UNDP in Viet Nam

EAST ASIA: FROM MIRACLE TO CRISIS

Key Lessons for Viet Nam

A UNDP Staff Paper

(Updated Edition)

November 1998

FOREWORD

East Asia: From Miracle to Crisis outlines some of the main lessons from the East Asian development experience which are most relevant to Viet Nam at this current juncture in the country's development process. In order to be useful to Vietnamese policy- and decision-makers, the paper focuses particularly on lessons for the *role of the state* in contributing to successful and sustainable development, and in minimizing the likelihood of crisis and instability. While considerable attention is paid to lessons learned from the ongoing regional financial crisis, these are placed in the broader context of the many impressive achievements and positive lessons in the region over the past forty years.

Most noteworthy, poverty has been reduced substantially in all of East Asia's newly-industrialized economies (NIEs) following years of investment in human development and rapid economic growth. The regional crisis is now reversing some of these gains in a few of the countries concerned. Therefore, the lessons learned and outlined in this paper are also highly relevant to the sustainability of poverty reduction and human development achievements.

Viet Nam is still in a position to benefit from these lessons in order to avert crisis and instability, avoid the growing human suffering now being experienced in some of the *crisis countries*, and eventually achieve prosperity and sustainable poverty reduction. Notably, well before the ongoing regional crisis began to emerge in late July 1997, the United Nations published an analysis in October 1996, which attempted to alert Viet Nam that it appeared to be heading towards its own major financial crisis within five years for many of the same largely internal reasons that a number of countries in East Asia are now suffering crisis.[1]

The social impact of such a financial crisis in Viet Nam would be far more profound, protracted and painful than is the case in those countries currently in crisis, given Viet Nam's still very much lower income per capita and more widespread poverty. This generally lower level of income and savings would provide far less scope to absorb the related adjustments and austerity. Encouragingly, since the outbreak of the regional crisis, there has been a new

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[1] *Catching Up: Capacity Development for Poverty Elimination*, UNDP and UNICEF, October 1996.

series of reform-oriented policy statements and programmes from both the Party and the Government recognizing the need for a continued deepening and widening of the country's reform process. As in the past, the challenge will be to further convert such sound policy statements into reform actions.

Perhaps the single most important lesson to be learned from the ongoing crisis relates to the importance of taking concrete actions sooner rather than later. In the months just before the crisis erupted, all of the governments in the countries concerned probably continued to feel reasonably confident that there was still ample time to implement the reforms needed to redress internal financial, structural and institutional vulnerabilities. Nevertheless, just as those who ignore history are destined to repeat it, it is also true that crisis often spawns opportunity for those willing to take timely action.

Edouard A. Wattez
UN Resident Coordinator and
UNDP Resident Representative

Hanoi, Viet Nam, November 1998

Supplements Since First Edition

This second edition of *East Asia: From Miracle to Crisis* builds upon the analysis of the first edition published in June 1998. The first edition outlined some of the most important positive and negative lessons from the East Asian development experience over the past forty years, including from the ongoing regional crisis. In order to be useful to policy- and decision-makers, the focus was on the *role of the state*. While the lessons drawn remain relevant to many developing countries, a final section outlined key lessons particularly relevant to Viet Nam at this current juncture of the country's development process.

This present edition supplements the analysis in the first edition in several ways. First, it updates the analysis in light of more recent developments. Secondly, it looks more closely at the social impact of the regional crisis in the countries most affected, the potential impact on Viet Nam, and related social policy implications. Thirdly, this edition attempts to add clarity to the rich, but at times confusing, international debate on the regional crisis in the hope of facilitating the domestic policy debate and needed actions in Viet Nam. This second edition is also written in a non-technical manner to maximize accessibility.

Part of the basis for the supplements to this second edition was a two-day policy conference on the *role of the state* in the origins and management of the regional crisis organized by the Central Institute of Economic Management (CIEM) with UNDP assistance in Hanoi on 31 August – 1 September. The conference involved high-level policy advisors and eminent researchers from Indonesia, Thailand, South Korea, Malaysia, Viet Nam, Sweden, Canada, and the USA. The main purpose of the two-day dialogue was to share country experiences and lessons learned in the origins and management of the crises in the various Asian countries concerned, and to examine the relationships between *globalization, governance and stability*. The conference was motivated by the first edition of *East Asia: From Miracle to Crisis*, and a desire by Vietnamese officials to better understand the ingredients and policies for preserving stability, which has been for many years, and remains, the highest priority of the Vietnamese State. The two-day conference largely endorsed the lessons learned and policy implications outlined in the first edition, while supplements and qualifications offered at the conference are taken into account in this second edition.

The views expressed in UNDP staff papers are not necessarily the official views of the United Nations Development Programme.

East Asia[1]:
From Miracle to Crisis
Key Lessons for Viet Nam

I. Introduction

Purpose

This paper briefly outlines some of the most important lessons learned from the East Asian development experience over the past forty years, with particular focus on the ongoing regional crisis. The paper attempts **to help facilitate the domestic policy debate and needed policy actions in Viet Nam** so that the country averts crisis, resumes strong and sustainable development, and further reduces poverty in a sustainable manner. In order to be useful to policy-makers, the following analysis focuses on experiences and lessons learned on the *role of the state* in the successes and failures of East Asia. Based on these experiences and key lessons learned, the related policy implications for Viet Nam are briefly outlined. Lessons learned and related policy implications are also outlined for mitigating the social impact of economic downturns, and minimizing hardships on the most vulnerable of the Vietnamese people. All of these important lessons learned and policy implications provide the basis for resuming strong and sustainable development, **while preserving stability, which has been for some years, and remains, the highest priority of the Vietnamese State.**

As such, this paper builds upon the first edition published under the same title in June 1998. This current edition supplements that earlier analysis by further analyzing the likely social impact of the regional crisis in Viet Nam and related social policy implications. Moreover, in light of recent developments both regionally and globally, this edition further explores the relationships between globalization, governance and stability. Equally important, this second

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[1] For purposes of this paper, East Asia includes South East Asia, and the development experiences surveyed include those of the first-tier newly-industrialized economies or NIEs (Japan, South Korea, Taiwan, Hong Kong, and Singapore) as well as the second-tier NIEs (Malaysia, Thailand, Indonesia and The Philippines). Reference to main-land China's experience is made when relevant.

edition attempts to assist Vietnamese policy- and decision-makers in sorting through the very diverse and at times confusing, international debate on the regional crisis in order to facilitate the domestic policy debate and needed policy actions in the country.

Deepening Impact

Viet Nam has so far been much less severely impacted by the ongoing regional crisis compared with a number of other countries in the region. There are **several reasons** for this including: the country's lack of dependence to date on liquid foreign capital; the non-convertibility of its currency; as well as layers of other regulations (which provide some temporary shelter from the outside storm, but also impose heavy economic costs). The impact of the regional crisis has also been slowed by the fact that much of the Vietnamese economy is still informal, and only indirectly linked to the formal regional and global economies.

Nevertheless, **while growth in GNP is still positive, it is clearly on the decline** in line with a considerable reduction in export growth and foreign direct investment. Continued internal structural weaknesses, which had been masked by high growth rates in recent years fuelled by easy foreign money, will be increasingly exposed as finance becomes more scarce. As a consequence, **the social impact of the regional crisis on Viet Nam is also expected to gradually deepen during 1999 as unemployment in the formal sectors, especially in urban areas, continues to gradually rise**. This in turn risks reversing some of the country's significant achievements in poverty reduction over the past twelve years, and increasing vulnerability to social hardships. **Fortunately, through timely and effective policy actions, Viet Nam can still avert sinking into the kind of crisis conditions being experienced in a number of other countries in the region.**

In Search of Valuable Lessons Learned

Viet Nam's development strategy has been increasingly influenced by the East Asian development experience, particularly since the collapse of the former centrally-planned economies of Eastern Europe and the former Soviet

Union in the late 1980s. The increasing influence of East Asia was of course also due to Viet Nam's geographical location, as well as the impressive record of exceptionally high rates of growth and development in a significant number of the East Asian economies over the past forty years. Indeed, this extraordinary development performance became widely known as the East Asian "miracle".[2]

Prior to the outbreak of the regional crisis, Vietnamese policy-makers had been attempting to learn and benefit from the successful socio-economic experiences of these "miracle economies", while at the same time ensuring stability. Moreover, the heavy role played by the state in directing development in some of these other countries may have seemed appealing to many officials in Viet Nam, which has been in cautious (and perhaps at times reluctant) transition from a centrally-planned to a more market-based economy. **The outbreak in July 1997 of the ongoing regional crisis has understandably resulted in renewed debate and caution within official circles in Viet Nam on the merits of the development policies pursued in a number of East Asian economies**. This is, of course, healthy and provides an opportunity to review and take stock of the likely benefits and costs of selected policies and practices being pursued in Viet Nam.

Confusing International Debate

Unfortunately, **the domestic policy debate in Viet Nam appears to have been prolonged, and needed actions further delayed, by the rich but at times confusing international debate** on the regional crisis, particularly on the respective roles played by "liberalization" and "globalization". The international debate has been at times obscured by ideological over-reactions, attempts to deflect blame , and lack of perspective on the broader East Asian development experience. In some cases, East Asia's many achievements over the past forty years, and the related policy lessons, appear to have been largely written off by many in the "western" world, and the "miracle" is now considered to have been a "mirage". The term "globalization"

[2] The term "miracle" was most often used in describing the past development performance of Japan, South Korea, Taiwan, Singapore and Hong Kong.

has often been misused and treated synonymously with the globalization of liquid capital, without reference to its many other dimensions. Similar broad-based misuse has been made of the term "liberalization". Symptoms and catalysts like capital flight, asset price "bubbles" and "non-performing loans" have often been confused with the more fundamental causes of the crisis. Considerable attention has been focused on "market failure" without questioning why markets appear to have failed. The *role of the state* in the origins of the ongoing crisis, and related policy implications, has received only superficial coverage. Broad-based generalizations have been made about the causes of the crises in the various countries concerned without analyzing some important differences. Liquidity issues have often been confused with solvency issues. Orthodox over-reactions to issues like capital controls have cost credibility in the policy debate. The desire by some to be the first to unveil grandiose schemes as solutions to the regional crisis has distracted from the fundamental issues and urgent work at hand in the individual countries concerned. Therefore, subsequent sections of this paper also attempt to add clarity to these issues in a non-technical and understandable manner.

Structure of Paper

This paper is broadly organized as follows:

First, the ongoing regional crisis is put into the context of East Asia's broader development experience. This section emphasizes that, despite the ongoing crisis, there have been many development achievements in East Asia, and many of these achievements remain very much intact. In addition, the origins of the crisis are put into perspective, the respective roles of "government failure" and "market failure" are analyzed, similarities and differences across countries are briefly examined, and the role of liberalization and globalization are assessed.

Second, some of the most important positive lessons for Viet Nam that can be discerned from East Asia's many achievements over the past forty years are briefly outlined, followed by some of the more relevant negative lessons underlying the current crisis. Notably, some formerly ambiguous lessons from the East Asian "miracle" now appear much clearer in light of the crisis. These lessons relate particularly to the past heavy role of the state in affecting the allocation of finance and investment in commercial areas in a non-neutral manner.[3]

Third, the paper briefly analyzes the economic and social impact on Viet Nam of the regional crisis.

Finally, this paper highlights some of the most important lessons learned and policy implications for Viet Nam today, particularly regarding the *role of the state* in successful development and sustainable poverty reduction.

II. The Crisis in Perspective

This section attempts to add some balanced perspective on the regional crisis, while also attempting to provide some clarity to a number of important issues of recent concern to Vietnamese officials, in order to facilitate needed policy decision-making and actions in Viet Nam.

