladies and gentlemen.

On behalf of UNDP, it is an honour and a pleasure for me to deliver the closing remarks at this important international conference.

The region and Viet Nam have achieved unparalleled success in economic development that led to tangible improvements in people's lives. Asia-Pacific is now a largely middle-income region. At the same time, the growing share of poor people and rising inequalities are causes for concern. Inequalities persist in education, health, nutrition, living conditions; and are compounded by disparities in voice and participation that are also gender and ethnicity-based.

Uneven development progress seen across and within countries has been related to differences in the quality of political, economic and environmental governance. Challenges remain across Asia-Pacific region for strengthening institutions, improving public administration and service delivery, and enhancing access to justice, transparency and accountability.

Mitigating and adapting to the impacts of climate change are key to sustained human development in the region. Beyond climate change, effective management of natural resources such as forests, water, fisheries and minerals, is of utmost importance given the over-exploitation of natural wealth and environmental degradation.

For Viet Nam, this discussion is very timely and pertinent. The Government is reviewing thirty years of Doi Moi, which has helped lift tens of millions people out of poverty. As the country moves further, it needs new policies and institutions which ensure that growth accelerates, but importantly is also inclusive and sustainable. As many contributors underlined, these features - inclusiveness and sustainability - also contribute to growth.

I would now like to pick up on some key themes discussed in the conference and attempt to synthesize the key messages emerging from the discussion.

We began with a keynote speech by the Deputy PM that set the scene and highlighted the main challenges to be addressed such as the role of state in the economy, agricultural sector modernization, opportunities and pitfalls of greater regional and global integration. He also touched on institutional and policy reforms necessary to facilitate continued growth.

The UNDP Administrator reminded us that these are the challenges faced by many countries and reinforced the global importance of sustainability and inclusiveness - and also of transparency and accountability - for continued progress in human development.

The first session highlighted the significance of tackling inequality as a win-win for accelerated growth. It outlined some policy and institutional reforms, ranging from macroeconomic instruments to structural interventions.

Yesterday afternoon we looked at financial and SOE sector reforms to improve economic efficiency, productivity and competitiveness. The Indonesian and Chinese examples clearly showed that regulatory mechanisms that combine good economic governance and market discipline are central to success of reform efforts.

This morning we examined the middle-income traps and factors contributing to growth deceleration globally and in the region. This is characterized by slow movement through the value chain, high levels of inequality and low level of productivity and innovation. New challenges require new policies and institutional capacities. This is particularly pertinent to agriculture and rural development, the sector in which a majority of the poor are engaged. At Viet Nam's stage of development, modernizing agriculture remains vital - it is clearly still a sunrise, rather than a sunset sector.

The final session addressed the opportunities and challenges with regards to regional and global integration. Many speakers have highlighted that free trade agreements offer an anchor for institutional and policy reform. However, success is not guaranteed unless institutions are inclusive and Viet Nam's economy becomes less divided between state and non-state, foreign and domestic, formal and informal, and rural and urban sectors.

These have been highly relevant discussions and lessons for Viet Nam as it examines its economic reform agenda in the context of the thirty-year review of Doi Moi.

UNDP has long been a partner of Viet Nam in renovating its development model. Moving ahead, UNDP stands ready to deepen and take forward the very useful discussions that have taken place in the past one and a half days through sharing innovative solutions and relevant experiences.

These issues will be at the heart of the next Viet Nam Human Development Report focusing on inclusive growth. Many of the policy ideas that were discussed in the conference will inform the continuing engagement with senior levels of the Government as part of the Viet Nam Executive Leadership Programme and other interventions supported by UNDP. Specifically, accelerating human development and livelihoods with a focus on ethnic minority communities and remote areas, as well as promoting public administration reform at local levels, are promising strategies that UNDP is taking forward with its partners.

This is our closing session but not the end of this important dialogue. Having served in Viet Nam in 1990s and seeing the progress made as well as encouraging discussions in this conference, I remain positive that Viet Nam will make the right policy choices to renovate its economic development model and secure a sustainable and prosperous future for all.

In conclusion, I would like to thank the Ministry of Foreign Affairs and Viet Nam Academy of Social Sciences for co-organising this conference jointly with UNDP. Our special thanks go to all the international and Vietnamese resource persons and speakers for sharing their insights.

CLOSING REMARK

Nguyen Phuong Nga

Vice Minister

Ministry of Foreign Affairs

Mr. Nicholas Rosellini, UNDP Deputy Assistant Administrator and Deputy Regional Director for Asia and the Pacific,

Mr. Nguyen Quang Thuan, Vice President of the Viet Nam Academy of Social Sciences,

Ms.Pratibha Mehta, UN Resident Coordinator and UNDP Resident Representative,

Distinguished participants

After one and a half day, the international conference entitled "Economic Reforms for Inclusive and Sustainable Growth: International Experience and Lessons for Viet Nam" has been a success. On behalf of the co-organizers, I would like to express my sincere thanks for the participation and effective contributionof international and local speakers and all participants for the success of this workshop. At this workshop, we have listened to two very important speeches by Deputy Prime Minister, Minister of Foreign Affairs on the development vision of Viet Nam until 2020 and a speech by UNDP Administrator Helen Clark on the agenda development post-2015 and challenges for inslusive and sustainable human deveopment. The workshop was organized into three plenary sessions discussing around the main theme of economic reforms for inclusive and sustainable growth with a total of 16 presentations by international and local speakers, hundreds of comments, questions and discussions of nearly 200 participants to this conference. This active participation of all participants during discussion sessions have contributed to an open exchange and dialogue, contributing to the success of the workshop. The workshop can be said to have achieved the objectives of creating a platform for Vietnamese participatns to exchange with international experts and scholars on socio-economic development experience, especially in the implementation of economic reforms in order to achive inclusive and sustainable growth.