Remembering the Achievements

Despite the ongoing regional crisis, there have been many impressive development achievements in East Asia which remain largely intact. Real income per capita has grown tremendously and poverty has been reduced substantially over the past forty years, particularly in Japan, South Korea, Taiwan, Singapore and Hong Kong, and to a significant but lesser degree in Malaysia, Thailand and Indonesia (see Chart 1).

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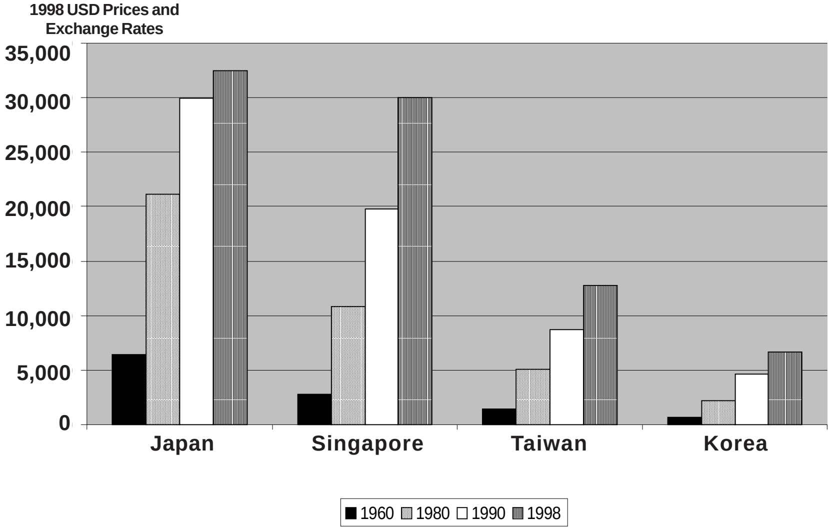
[3] Of course the state in all countries must carefully plan and direct public sector investments in basic infrastructure, basic social services, environmental management and other areas where the *invisible hand* of the market tends to *fail* because the rate of return on such *public goods and services* cannot be easily captured by private investors, or where over-exploitation results because private investors are able to avoid paying the full costs.

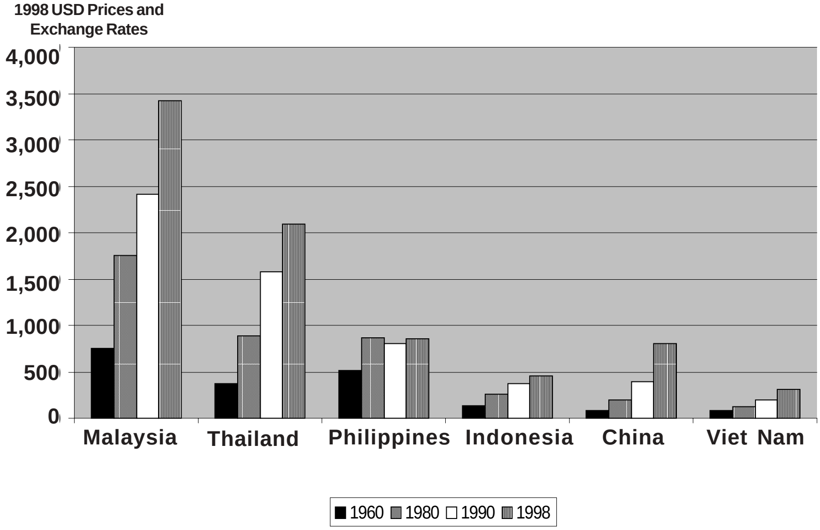
Chart 1: Long-term Trends in Real Income Per Capita (1960-98)

(Valued in US$ at 1998 Exchange Rates and Prices)

First Tier Asian Economies



Second Tier NIEs Plus China and Viet Nam



The regional poverty rate was reduced by more than two-thirds since 1960 and life expectancy increased on average by more than a decade. While the term "miracle" may have been misleading, these achievements were very real, and built on the hard work, thrift, perseverance and discipline of the people of these countries. With the possible exception of Indonesia, where financial, structural, social and political challenges appear greatest, and may require a long recovery period, all of these countries are likely to sustain most of their past achievements and further build upon these following a few years of effective restructuring. While there may be some further temporary losses in real incomes over the coming two or three years in some of these countries, there is scope to absorb these in most countries concerned if effective and equitable policies are pursued.

Notably, even with the considerable contraction of real incomes in 1998 in some of East Asia's newly-industrializing economies, the vast majority of people in most of these economies continue to enjoy a much higher level of prosperity and social well-being than is the case in those developing Asian economies that pursued less market-based and less open development strategies. This is the case whether current per capita incomes are valued at pre-crisis exchange rates or at the much depreciated exchange rates prevailing in 1998.[4] (See Chart 1 and Appendix Table 1.) While a few countries have temporarily lost one or two years of real income gains during 1998, and there may be some further smaller losses in 1999, most of the gains in income per capita and poverty reduction over the past forty years remain very much intact. These achievements will be further built upon following a few years of effective restructuring, and poverty will resume its decline. Therefore, once the current period of restructuring in East Asia is passed, most of the development strategies and policies of much of **East Asia** are **likely to remain a most worthy model for other developing countries attempting to escape poverty.**

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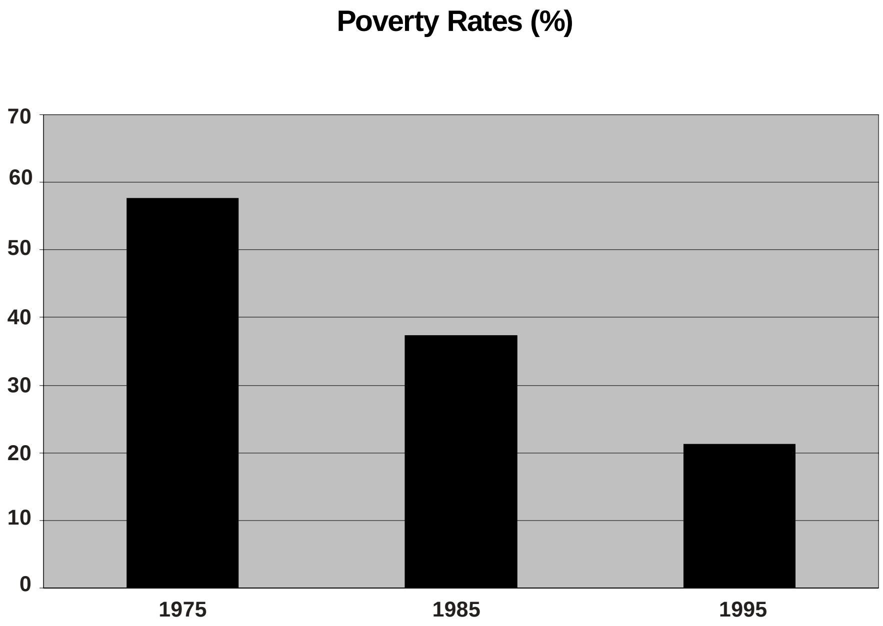
[4] Converting income per capita figures expressed in US dollars at the substantially devalued nominal exchange rates obviously exaggerates the decline in real incomes during 1997-98.



The Role of the State in East Asia's Successes and Failures

Prior to the outbreak of the ongoing regional crisis, the *state* in many East Asian countries had long been credited for much of the "miracle". Effective macro-economic policies created incentives for substantial savings and investment, and labor-intensive export-oriented development by the private sector. The state was also credited for strategic public investments in basic infrastructure, education and health, and in a few cases, effective and equitable land reform, which together created the basis for rapid and equitable growth in many East Asian economies. **Together these policies enabled and strongly promoted the development of dynamic private sectors which were the engines of East Asia's rapid growth and development.** Rapid and equitable growth dramatically reduced poverty and provided the dividends for reinvestment in health, education and human development, which in turn provided the basis for progress towards higher levels of development. In retrospect, most of these policies were highly effective.

At the same time, the state in a number of East Asian countries also played a considerable interventionist role in directing or influencing investments in commercial areas. "Policy loan" schemes were typically in place to promote investments in state-selected commercial areas. Government "moral suasion" was often exercised on domestic banks, both state and private, to finance state-sanctioned investments in the private sector. State guarantees, both explicit and tacit, provided domestic bankers and investors with comfort that the state would ultimately bare much of the risks and underwrite potential losses. Commercial developments were often based on personal relationships between state and private sector parties, and in retrospect, corruption appears to have played a role in developing some high cost investments and/or misappropriation of funds.

There was in some areas a considerable blurring of the state and private sectors. Lenders and investors, both domestic and foreign, developed the perception that the creditworthiness of many large private sector companies and banks was essentially backed by government creditworthiness, which in turn was fairly high in many East Asian economies thanks to conservative public sector budget management. Hence, lenders and investors were not very demanding on issues of transparency and accountability, and were willing to lend and invest on the basis of limited information. At the same time, prudential supervision of banks was weak, and domestic financial markets remained relatively protected from open competition with foreign institutions. **All of this in turn appears to have held back the development of healthy banking and financial sector practices and skills, and created a lending and investment culture willing to compromise on commercial criteria and take high risks.**

In short**, heavy state involvement for years in the allocation of investment resources in commercial areas considerably blurred state and private sector creditworthiness and related risks, and created a lending and investment culture very prone to "moral hazard**".[5] This in

[5] For example, belief by lenders and investors that the state would ultimately bail out state "guaranteed" investments and "too big to fail" corporations and banks that got into trouble through bad investment decisions.

turn promoted risky lending and investment behavior by private sector banks, finance companies and corporations in the absence of independent and effective prudential supervision and capital adequacy. **This lending and investment culture became very quickly unsustainable following the liberalization of cross-border capital flows in a number of countries during the first half of the 1990s.**

Another very important and related issue concerned the general lack of transparency and access to reliable information on which to base rational investment decisions. Reliable information is essential to effective and well-functioning markets**. State failure in either withholding essential information from the market or in failure to enforce legal requirements related to transparency, accountability and financial reporting in the corporate and banking sectors also helped set up "market failures" and the regional financial crisis.**[6] Many investors appear to have naively invested on very limited positive information and speculation (eg. based on faith in the "miracle"). Following the first hint of bad news in July 1997, **many investors fled out of "fear of the unknown".** This flight was often accelerated **by dramatic statements in the international media,** and often **based on little concrete information**. **The absence of reliable and balanced information,** and the general lack of transparency in the "core crisis countries" (Indonesia, Thailand and South Korea), **fuelled speculation, contagion and a downward spiral of self-fulfilling prophecies. The lack of transparency and reliable information deepened the crisis** more than would have been the case had more reliable and balanced information been available to investors in recent years.

Similarities and Differences Across Countries

While the core crisis countries shared a number of similarities, there were also some important differences. Similarities included: underdeveloped financial markets prone to moral hazard; lack of enforced financial market prudential supervision; a general lack of transparency and

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[6] In simple terms, a "market failure" is deemed to have occurred when a completely free market leads to a sub-optimal outcome.

reliable information in critical areas; the buildup over time of internal financial and structural imbalances in the financial, corporate and real estate sectors; and increased reliance in recent years on liquid foreign capital following the liberalization of cross-border capital flows**. Differences related to the role played by the state in creating vulnerabilities to crisis.** In Thailand, the role played by the state was more indirect through perverse exchange rate and interest rate policies. In South Korea and Indonesia, the role played by the state was more direct in negatively influencing the allocation of investment resources in unsustainable commercial areas over a lengthy period of time. This also appears to have held back the development of independent and healthy banking sectors based on commercial criteria. **These vulnerabilities were then in recent years exposed to the volatility of liquid global capital through the liberalization of cross-border capital flows.**

The recent experience of Thailand, where a large number of family-owned finance companies faced little accountability or prudential regulation, **appears to come closest to "market failure".** Such finance companies engaged in increasingly risky speculative lending often based on personal relationships and compromised commercial criteria. The establishment of the Bangkok International Banking Facility in 1992 helped feed the lending frenzy with short-term foreign debt. However, even in the case of Thailand, the State appears to have played a heavy role in the origins of today's problems through perverse exchange rate and interest rate policy, despite a substantial and widening deficit on the country's external current account. The maintenance of a fixed exchange rate and high domestic interest rates to support the exchange rate encouraged a significant rise in unhedged borrowing from abroad, including significant short-term debt. Foreign debt rose from 38% of GNP to 62% during 1988-97. In addition, state/private sector collusion reportedly played a role in the allocation of credit in commercial areas.

The case of South Korea appears to be much more related to "government failure". Chaebol debt-to-equity ratios of 5 to 1 (the figures are still being calculated in Seoul), were not built up over a few years, but over 15 to 20 years, facilitated by government "moral suasion" on domestic banks. Prior to the liberalization of cross-border capital flows, debt-to-equity ratios were already among the highest in the world at well over 3 to 1. The sudden liberalization of cross-border short-term debt flows in 1994 in Korea appears to have simply topped up already high debt-to-equity ratios. The subsequent collapse of the exchange rate, which increased the domestic currency value of Chaebol debt, as well as the deflation of equity values, exacerbated an already very serious domestic debt situation. The total amount of South Korea's foreign debt as a share of GNP and exports was still quite manageable as of June 1997 at 30% of GNP and less than 100% of exports. The problem with the country's foreign debt was not its amount, but rather its highly liquid composition (a problem which could have been avoided given the country's previously high credit rating and the scope for earlier refinancing). The real underlying problem was the heavy domestic debts carried by the Chaebol, and encouraged and facilitated for many years via heavy state influence and moral suasion on South Korean banks**. This appears to have also held back the development of healthier banking sector skills and practices, as well as greater use of equity-based financial markets, broader-based corporate ownership, and greater transparency and accountability.**

The case for "government failure" in Indonesia appears even stronger for a variety of other reasons related to the State's past extensive influence on financial resource allocations in the private and commercial sectors over a number of years. (The then ruling Suharto family and friends were effectively the State in Indonesia.) Lack of transparency, explicit and tacit state "guarantees", and moral hazard appear to have played a significant role in the misallocation of investments in the country. Indonesia's foreign debt ratios have been among the highest in East Asia for many years, at well over 200% of export revenues, leaving the country vulnerable to financial instability from exogenous shocks. There were reportedly very few large projects that escaped the direct or indirect involvement of the Suharto family. For example, the bankruptcy of the Hong Kong-based investment firm Peregrine was precipitated by a reported $250 million loan to an Indonesian taxi company, allegedly based mainly on the relationship between this company and President Suharto's daughter. (The loan begs the question of why a taxi company would ever need $250 million?) Even the so-called "privatizations" of state owned enterprises (SOEs) were reportedly largely bargain sales and transfers to family friends, many of whom remained reliant on family-influenced state bank financing.

The economies that have best weathered the regional crisis are the ones that have relied mainly on domestic savings for development, avoided excessive reliance on foreign debt, and built up significant foreign exchange reserves as a safeguard against potential capital flight.[7] These more stable economies include Japan, Taiwan, Hong Kong, China, and Singapore. For example, Taiwan, which followed a policy of *pay as you go* to higher levels of development based on sizeable trade surpluses and domestic savings, has accumulated nearly $100 billion of foreign exchange reserves (plus billions of dollars of other foreign assets). Taiwan is now in the enviable position to capitalize on the many bargain opportunities in the region. Similarly, China's savings rate is quite high at more than 40% of GDP and foreign debt is quite low at less than 20% of GNP. Moreover, the country's foreign exchange reserves remain among the highest in the world, providing considerable comfort to foreign lenders and investors (while lack of currency convertibility on capital account transactions also provides a hurdle to sudden capital flight). Japan is a net creditor to the rest of the world with substantial foreign exchange reserves. Japan's current growth difficulties relate to the past misallocation of a significant share of its huge stock pile of domestic savings and wealth, and the continued postponement since 1990 of provisioning against non-performing loans in its banking sector. In light of Japan's very high level of income per capita and wealth, the country has more than enough means to absorb these losses once the politicians agree on the distribution of the related costs and a clear schedule for provisioning.[8]

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[7] In principle, the source of financing, domestic or foreign, should not matter as long as the overall incentive system, relative prices and investment environment are rational. However, in our less than perfect world, foreign financiers have proven to be less demanding on these criteria as well as on transparency, information availability and accountability until crisis strikes (which is too late!). This is particularly the case in less developed countries where foreigners often provide financing on the basis of state guarantees, explicit or implicit understandings, and "relationships", and have proven to be more willing to compromise on pure commercial criteria. Many of these same conditions seem to have applied, in certain cases, to ODA loans and willingness to compromise on information availability and rational policy (again, until crisis strikes!).

[8] In general, national debt problems based on domestic savings largely confine the problem to one of domestic distribution of the losses, whereas when foreign creditors are involved, a country must ultimately give up to outside parties a portion of national goods, services or wealth.

Nevertheless, relying mainly on domestic savings will help shield a country from the volatility of liquid global capital, but not from the development of imbalances and eventual instability caused from within. Much of the financial problems of the crisis countries are also based on misallocated domestic savings. This is particularly the case in South Korea following years of government "moral suasion" on domestic banks to lend to over-expanding Chaebol. Minimizing the risk from this internal source of vulnerability and instability implies less state influence in the allocation of investments in commercial areas, enforcement of prudential bank capital and lending guidelines, and enabling the development of effective domestic financial markets.

In retrospect, the flight of liquid global capital from some countries in the region may have forced an early halt to increasingly risky lender and investor behavior, and averted the buildup of an even more dangerous regional financial crisis than is currently the case. Ideally such corrections should occur in a much more orderly and less destabilizing manner to minimize human hardship. Less reliance on liquid foreign capital would have probably resulted in a more orderly withdrawal of financing, but perhaps only after the imbalances became much larger and more obvious. Moreover, experience suggests that politically-difficult decisions and actions related to financial and **structural adjustments take much greater political leadership and courage in the absence of crisis, even though such adjustments cause much less hardship during periods of high growth.**

The Role of "Liberalization"

While the main focus of this paper is on the role played by the state in the East Asian development experience, **international financial "market failure" has also clearly played a significant role in the origins of the current regional crisis**. The further liberalization of cross-border capital flows in a number of East Asian economies during the early 1990s resulted in a rapid rise in foreign short-term lending and portfolio investment. Some of this appeared to have been "supply-driven" by over-enthusiastic foreign bankers and investors seeking easy returns outside their respective home countries and based on of "blind faith" in new "miracles" in East Asia. These new foreign financial obligations added to existing imbalances in the already vulnerable internal financial systems of Thailand, South Korea, Indonesia and Malaysia. Subsequently, the sudden withdrawal of this liquid foreign capital on the first hint of problems, destabilized vulnerable national financial markets, and in some cases damaged even well-managed and profitable companies which suddenly found themselves without access to adequate working capital. This abrupt shift, often fuelled by speculation and dramatic statements in the international media, accelerated the flight and appears to have deepened the crisis more than should have otherwise been the case based on fundamentals.

Unlike most markets for goods and services, **financial markets have been known for years, both in theory and in practice, to be prone to high risk taking and "market failure" in the absence of effective prudential supervision** which is needed to ensure capital adequacy and adequate provisioning against bad loans. This is nothing new. It is true for both developed and developing countries in both the "west" and the "east". Bankers and financial markets are lending and investing other people's money, and hence are sometimes not as risk sensitive as the actual owners of the money. The same is true for both national and international banks and financial markets. Nevertheless, based on the experience of many countries over many years, private financial markets have proven to be far more effective than governments in allocating financial resources in commercial areas in the presence of effective prudential supervision. The very poor performance, unsustainability and eventual collapse of central-planning in many countries over the past fifteen years is testament to this experience.[9]

The governments of the East Asian crisis countries appear to have been slow to enforce effective prudential supervision for a few reasons. The lack of reliable information, accounting and auditing on the real financial health of domestic corporations and banks belied the urgency of the

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[9] The expectation by some that liberalized financial markets in recent years in countries like Russia should have, after only a few years, somehow corrected the structural and financial imbalances created by more than 60 years of central planning in the former Soviet Union, was and remains, completely unrealistic. Again, the development of effective institutions, prudential supervision and much more time will be needed to correct such long-standing and deep-rooted imbalances.

situation. In addition, high growth rates and inflated asset values stimulated by easy money appears to have also created a degree of official complacency. In addition, political procrastination in enforcing difficult decisions on banking and corporate constituents may have also played a role, **especially since government influence was often behind many risky investments and non-performing loans (NPLs).**

At the same time, **the broad-based misuse of the term "liberalization" in reference to the East Asian crisis has also served to confuse the policy debate.** First, liberalization of financial markets was only partial in many countries, as domestic financial institutions remained relatively protected from open competition with foreign institutions. Secondly, even in recent years prior to the crisis, the state continued to exercise moral suasion on banks to bail out over-extended and troubled companies. Thirdly, the perverse sequencing of liberalization of cross-border flows in some countries (eg. South Korea and Thailand) made it easier and more attractive to borrow short-term debt compared with longer-term debt or non-debt financial obligations.

In any case, **the liberalization of cross-border liquid financial flows added to and exacerbated already serious domestic financial situations in the crisis countries**. The blurring of state sector and private sector creditworthiness, moral hazard and blind faith in the "miracle" attracted "herds" of foreign bankers who lent considerable amounts to private sector banks and corporations. (In retrospect, the belief by foreign bankers that governments of the concerned East Asian countries would ultimately bail out domestic banks and corporations who invested the money unwisely has not been entirely incorrect considering the refinancing packages already negotiated and backed by explicit official government guarantees.)

The Role of Globalization

The term "globalization" has often been misused and maligned in a broad-based manner in reference to the regional crisis **based on a very narrow interpretation** of the term. In particular, "globalization" has often been used synonymously to mean the globalization of liquid capital, **without reference to its many other dimensions**. These other generally highly positive aspects of globalization include: **international trade; trade finance; long-term foreign equity investment; technology transfer; and the global transfer of useful information, knowledge and skills**.[10]

These other aspects of globalization are not characterized by nearly the same degree of volatility as global liquid capital. Moreover, based on considerable research over the past twenty years, it is now well-documented that **globalization has on balance made far more positive than negative contributions to the development of East Asia over the past forty years**. These positive contributions were essential to the remarkably rapid pace of poverty reduction in many countries in the region. The opportunities offered by globalization enabled export-led development, rapidly increasing incomes and substantial progress in human development, which in turn provided the basis for further progress and higher levels development. Again, even with the reduction in incomes and depreciated exchange rates prevailing in 1998, **those East Asian economies which were more open to the opportunities offered by globalization over the past forty years remain much more economically advanced and prosperous, and have much less poverty, than those countries that pursued less market-based and more inward looking development strategies**. (See Appendix Table 1.)