Distinguished participants,

The workshop discussed in depth on the role of institutions in ensuring inclusive and sustainable growth, on the relationship between economic growth and rising inequalities, policies for improved competitiveness, leveraging the potential of regional and global economic integration, reforms in areas of SOEs, financial and banking sector, agriculture and rural development, etc. in the process of economic reforms. I do not have the ambition to summarize all presentations and insightful comments that you have shared in this workshop, but I would like to highlight some of the contents discussed in depth for the nearly past two days.

*First,*the conference confirmed the importance of the pursuit of sustainable development as an indispensable requirement for socio-economic development of many countries in the current context of globalization. During this conference, we enjoyed useful discussions and exchange on the issue of sustainable growth from a theoretical but also practical views.

At the national level, we discussed on the experience of many countries as China, India, Thailand, Indonesia, etc. Despite the diversified approach to economic reforms, however, a common feature emerging from the conference is the necessity for pursuit of sustainable growth in the context despite the global economy is recovering from the 2008-2009 global financial crisis, countries still face many potential risks and challenges, in particular in developing countries.

Second, despite an acknowledgement that there is no one-size-fits-all model for all countries, and that countries have to rely on specific conditions to implement measures most appropriate, the conference has confirmed the importance of *uniform reform measures*. As reality shows, in many countries after the global crisis, the application of single, uncoordinated economic stimulus or tight government spending can only bring short term benefits, and therefore cannot be a comprehensive solution for inclusive growth. This has been a factor contributing great success to the process of economic reforms of many countries in East Asia as we have seen in this conference

A very important factor in the success of economic reforms that was repeatedly emphasized is the international integration. In the context of globalization, the socio-economic development of these nations are increasingly attached to the process of international integration and in practice, many countries successfully took advantage of international integration to create important development leaps. At the workshop, we had a lively discussion and exchange of ideass on how to foster the linkages between international integration and domestic economic reforms, based on which recommendations were presented, by taking advantage of process improvement way, and on that basis make recommendations about enlisting transition value chains and global production networks in East Asian countries, including Vietnam to serve the goal of stable growth firm. We also discussed the important role of a free trade agreements through a detailed analysis on the TransPacific Partnership Agreement.

Last but not least, we hope that this conference will help to convey more information to international speakers and participants on the progress in economic reforms towards an inclusive and sustainable growth in Viet Nam. As emphasized by the Deputy Prime Minister, Minister of Foreign Affairs H.E. Pham Binh Minh, with the objective of becoming a modern industrialized economy by 2020, Viet Nam is committed to reform process with three breakthroughs in perfecting the market economy with socialist orientation, development of the human capital and development of infrastructure. In the meanwhile, Viet Nam appreciates and is keen on receiving international experiences, recommendations and suggestions by the international community and researchers, scholars. I believe that representatives from ministries, branches, localities and the research community will consider and acknowledge all comments, experiences and best practices shared during this conference, based on which, they will make appropriate recommnedations and experiences to present to the Government for policymaking process of socio-economic development. We hope that international participatns to this conference will continue to be our friends, partners supporting Viet Nam's process of economic reforms towards inclusive and sustainable development.

Distinguished guests and friends,

On behalf of the Organizing Committee, I would like to once again express our sincere thanks to all speakers and participants for your participation and effective contribution to the workshop.

I would also to thank all organizing staff from the Ministry of Foreign Affairs, Viet Nam Academy of Social Sciences and UNDP and the translator team for their great effort in preparing for this workshop and for their very important contribution to the success of this workshop. Sincere thanks also to media agencies and journalists who broadcasted news about our workshop. Thanks to the Sheraton Hotel for supporting us for the good organization of this event.

On behelf of the Organizing Committee, I hereby declare the closing of the workshop. Wish you all happiness and success.

Thank you very much./.

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KỶ YẾU HỘI THẢO QUỐC TẾ

CẢI CÁCH KINH TẾ VÌ TĂNG TRƯỞNG BAO TRÙM VÀ BỀN VỮNG
KINH NGHIỆM QUỐC TẾ VÀ BÀI HỌC CHO VIỆT NAM

INTERNATIONAL CONFERENCE PROCEEDINGS

ECONOMIC REFORMS FOR INCLUSIVE AND SUSTAINABLE GROWTH
INTERNATIONAL EXPERIENCE AND LESSON FOR VIET NAM

Chịu trách nhiệm xuất bản
PGS.TS. NGUYỄN XUÂN DŨNG

Biên tập nội dung: ĐỨC BÌNH - THANH TRÀ
Kỹ thuật vi tính: DŨNG ĐẠT
Sửa bản in: ĐỨC BÌNH - THANH TRÀ
Trình bày bìa: MINH TRANG

In cuốn, khổ 16 x 24 cm, tại
Số xác nhận đăng ký xuất bản:
Số ngày
In xong và nộp lưu chiểu tháng

KỶ YẾU HỘI THẢO QUỐC TẾ

CẢI CÁCH KINH TẾ VÌ TĂNG TRƯỞNG BAO TRÙM VÀ BỀN VỮNG

KINH NGHIỆM QUỐC TẾ
VÀ BÀI HỌC CHO VIỆT NAM