In contrast, the growing globalization of liquid capital has clearly increased volatility in international financial markets. As a result, countries that choose to rely on such liquid foreign capital increasingly require highly effective national governance to preserve national financial stability. As demonstrated by the crisis countries, developing a reliance on liquid global capital can leave a country vulnerable to capital flight, and very quickly expose any serious internal structural weaknesses. Capital flight is more often a symptom than a fundamental cause of financial crisis. Nevertheless, recent regional experience suggests that sudden substantial capital flight can be destabilizing and can create some new solvency problems if it leads to a general drying up of working capital available to otherwise profitable

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[10] The emphasis on "useful" information in this context is aimed at addressing concerns about the negative impact of some kinds of information on the cultural and social fabric of a given society, a subject beyond the scope of this paper.

companies and businesses. The resulting disruption appears to have added to economic and social hardship. Judging from the regional experience, **complete openness to liquid global capital, along with the near instantaneous transfer of speculation enabled by modern telecommunications, can rapidly expose any internal structural weaknesses in individual countries and be potentially destabilizing.**

Developing countries with shallow and under-developed financial markets generally have much less capacity to manage the potential volatility that accompanies complete openness to liquid global capital. Since individual countries have little influence on globalization, **the best protection from weak global financial governance is effective national governance.** Judging from the regional experience, effective national governance to shield a country from outside volatility would include: developing a policy environment that encourages the rapid growth of and maximum reliance on domestic savings for development; minimal reliance on foreign debt, particularly short-term debt and liquid portfolio investment; and effective foreign exchange rate and reserve management. **In general, an effective national policy environment is also the best check against foreign lender and investor excesses and profligacy (and will also best ensure that domestic savings are effectively allocated).**

In light of the volatility of liquid global capital, the desire by some developing countries to protect themselves from the potential instability of liquid foreign capital is understandable. Again, this can be best achieved by developing an effective policy environment. **Disincentives to using liquid foreign capital such as withholding taxes on short-term foreign investments or regulations on liquid capital may also play a useful role in buffering a country from outside volatility, but cannot shield a country from problems created by weak internal governance.** In the case of Malaysia, the recent imposition of capital controls may play a useful role only if the temporary shelter from the volatility of global capital provided by such controls is used to implement more fundamental internal reforms that restore investor confidence. **Broad-based currency controls covering both trade and financial transactions are an excessive measure to address the narrower problem caused by the potential volatility of**

liquid foreign capital, and will do more harm than good to a country's development if used as more than a very temporary measure.

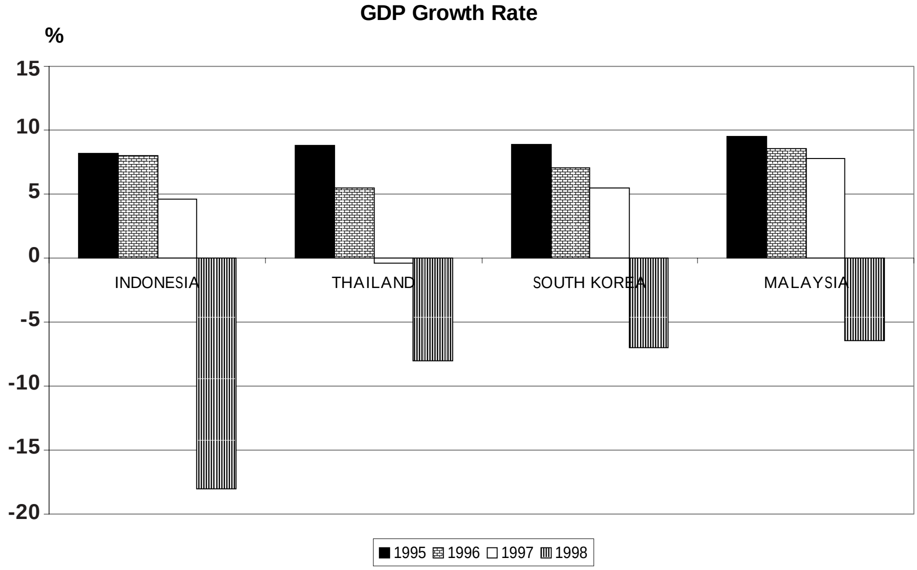
In contrast, the rapid growth in international trade and East Asian exports to richer developed country markets, related trade finance, long-term foreign equity investment and technology transfer, and the global transfer of useful information, knowledge and skills have not been characterized by such high volatility. To be sure, even international trade has had periods of high growth and low growth in line with the growth of the various national economies and structural changes in global markets. But these changes have generally been much more orderly (in the absence of widespread protectionism) and have often signaled a need to adjust or restructure production in line with changing global demand, structural changes in comparative advantages and changing opportunities. Recent examples in the region include the emergence of China as a major exporter (which has helped reduce poverty in that most populous nation), declines in Japanese import demand (due to needed internal restructuring), and slower international demand for micro-chips in recent years. **Nevertheless, as has been the case over the past forty years, the general trend is for continued growth in global trade, foreign direct investment, and other opportunities for increasing prosperity in those East Asian economies that enable their people to participate.**

Social Impact: Remembering the Poor and Vulnerable

The social impact of the crisis has been severe. Layoff and unemployment rates have more than doubled and continue to rise in all countries concerned in 1998 following sharp contractions of real GNP by an estimated 18% in Indonesia, 9% in Thailand, 7% in South Korea and 6% in Malaysia.[11]

[11] The significant but lesser impact in Malaysia has much less to do with the government's recent imposition of capital controls and much more to do with the country's lower reliance on liquid foreign savings in recent years compared with, say, Indonesia and Thailand; reluctance to impose austerity creating fiscal and monetary policies to avert worsening liquidity conditions; and the postponement, so far, of banking and corporate restructuring.

Rising unemployment and under-employment, reduced incomes, devalued savings, higher prices for some basic commodities and scarce government financing for social services, are all increasing human hardships in the crisis-hit countries.



Attempting to adequately assess and monitor the social impact of the crisis remains difficult due to the lack of timely data on social indicators. Even official data on unemployment rates in developing countries like Indonesia and Thailand do not adequately reflect the increase in human hardship and suffering due to weaknesses in the definition of employment, and difficulties in measurement of under-employment. Few can afford to be unemployed and doing nothing in the crisis countries given the near absence of social security systems. Virtually everyone is doing something to survive. Hence, typical survey definitions of unemployment do not adequately reflect the increase in hardship resulting from the crisis. Nevertheless, some broad conclusions can be drawn based on available information.

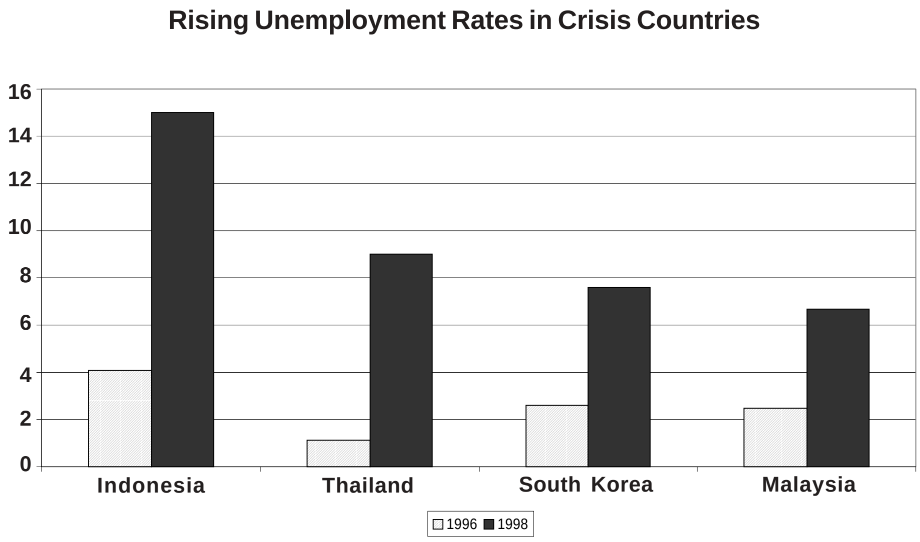
Judging from the experiences in the most affected countries, **the regional crisis appears to be having the hardest impact on the formal**

sectors (construction, manufacturing, financial services, business services, etc.), which tend to be **more concentrated in urban areas**. Layoffs in the formal sectors are reportedly being implemented typically on a "last in, first out" basis which has **negatively impacted female workers** more than male workers. All of this is, in turn, adversely affecting the health and education of children. In Indonesia and Thailand, UNICEF reports a significant rise in child malnutrition and a significant decline in school enrollment rates as parents have less income to pay school fees and related costs. All of this is creating new pressures towards child labor, as well as prostitution of women and children. This, in turn, will expose these vulnerable groups and the region to the further spread of HIV/AIDs.

Those who had become dependent on formal sector employment over a period of years find themselves with **less access to traditional family social safety nets** following layoffs. **The governments of the countries concerned had not set aside savings nor developed sufficient social security systems during more prosperous times to mitigate the social impact of the ongoing downturn.**

The impact of the regional crisis in rural areas where most of the poor typically live in East Asia has so far been more indirect and less severe, although natural disasters like prolonged drought in Indonesia caused by El Nino have created additional hardships. Tighter government financing is reportedly resulting in some reductions in fiscal expenditures on social services. Worker remittances and transfers to rural areas from migrant labor in urban areas or neighboring countries is also on the decline. Similarly, some reverse migration from cities to the country-side is reportedly adding to under-employment in agriculture and straining traditional family-based social safety nets. Tighter credit conditions also risk restraining rural production and distribution.

The change in the terms of trade resulting from substantial currency depreciation since July 1997 appears to be cushioning somewhat the impact in the rural areas of Thailand and Indonesia, especially in the agricultural sector, whose produce is typically priced in dollars in world markets. Hence, for any given dollar price per unit of agricultural produce determined in world markets, farmers in the crisis countries are



typically receiving more local currency for every unit of produce sold compared with prior to July 1997.[12] If world prices for agricultural products like rice are not too adversely affected next year by some expected increase in supply as farmers in the region respond to higher prices, much of this positive offset in rural areas should hold. In the case of Indonesia, El-Nino's negative impact on agricultural production and the disruption of distribution networks, contributed to areas of food shortages, which should be alleviated in 1999 as weather conditions normalize. At the same time, however, all of these economic and social pressures risk placing new strains on the rural environment including deforestation, wildlife depletion and extinction of endangered species.

In terms of social hardships, the hardest hit of the core crisis countries have been Indonesia and Thailand, largely due to their relatively lower average income and savings per capita even before the crisis, compared

[12] In retrospect, farmers in the crisis countries appear to have been effectively subsidizing much of the rest of their respective countries through low domestic currency prices received for their produce, which in turn was due to past over-valuation of domestic currencies. Currency over-valuation was in turn a result of excessive foreign capital inflows, much of which now appears to have been poorly invested, and/or government exchange rate policy.

for example with South Korea. This in turn implies less scope to absorb the related adjustments and austerity. **Indonesia** has been **hit by the triple impact of the regional crisis, severe drought from El Nino and political unrest.** The International Labour Organization (ILO) estimates that some 15,000 Indonesian workers are losing their jobs each day in Indonesia, and that the number of people living in absolute poverty (less than US $1 per day) could grow to 132 million by the end of 1999. Inflation stood at 82% in October 1998, and the price of such essential goods as antibiotics has doubled. Enrollment rates have reportedly fallen from 78% to 54% since July 1997. Moreover, the Government is concerned that up to 8 million primary school and junior secondary school students could drop out of school this year. In East and Central Java, NGO surveys indicate that child malnutrition and diarrhea, and anemia in women and children, have risen considerably since the beginning of the year.

In **Thailand**, average per capita income has declined by more than 10% since the onset of the crisis and unemployment has more than doubled. Some 3 million people, 80% of them women, are expected to be unemployed by the end of 1998. In some parts of Thailand the cost of rice has nearly doubled since the start of the crisis, while the cost of many other basic foodstuffs has increased 30 percent or more. Although military expenditures and other budgets have borne the brunt of budget cuts in Thailand, the education budget was trimmed 10.6% in 1997, while the health budget was cut 14.5%. An unpublished government survey indicates that 40,000 to 50,000 first-graders dropped out of school this year, almost three times as many as in normal years.

In **Malaysia**, public health centers, which in recent years treated mainly the poor, are now reportedly over-stretched due to demand for services from lower-middle class families that can no longer afford private care. As is the case in Indonesia, the poor in Malaysia are also turning to traditional healers and traditional birth attendants, which will likely lead to higher infant, child and maternal mortality.

In **South Korea**, average income per capita has declined by some 8 to 9% in 1998, and unemployment has nearly tripled from 2.7% in 1997 to around 7.5% in 1998. The country's much higher income and savings per capita compared with the other crisis countries, and minimal unemployment insurance for formal sector workers in large companies, provides some modest cushion, albeit highly inadequate for those laid-off. Reflecting the psychological distress and pain of unemployment, suicide rates among laid-off male middle-class workers are reportedly on the rise.

In all of the crisis-hit countries, governments have been caught unprepared to adequately assist the poorest and most vulnerable groups affected. The best social security for a country's people is full and sustainable employment and income, which in turn is facilitated by sound government policies. Nevertheless, occasional significant downturns are unavoidable. The regional crisis has painfully demonstrated the importance of having developed beforehand efficient and equitable basic social services, as well as contingency plans to deal with exceptional crisis situations and natural disasters in order to assist the most vulnerable, minimize hardships and preserve stability.

III. Key Positive Lessons

Despite the ongoing crisis in a few of East Asia's newly-industrialized economies (NIEs), and the general economic downturn in the region, most of East Asia's achievements over the past forty years remain very much intact. This section briefly outlines some of **the most important positive lessons from the broader East Asian development experience and successes over the past forty years**, which are particularly relevant at this current juncture of Viet Nam's development.

1. **Well-Informed and Decisive State Leadership:** The most successful development experiences, particularly in Japan, South Korea, Taiwan and Singapore, were based on well-informed and decisive leadership. State leadership that was kept well informed with reliable information on emerging development challenges was, in many cases, critical to setting strategic direction, capitalizing on comparative advantages, realizing emerging opportunities and, in some cases, averting crisis. This was the case whether a country was

effectively a one-party state or a multi-party state. Similarly, leadership in these first tier newly industrialized economies (NIEs) demonstrated flexibility and decisiveness in backing away from past bad decisions and mistakes in order to minimize related costs and avert crisis. While leadership was by the state, management and implementation of development was largely by the non-state sectors in all successful countries. The emergence of financial crisis in a few NIEs during 1997-98 reflects, among other things, a temporary lapse in decisiveness and lack of reliable information on which to base needed decisions. In some cases, governments appeared to be unaware of the real financial health of the domestic banking and corporate sectors, as well as of the total amounts and nature of foreign obligations incurred by their countries. The experience of South Korea is particularly illustrative. (See Box on *President Park's Decisive Leadership*.)

2. **Sound Macroeconomic Policy Management is Essential to Rapid and Sustainable Development:** The importance of a rational and stable macroeconomic environment needed to encourage savings and investment is now well known and accepted. The most successful development experiences in East Asia and elsewhere have occurred in the context of low budget deficits, rational growth in money and credit, relatively low inflation, and limited growth in public sector debt. Real interest rates were usually maintained at positive levels to encourage domestic savings; and exchange rates were managed to avoid overvaluation, promote exports and help maintain balance of payments financial stability. Thanks to the stability and relative predictability of the macroeconomic environment, families were confident to invest their long-term savings in official financial markets, and entrepreneurs were not afraid to invest in projects with long payback periods. As a result, the savings and investment rates in the newly-industrialized countries of East Asia over the past forty years have been among the highest recorded anywhere in the world, which in turn encouraged the rapid accumulation of physical and human capital. The rational and stable macroeconomic environment, combined with other factors outlined below, fuelled high economic growth rates, increased prosperity and rapid poverty reduction.

President Park's Decisive Leadership

As South Korea's import substitution policies of the 1950s became increasingly unsustainable financially during the early 1960s, then President Park, in close consultation with the private business sector, exercised decisive leadership in shifting the country towards strong export promotion to narrowly avert a serious balance of payments financial crisis. This shift was also encouraged by the planned phase-out of U.S. aid following a ten-year period of Korean post-war reconstruction. The South Korean leadership's commitment to export promotion was reflected by President Park's personal direct involvement in the daily monitoring of export data, weekly meetings with business leaders on export performance, and state directed support to successful exporters based on their actual performance (rather than planned or promised export performance). This also reflected the South Korean President's commitment to being kept well informed with reliable economic and financial data. The South Korean leadership's willingness to back away in the early 1980s from the less successful and financially-unsustainable attempt to "pick winners" in heavy industry in the mid- to late-1970s also reflected well-informed, decisive and flexible leadership, and contributed to again narrowly averting a serious financial crisis in the mid-1980s. In the years following 1985, South Korea's balance of payments swung into large surplus and the country eliminated its large net foreign debt with the rest of the world by 1990. Moreover, by 1996 income per capita exceeded $11,000 per annum (a more than ten-fold real increase since 1960) and was fairly equitably distributed by international standards (a gini coefficient of only 0.34). However, the significant liberalization of cross-border short-term financial flows in the early 1990s enabled a further build-up of already high corporate debts of Chaebol, and left the country vulnerable to financial crisis. While the total amount of foreign debt relative to GNP and exports had not reached unmanageable proportions, the maturity structure, particularly the surprisingly heavy build-up of short-term debt, unmatched by liquid assets, left the country vulnerable to a liquidity crisis. Some initial liquidity problems appear to have deteriorated into solvency problems following the general drying up of working capital available to even solvent companies. All of this added to and deepened already significant solvency-related problems in the domestic corporate and banking sectors.

3. **The importance of relying mainly on domestic savings for development, and minimizing reliance on foreign debt:** This is an old lesson, which deserves renewed prominence in light of the ongoing crisis. The most successful NIEs have maintained domestic savings rates of well over 30% of GNP. Notably, the economies least affected by the crisis are the ones that have relied mainly on domestic savings for development and avoided excessive reliance on foreign debt, especially Japan, Taiwan, Hong Kong and Singapore. On the other hand, Indonesia has been carrying a relatively heavy foreign debt for some years (67% of GNP at the end of 1997), which involved a continued financial balancing act, and left the country vulnerable to financial crisis. Similarly, Thailand's foreign debt is also significant as a share of GNP (62%). The Philippines, despite restructuring and progress in recent years, is still carrying significant debts from the Marcos years (63% of GNP). In the case of South Korea, total foreign debt is significant but more manageable as a share of GNP (31%). As indicated earlier, the foreign debt problem in South Korea initially had as much to do with its term and liquidity structure as it had to do with the quality of related investments financed by foreign debt. (Again, South Korea's financial difficulties are more related to heavy domestic debts owed by the Chaebol to domestic banks.) China's high savings rate (more than 40% of GDP), relatively low past recourse to foreign debt (18% of GNP) and substantial liquid foreign currency reserves largely explains why it has been less affected so far by the ongoing regional financial instability. (China's non-convertible currency for financial transactions also provides a hurdle to capital flight.) Again, Taiwan, which followed a policy of *pay as you go* to higher levels of development based on sizeable trade surpluses and domestic savings, has accumulated nearly $100 billion of foreign exchange reserves (plus billions of dollars of other foreign assets), and is now in the enviable position to capitalize on the many bargain opportunities in the region. In this regard, the state has an important role in developing and maintaining an environment where savers have strong confidence that the state will ensure the long-term integrity of property rights and wealth ownership; a currency in which savers can have confidence in its long-term value; the maintenance of positive real interest rates; a sound and healthy

banking sector in which depositors can have long-term confidence; and a rationally-valued exchange rate that does not encourage excessive foreign borrowing of undervalued foreign currencies.

4. **Export-led development based on comparative advantage**, which was often in the form of labour-intensive manufactures, was **the basis for success in most of the "miracle" economies**, particularly those with small domestic markets (as measured by income per capita, purchasing power or population size). Developing countries with small domestic markets have found it much easier to sell higher value added products to richer export markets in order to earn their way to higher levels of development. (The scope for *protected import substitution* is considered in the next section.) **Therefore, a considerable degree of openness to international trade** and (as explained more fully in the next section) carefully managed openness to international finance is **essential** for the rapid development of low-income countries. The most important state contribution to such strategies was through government "indirect interventions" aimed at ensuring a rational and stable macro-economic environment including competitive exchange rates; and public sector investments in basic public infrastructure to facilitate production, human resource development and exports. Many of the NIE governments also employed more "direct interventions" to promote exports, although the contribution of some of these is still open to debate, even in the countries concerned. The most successful direct interventions were "neutral" and did not try to "pick winners" or discriminate which exports should be promoted and rewarded. All proven exports were rewarded in various ways (e.g. preferential credit allocations, tax breaks, industrial licenses, and even domestic protection in some cases). Moreover, incentives and direct support for exports were based largely on *actual* export performance rather than planned or promised export performance. In all successful cases, direct and indirect interventions to promote exports were aimed largely at the non-state sector's export development. **State leadership played the key role in creating an incentive framework for the promotion of exports, but management and implementation was largely left to the private sector.**

5. **Heavy investment in human resource development**, particularly **education and training**, has been the foundation in most of the more successful East Asian economies for graduating to increasingly higher levels of development. While other less successful economies outside East Asia allocated similar shares of government budgets and gnp to education, the more successful East Asian countries allocated the largest proportions to universal basic education (primary and secondary) relative to higher education during the earlier stages of development. **Such broad-based human resource development better enabled broad-based participation in the fruits of development, sustainable poverty reduction and sustainable social stability.**

6. **State leadership in promoting the development of the private sector and private sector-led growth is essential to successful development and sustainable poverty reduction.** This lesson is extremely important (but it is too often taken for granted). In all successful developed and developing economies, both inside and outside the region, the private sector has been the main engine of sustainable growth and development.[13] This has been the case whether a country was effectively a one-party state or a multi-party state. In the case of Japan and Korea, the non-state sector had always produced the largest share of GNP, and this share has grown further over the past thirty years. In the case of Taiwan, there was a fairly large state owned enterprise sector in the early 1950s. However, the subsequent development of the non-state sector as reflected in available data is quite striking. (See box.)

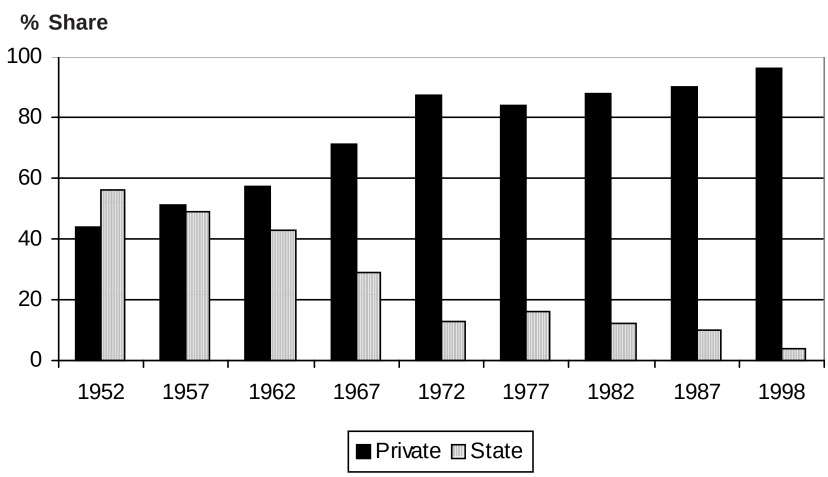
   In the case of Japan and Korea, industrial and non-industrial production of the state sector was always relatively small compared

[13] This has been the case in Japan, Taiwan, Hong Kong, Singapore, South Korea, Malaysia, Thailand, and Indonesia. Notably, while the state played a significant role in directing development in Japan, production was by the private sector. Similarly, the Chaebol in South Korea were never state-owned, but rather privately-owned

Taiwan's Private Sector Generates Prosperity with Stability

In 1952 Taiwan's state sector accounted for 57% of industrial production compared with only 43% from the private sector, income per capita was very low and poverty widespread. The shift towards a private sector driven labour-intensive-export-development strategy in the early 1960s, witnessed an increase in real income per capita of more than 8 fold in the ensuing 35 years. Most notably, the state's share of industrial production declined to only 5% and the non-state sector's share rose to 95%, even though the level of industrial production by the state did not actually decline but grew modestly despite the usual inherent inefficiencies of SOEs. Also notable, the SOE sector in Taiwan was re-oriented to produce intermediate inputs for the export-oriented private manufacturing sector and hence was indirectly export-oriented. Thanks to the large balance of payments surpluses over the years, and substantial foreign currency reserves accumulated, Taiwan now enjoys considerable prosperity, lower poverty and much more stability than most other economies in the region.

Taiwan: Shares in Industrial Production by Ownership



to the non-state sector, as was the case in all other successful countries surveyed here. The Korean *Chaebol* have always been private sector owned and managed, not state owned enterprises or general state corporations, although the Korean Government attempted to broadly direct their activities towards exports during Korea's most successful development periods.

Notably, no country has successfully developed with a development strategy led by state-owned enterprises (SOEs), although many countries have tried and failed (e.g. the former Soviet Union, the former Comecon countries of Eastern Europe, North Korea, and others). Despite progress in China over the past twenty years, the country cannot yet be considered a development success story given its continued low income per capita, widespread poverty and highly vulnerable SOE and banking sectors. Moreover, even in China the SOE sector is now being rationalized more aggressively to better ensure financial sustainability. Also noteworthy, the main sources of China's success to date have been the export-oriented Special Economic Zones (SEZs) and the private or quasi-private sectors, particularly the dynamic town and village enterprises (TVEs).

7. Especially for low income economies**, an industrial sector based on small and medium-sized enterprises better enables flexibility, adaptability, risk diversification, sustainability and stability.** This has been most clearly demonstrated by the dramatic success of Taiwan over the past 35 years. Low-income economies can least afford and manage the high costs and risks attached to developing industrial sectors narrowly based on large specialized capital intensive industries. Again, the South Korean Government's attempt to direct substantial credits towards the development of large capital-intensive industries during the latter half of the 1970s brought the country to the edge of financial crisis during the first half of the 1980s.

8. **Maintaining a competitive exchange rate is essential** to promote exports, discourage excessive reliance on imports, as well as to ensure rational financial planning and discourage excessive foreign borrowing of under-valued foreign currencies (which later become difficult to repay at more realistic exchange rates). Notably, in many of the miracle economies over the past forty years, significant devaluations were often followed by periods of rapid growth in exports and incomes. For instance, the shift towards strong export-promotion in Taiwan in 1958 and subsequent export growth during the 1960s began with a substantial devaluation of the exchange rate. During the first half of the 1980s, the exchange rate of the Taiwan dollar vis-a-vis the US dollar was carefully managed so as to avoid a real appreciation, which in turn contributed to the Taiwanese export boom to the US during the 1980s. South Korea's export boom during the 1960s followed a series of devaluations to avoid real effective appreciation of the exchange rate. Moreover, the increases in Korean exports between 1982 and 1988 were related to a real depreciation of the won. The export booms in Malaysia, Thailand, and Indonesia during the 1980s have also demonstrated the role of favorable exchange rates. None of the successful episodes of export growth would have been possible if the currency of the exporting country had been significantly overvalued. Moreover, **a competitively-valued exchange rate is also a more neutral and economically-efficient means of protection from excessive imports** than is maintaining an over-valued exchange rate along side distortionary import controls, which in turn distorts relative prices and costs, and the flow of investments.

9. Facilitating Access to Global Flows of Information and Knowledge: Another important ingredient of success in the newly industrialized economies of East Asia has been their ability to tap into the more economically-developed world's wealth of useful information and knowledge. Considering the significant costs involved in collecting information about foreign markets and technologies, especially prior to the development of the World Wide Web, few if any private sector firms in East Asia had the financial capacity to commit their own funds for these purposes. Governments in East Asia therefore often played a central role in establishing and supporting institutions for the generation and transfer of information and knowledge. In many cases, this has been a very effective form of state support and subsidy, particularly in areas relevant to exports. All of the successful NIEs established institutions to support export marketing and technology transfer, with very good results. There are also examples of more direct government activities to generate useful information and knowledge. For instance, in the early 1960s, the Taiwanese government sponsored a study by Stanford University experts to identify industries where Taiwan could be expected to have comparative advantages: these industries were then chosen for specific export promotion policies. In Korea, President Park's monitoring of exports and export markets highlighted the role of continuous information flows as an input to economic policy making. In Japan, MITI took on a central role for the import of foreign technologies, and managed not only to achieve rapid dissemination of new technologies among domestic firms, but to keep the cost of technology transfer very low. Moreover, part of Japan's earlier success was based on improving and adding-value to foreign ideas and technologies.

10. **Considerable Degree of Openness to Outside Opportunities:** All of the most successful East Asian economies enjoyed rapid development by maintaining a considerable degree of openness to outside opportunities, particularly international trade, foreign technology, global information and knowledge, and international finance. One would be hard pressed to come up with an example of a mainly autarkic economy that has developed successfully. Notably, most of the more autarkic and closed economies of the world remain relatively impoverished.

11. **Other Relevant Positive Lessons** included **promotion of strong agricultural sectors** to complement, or as the basis for, initial industrialization; the development of **competent civil services and strong institutions** to facilitate development; **effective public infrastructure investment**, including in rural areas; and state promotion of **broad-based participation in development** (through universal basic education and equitable land reform in the cases of South Korea and Taiwan).

IV. Key Negative Lessons

Let us now turn to some of the more negative lessons from the East Asian experience, particularly from the ongoing financial crisis, but also from some of the earlier experiences in the region. Again, the following focuses only on those lessons that are most relevant at this current juncture of Viet Nam's development:

1. **High economic growth rates, even in the presence of relatively healthy macroeconomic policy indicators, do not necessarily imply sustainable development.** As the ongoing crisis has clearly demonstrated, **an array of other types of policies** which impact on the **overall incentive framework** and the quality of resource allocations and investments, or which affect the **ability of markets to function efficiently**, have an equally critical role to play in sustainable development. In the years before the current crisis emerged, most of the East Asian countries concerned were enjoying relatively high rates of economic growth and seemingly reasonable macroeconomic indicators (low budget deficits or even surpluses in some cases, low inflation rates, and reasonable growth in the money supply). In some cases, current account deficits had become significant, although this latter factor, by itself, was not cause for great concern, since most countries pass through periods of deficit and surplus on their way to higher levels of development. However, the **role played by the state for many years in directing or heavily influencing the allocation of financing in commercial areas, considerably blurred state and private sector creditworthiness and related risks, and created a lending and investment culture very prone to "moral hazard" and high risk taking.** The general lack of transparency and reliable information on which to base rational decisions also contributed to a large number of unsustainable investments financed by domestic and foreign debt. The related build-up over time of weak and non-performing loans, combined with inadequate bank capital and loan-loss provisioning, left these countries vulnerable to financial crisis.

2. **State-directed lending in commercial areas eventually has heavy inefficiency costs contributing to the build-up of financial and structural imbalances, financial instability and crisis.** State-directed lending has proven particularly damaging when the state has attempted to "pick winners" by directing lending to specific industries or interest groups. This was the case in South Korea during the latter half of the 1970s and early 1980s through state-directed bank loans to Chaebol investments in heavy capital intensive industries, which brought the country to the brink of financial crisis in the mid-1980s. In more recent years, despite the significant liberalization of South Korean financial markets, the State continued to exercise "guidance" and moral suasion on domestic banks to lend to Chaebol, even when the solvency of some of these Chaebol appeared quite shaky. State directed lending may have also impeded the development of private sector banking and financial skills. Similarly in Indonesia, state-directed lending to the then ruling family's interests underlies much of that country's current difficulties. **State-directed lending appears to have been least damaging, and in some cases even helpful, when it was broadly directed in a *neutral* manner towards developing and promoting exports** (e.g. South Korea and Taiwan during the 1960s and early 1970s).

3. **Similarly, state-influenced lending, either through explicit or implicit guarantees on loans to the banking and corporate sectors, also eventually has heavy costs which contribute to financial and structural imbalances**. Again, South Korea and Indonesia provide the clearest examples. In some cases, the guarantees were not written into contracts, but rather were unwritten tacit understandings (or misunderstandings!). For example, the bankruptcy of the Hong Kong-based investment firm Peregrine was precipitated by a reported $250 million loan to an Indonesian taxi company, allegedly based mainly on the relationship between this company and President Suharto's daughter. In the case of South Korea, domestic and foreign lenders believed that the Korean Government would ultimately bail out any financially troubled banks

or Chaebol. State influence in the case of Thailand was somewhat different, but again an example of *government failure*. The Thai Government's long-held policy of fixing the exchange rate despite a burgeoning external current account deficit in recent years encouraged a build-up of speculative short-term foreign borrowing which became unmanageable once the exchange rate was unavoidably devalued. High domestic interest rates relative to foreign rates, needed to reduce pressure on the exchange rate, also encouraged such foreign borrowing.

4. **Government failure in either withholding essential information from the market** or in **failure to enforce legal requirements related to transparency, accountability and financial reporting** of corporate finance helped **set up the market failure and** ongoing financial **crisis**. One of the single most important ingredients to well-functioning and efficient markets is easy access to reliable information on which rational decisions can be based. Lack of reliable information increases the risk of over-investment in some areas and under-investment in others, and can contribute to dangerous speculation and investor "herd mentality". In the years leading up to the current regional crisis, little was known about the real financial health of the corporate and banking sectors in Indonesia, South Korea, and Thailand due to the lack of reliable published audits on which private domestic and foreign investors (including depositors and lenders) could make informed and rational decisions. Moreover, the continued lack of reliable information and investor fear of the unknown appears to have played a significant role in the continued high degree of capital flight from the crisis countries, which in some cases appears to be contributing to financial problems of some formerly sound investments. Hence, redressing the information void as well as greater transparency will be essential to restoring investor confidence and recovery in the crisis countries.

5. Adequate **information on foreign debts** needs to be collected and monitored in order to enable **adequate debt management** and avoid

balance of payments financial crisis.[14] (This is a very old lesson that seems to be re-learned with increasing frequency in this century, most recently in Latin America, Eastern Europe and Africa during the late 1970s and early 1980s.) Not only must the **total amount** of foreign debt be monitored, but also its **term structure**, as well as any **contingent obligations** that become real effective obligations following changes in certain borrower or market conditions (e.g. state guarantees, letters of credit, interest rate and cross-currency swaps, etc.).

6. **The potential volatility of liquid global capital can be destabilizing for developing countries with shallow and under-developed financial markets, and internal vulnerabilities**. Careful macro management of the liquidity and maturity structure of a country's foreign financial obligations is critical to reducing vulnerability to sudden capital outflows and resulting liquidity crises which can in turn impact on solvency. While a great deal of the current regional crisis is a result of a build-up over time of weak or poorly performing investments, vulnerability to crisis was heightened by a sizeable build-up of short-term foreign debts, not matched by sufficient amounts of liquid foreign assets. In addition, vulnerability was further increased by a build-up of portfolio equity flows in developing stock markets which could be quickly liquidated (as occurred in all of the crisis countries). For example, just prior to the emergence of the regional crisis, and before

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[14] Calculating more accurate foreign debt figures before vulnerability developed would not have been so difficult despite incomplete debt statistical information collected domestically by the governments concerned. Had such governments, or the multilateral organizations concerned, simply added available debtor country data with available creditor country bank data (particularly as available from the Bank for International Settlements and other Euromarket data sources), and made some simple adjustments to eliminate double-counting, a near complete picture of both total foreign debts and broad maturity structures could have been determined to enable earlier warning and actions to avert much of the current crisis. This statistical approach would have captured most foreign debts with the exception of some types of direct credits from foreign non-bank private sector businesses (e.g. direct supplier credits, inter-corporate project loans, etc.)

recent debt rescheduling, South Korea's short-term debt accounted for more than 60% of total foreign debt (see appendix table 2), and was not matched by sufficiently liquid assets. South Korea would have fared much better in the current crisis if the country's banks had borrowed at much lengthier terms (which would have been easily feasible in the years prior to the outbreak of the crisis given the country's previously strong credit rating). This would have enabled greater time for a more orderly restructuring of the corporate sector without outside pressures, and would have reduced the likelihood of some liquidity problems deteriorating into solvency problems because of lack of available working capital from the now much more cautious and demanding financial markets.[15] In Thailand, the Government's exchange rate and interest rate policy, combined with inadequate prudential supervision, contributed to the short-term debt build-up. **For developing countries with shallow financial markets or weak capacity to manage the potential volatility from liquid global capital movements, an incentive framework that discourages short-term foreign borrowing and liquid portfolio investment may be prudent. Withholding taxes on new short-term and liquid foreign financial investments, and other disincentives to new liquid global capital may play a useful role.**

7. **Lack of effective prudential supervision of the financial sector**, which is needed in all countries, both developed and less developed, **enabled *market failure* in the banking sectors** in a number of these countries. (Again, this is a very old and recurrent lesson learned by a wide variety of both developed and less developed countries in all regions of the world.) This is one area where more effective government regulation and supervision is clearly needed in all of the current crisis countries to minimize the risk of additional *market failure*, since unregulated banking by nature can be prone to excessive risk taking and *moral hazard*. This kind of market failure was particularly highlighted in the case of Thailand, where family-controlled

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[15] At the same time, some observers believe that some degree of crisis was needed in South Korea to force the needed political and policy changes.

banking and finance companies, often lending on the basis of personal relationships, with limited accountability to financial regulators, built-up large portfolios of speculative investments in real estate. At the same time, inappropriate exchange rate policy in the presence of a large current account deficit and relatively high domestic interest rates encouraged short-term foreign debt financing which further heightened Thailand's vulnerability to liquidity and solvency problems. **Lack of prudential guidelines, or their enforcement, needed to ensure reliable accounting of non-performing loans and related capital and loan-loss provisioning, contributed to the build-up of sizeable bad loan portfolios in the financial sector**. In the case of South Korea, the liberalization of cross-border short-term financial flows in the early 1990s resulted in a dramatic increase in short-term foreign borrowing by South Korean merchant banks, which in turn on-lent to over-expanding and financially-troubled Chaebol. This new lending contributed further to the Chaebols' already high debt-to-equity ratios financed by past domestic debt, and left the country highly vulnerable to both liquidity and solvency problems once the regional contagion and herd mentality began to turn adverse. **Lack of sufficiently developed banking and capital market skills**, combined with past state involvement in directing investments in commercial sectors, contributed to inefficient capital allocation.

8. **State "socialization" of private sector debt obligations (through government guarantees on falling due or overdue private sector debts) unfairly passes the costs of past bad investment decisions from irresponsible lenders and borrowers to the general population, including the poor.** If private borrowers are ultimately unable to repay, which is often the outcome of such "guaranteed" arrangements, such private sector debt effectively becomes state debt. The costs for repayment are eventually passed on to the general population through future tax increases, reduced spending and subsidies in the social sectors, inflationary printing of money and/or future balance of payments adjustments. (This is another old lesson from the Latin American debt crisis of the early 1980s.) The pressure for the state to "socialize" private sector debts will be directly related to the country's vulnerability to a deteriorating liquidity crisis and related potential real side socio-economic adjustments or instability resulting from continued capital flight. Again, the governments of Thailand, South Korea and Indonesia felt compelled to guarantee a significant portion of falling due private sector debts in an attempt to slow capital flight, maintain access to foreign credits and minimize real side socio-economic adjustments in the short-term.

9. **Corruption,** which was facilitated by the general lack of transparency, combined with state directed or state influenced investment in the private sector, contributed to the development of high cost and financially unsustainable investments. While difficult to quantify as a percentage of GNP in each of the concerned countries due to the lack of information, judging from media reports and anecdotal evidence, this appears to have been particularly the case in Indonesia, Thailand and South Korea (as well as the Philippines under the Marcos regime of the 1970s, which led to that country's protracted financial and social crisis of the 1980s).

10. **Protectionist trade policies aimed at** developing **import substitution** industries tended to quickly lead to balance of payments problems and **lack** of **financial sustainability**, especially where the domestic markets were small (particularly as measured in terms of income per capita and purchasing power).[16] Almost all countries in East Asia have at one time or another attempted protected import substitution, including Taiwan and South Korea during the 1950s, Singapore in the early 1960s, and Malaysia, Thailand and others during the 1970s and early 1980s. However, experience indicates

[16] A clear distinction needs to be made between ***efficient import substitution***, which should be encouraged and which eventually comes about naturally for many products and countries where the incentive framework and investment environment is rational; and ***protected imported substitution***, which often results in inefficiency due to insufficient competition with more efficient foreign producers. Such inefficiencies are greatly compounded when domestic producers also enjoy government protection from domestic competition and through related monopoly powers.

that the smaller the domestic market's purchasing power, the more quickly balance of payments financial difficulties, or even crisis, were experienced. Only Japan appears to have been able to absorb the related inefficiencies and enjoy some of the possible positive externalities for industrialization that might have come from protected import substitution due to that country's greater domestic purchasing power even as far back as 1955.[17] In any case, the developed countries were much more sympathetic to protectionist policies of less developed countries during the 1950s-70s, partly due to the *Cold War* agenda. Today, richer countries are much more demanding on trade liberalization as a basis for admitting exports from less developed countries, and hence the scope for protected import substitution is very limited.

11. **Ironically, the most closed and autarkic economies, both inside and outside the region, have tended to be the most prone to economic and financial crisis, and instability.** This includes the former Soviet Union, a number of other former Comecon countries in Eastern Europe, the former Yugoslavia, Albania, and today's North Korea. A small minority of other relatively closed economies remain stable for the time being, but at relatively impoverished levels. A considerable degree of openness to international trade was essential to the export-led development strategies of most successful East Asian economies, although a sufficient degree of openness to international finance was also important, particularly trade finance and foreign equity investment. At the same time, **the ongoing regional crisis has demonstrated that certain types of global capital flows can be**

[17] Even as early as 1940, Japan already had an impressive industrial complex and network of international trading companies and offices abroad. Measured in today's values, Japan's average income per capita in 1955 was already in the order of $4,000 per capita per annum, reflecting significant domestic purchasing power, as well as a considerably higher level of development and official technocracy than most South East Asian economies today. For example, Viet Nam's income per capita today is in the order of $336 per annum, or at best, an estimated $1,100 on a purchasing power parity basis.

highly volatile, and suggests that the degree of openness to such global finance needs to be managed much more carefully than that for trade. This is particularly the case for less developed low-income economies which have weak capacity to absorb the potential volatility that accompanies openness to liquid global capital flows; or which have insufficiently developed financial markets needed to ensure efficient capital allocation; or inadequate supervisory institutional capacity to safeguard against excessive risk taking or abuse. **Openness to long-term foreign direct equity investment (FDI) has proven to be far more manageable and far less volatile than has been the case for foreign debt, particularly short-term debt, or portfolio equity investments.**

12. An **inequitable distribution of the benefits and costs of development** can eventually **compromise social stability**. This is another very old and recurrent lesson. If the general population tends to receive a disproportionately small share of the growing benefits of development in good times, but is expected to bare a disproportionately large share of the adjustment costs in bad times, preserving economic, social and political stability becomes more tenuous. Among the current crisis countries, Indonesia appears most vulnerable in this regard. While it is true that the officially reported poverty rate decreased significantly over the past thirty years in Indonesia, average income per capita remained relatively low, a small minority of the population appears to have reaped vast benefits (in a perceived highly unfair manner in the case of the Suharto family and friends), and the general population is now being called upon to bare a disproportionately large share of the adjustment costs which it can ill afford. Poor governance has meant that past progress on poverty reduction is not being sustained, but reversed.

13. Ensuring a reinforced social safety net during times of crisis to protect the poorest and most vulnerable in society will better preserve stability, equity and the conditions for future growth and development. The countries currently in crisis remain ill-prepared to deal with the social consequences of the ongoing financial and structural adjustments.

Almost by definition financing is most scarce during times of financial crisis. Hence, the funding for a reinforced social safety net needs to be accumulated during times of high economic growth and relative prosperity. The development of a **"social contingency fund" or "human development fund"** to reinforce the social safety net during times of economic downturn might be financed via a luxury goods tax. This would likely involve a redistribution of income from the beneficiaries of the fruits of development to the less well-off. Such a contingency fund would need to have a well-defined separate legal status to ensure that it could only be accessed under certain conditions and for well-defined social purposes (eg. retraining displaced workers, temporary income supplements, etc.), and not for general budgetary or balance of payments financing.

14. **Excessive gradualism and postponement of needed reforms eventually leads to the build-up of dangerous structural and financial imbalances, and vulnerabilities to destabilizing shocks.** In many cases, the governments in the crisis countries were aware for some years of the need to redress legal and regulatory impediments and gaps which resulted in problems related to transparency, accountability, corruption, financial sector capital adequacy, loan-loss provisioning, prudential supervision, corporate sector profligacy and others. Nevertheless, even in the few months prior to the outbreak of the ongoing crisis in July 1997, most of the governments concerned appeared to believe that there was still plenty of time to implement the needed reform decisions and actions on a very gradual step-by-step basis.

V. Impact on Viet Nam

Challenges Remain Largely Internal

As is now well-known, considerable progress has been achieved in improving the overall well-being of the vast majority of the Vietnamese people since the launching of the *doi moi* reform process in 1986.[18] This progress and related achievements were impressive by any standard, but particularly so far a country in transition. Most noteworthy, poverty has been reduced from more than an estimated 70% in the mid-1980s to somewhere closer to 30% in 1998 according to recent preliminary data.[19] Also noteworthy, these achievements were largely a result of state leadership in enabling greater participation of the non-state sector in the development process through land reform and a significant degree of market-liberalization; as well as increased openness to opportunities offered by the outside world.[20] Despite these achievements, Viet Nam is still among the poorest countries in East Asia. Average income per capita remains very low at around US$310 per annum, and poverty and near-poverty remain widespread, particularly in rural areas where 80% of the population and 90% of the poor live.

Nevertheless, the country is in the very fortunate position to be able to benefit from all of the experiences and lessons learned in the region, in order to avert crisis and socio-economic instability, and eventually achieve prosperity and sustainable poverty reduction with long-term stability. Notably, well before the ongoing regional crisis began to emerge in July 1997, an analysis published by the United Nations in 1996 attempted to alert **Viet Nam** that it **appeared to be heading towards its own major financial crisis within five years for many of the same reasons that a number of countries in**

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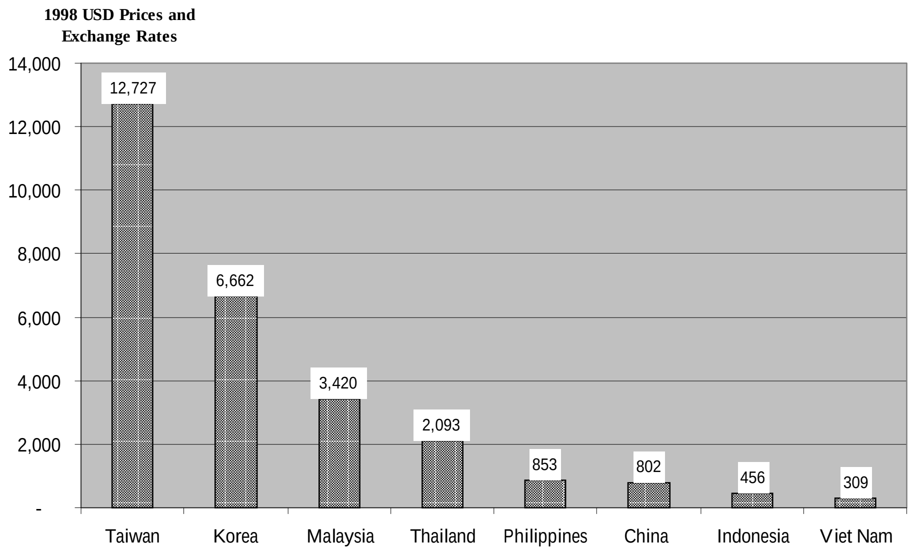
[18] Since the mid-1980s, real income per capita has nearly doubled in Viet Nam. Infant mortality has been reduced by an estimated 18%, and under age 5 mortality by 15%. Nutrition, access to clean water, literacy and other social indicators have improved significantly. Life expectancy at birth has increased by an estimated 5 years. Most noteworthy, poverty has been reduced from more than 70% to somewhere closer to 30% according to recent preliminary data. In short, the development process in Viet Nam over the past 12 years has been fairly equitable and broad-based, despite some growing urban-rural disparities, and disparities with some of the more mountainous and isolated regions inhabited by ethnic minorities.

[19] Preliminary data from a second Living Standards Measurement Survey (LSMS) supported by Sweden, the World Bank and UNDP.

[20] See for example *Some Lessons Learned in Supporting the Transition from Poverty to Prosperity*, UNDP Staff Paper, September 1997.

East Asia are now suffering crisis.[21] The impact of such a crisis in Viet Nam would be far more profound and painful than in the other crisis countries, given Viet Nam's still very much lower per capita income and more widespread poverty, which implies less scope to absorb the related adjustments and a much lengthier and protracted period of crisis. (For example, Viet Nam's average income per capita in 1998 of around US$310 per annum is still far below the 1998 "crisis income levels" of US$6,700 per capita in South Korea, US$3,400 in Malaysia, US$2,000 in Thailand, US$853 in Philippines, US$456 in Indonesia, and only a fraction of current incomes in Japan, Taiwan, Hong Kong and Singapore. See Appendix Table 1.)

Annual GDP Per Capita in 1998



In particular, the UN analysis in 1996 concluded that while many of the traditional macroeconomic indicators looked very impressive in Viet Nam

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[21] *Catching Up: Capacity Development for Poverty Elimination*, UNDP and UNICEF, October 1996.

(e.g. GNP growth, inflation, the budget deficit, etc.), a deeper analysis strongly indicated that **the existing framework of incentives, processes and government interventions influencing the allocation of commercial investments in Viet Nam appeared financially unsustainable.** The State continued and continues to play the dominant role, either directly or indirectly, in determining the allocation of investments in commercial areas. As a result, many commercial investments were and remain largely in unsustainable capital-intensive and import-substituting industries which require significant protection from foreign competition to survive. State-directed bank credits and state-influenced foreign direct investment were contributing little to employment growth, and increasing the risk of *moral hazard* (eg. the risk of over-lending and investment in risky areas on the belief that the Government would ultimately bail out failed investments). Lack of reliable information in commercial-related areas important to ensuring effective market outcomes increased the risk of *government failure* and *market failure*, particularly in the state-owned enterprise and banking sectors. The non-state sector remained hampered by heavy layers of regulations and controls which impede markets, and isolate Vietnamese people from the opportunities offered in international markets.

In short, Viet Nam's challenges were (and remain) largely internal. The rapid growth of foreign financial obligations increased the urgency for more rapid concrete reform of Viet Nam's overall incentive framework, systems and processes for allocating investment resources. Foreign money appeared much "too easy" as foreign lenders and investors wanted "in" on the "ground floor" of a potential "tiger economy" which, in turn, was contributing to a shift from reform-led growth to financially-stimulated growth. Such financially-stimulated growth was masking the need for further reform to ensure sustainability and avoid a boom-bust growth scenario leading to serious financial crisis. **There was clearly a need for a more rational balance between the pace of debt financing and the pace of reform.**

Fortunately for Viet Nam, at least, the regional crisis could well have, on balance, a very positive impact on the country's development process for a number of reasons. Firstly, Viet Nam is now able to benefit from some additional lessons learned in the region and to adjust its policies so as to avert such a crisis.[22] Encouragingly, since the outbreak of the regional crisis there has been a new series of reform-oriented policy statements and programmes recognizing the need for much greater progress on concrete reform (e.g. Prime Minister Phan Van Khai's five-year programme unveiled in October 1997; the Resolution of the 4th Party Plenum in December 1997; official calls for accelerated equitization of state-owned enterprises (SOEs); and a large number of new laws, decrees and guidelines which should enable accelerated reform). As in the past, the challenge will be to translate such sound policy statements and laws into reform actions.

Secondly, the reduced availability of external financing from both inside and outside the region implies that the pace of foreign financing in Viet Nam will be brought much more into line with the actual pace of reform, thereby reducing the scope for highly risky investments and over-investments. Future foreign investment will likely be much more sensitive to the rationale of the overall investment environment as well as the commercial viability of individual investments.

Thirdly, increased competition in the region for now more scarce foreign capital will eventually encourage further reforms in Viet Nam in order to attract some of this capital, so as to avoid falling far behind in regional terms.

All of these factors should, on balance, increase the efficiency of capital investment in Viet Nam and its financial sustainability.

Delayed Impact

While Viet Nam's main challenges are largely internal, the ongoing regional crisis will also unavoidably slow the country's growth rate in the short-term. **Viet Nam has so far been much less severely impacted by the**

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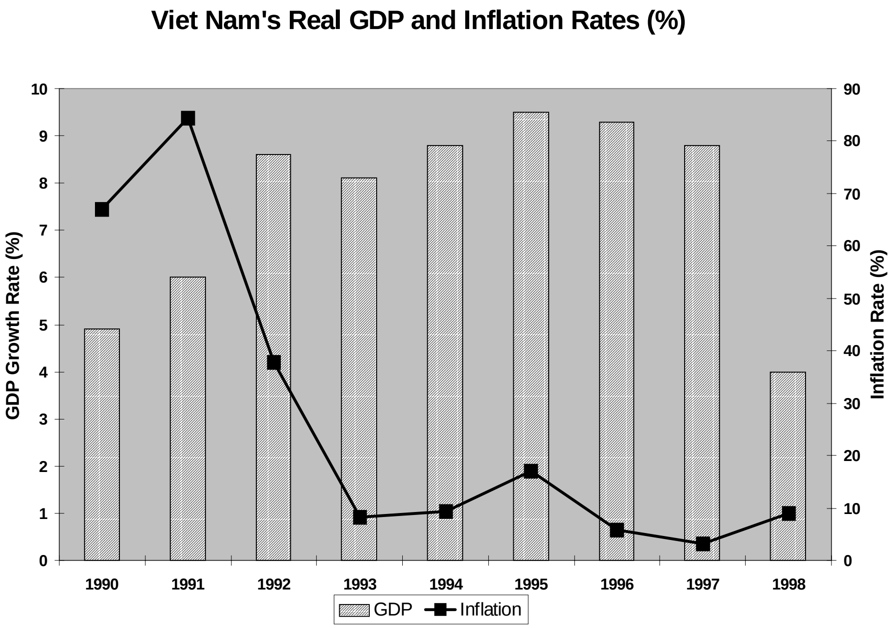
[22] For example, prior to the regional crisis, attempting to convince some policy-makers in Viet Nam about the dangers of state-directed investments in the corporate sector was more difficult in light of the apparent success of the Chaebol in South Korea, and the apparent corporate success in Indonesia despite widespread nepotism and the heavy hand of the state in directing or influencing the allocation of capital.

ongoing regional crisis compared with many other countries in the region. There are **several reasons** for this including: the **country's lack of dependence so far on liquid foreign capital**; the **non-convertibility of its currency**; as well as **layers of other regulations** (which provide some temporary shelter from the outside storm, but also impose significant economic costs). Moreover, much of the Vietnamese economy is still subsistent, informal, and only indirectly linked to the formal regional and global economies.

Nevertheless, **while growth in Viet Nam's GDP is still positive, it is on the decline** in line with a considerable reduction in export growth and foreign direct investment. Export growth has continued to decline since the beginning of 1998, and is expected to fall to near zero growth for the year, down from an average 25% in recent years. Disbursements from foreign direct investment for the first nine months of 1998 were reportedly down to some US$1.0 billion, and are expected to fall more than US$1 billion short of last year's US$2.6 billion. More important, **continued internal structural vulnerabilities**, which had been masked by high growth rates in recent years fuelled by easy foreign money, **will be increasingly exposed as finance becomes more scarce**. Therefore, GNP growth is expected to decline to between 4-6% during 1998, down from 8-9% in recent years, with further weakness expected next year. **However, in contrast to Indonesia, Thailand and South Korea, the impact of the regional crisis on Viet Nam is expected to remain more gradual compared with the sudden deterioration and sharp contraction characterizing these other countries.**

Therefore**, stability has been largely preserved, but as outlined earlier, this stability is with a very low level of income and persistent widespread poverty.** Viet Nam's dense regulatory environment creates a buffer to outside volatility, but also to outside opportunities. As a result, Viet Nam remains far behind many other East Asian economies, and among lowest income countries in the world. Moreover, while regulations and controls lock out a degree of outside volatility, many of such regulations and controls in Viet Nam, particularly on international trade in goods and services, are also locking in inefficiencies and the continued development of financial and structural imbalances.[23] Such regulations and controls will minimize instability in the very short-term, but not over the longer-term. **In short, Viet Nam's fundamental development challenges and risks to longer-term stability remain largely internal, not external.**



Deepening Social Impact

The social impact of the regional crisis on Viet Nam is also expected to gradually deepen during 1999. Judging from the experiences of other countries in the region and preliminary indications in Viet Nam, hardest hit will likely continue to be the formal sectors, particularly in urban areas, including construction, industry, real estate

[23] See for example *Catching Up: Capacity Development for Poverty Elimination*, UNDP and UNICEF, October 1996.

development, financial services, hotels, and business services. The foreign invested sectors will likely continue to layoff workers, and eventually so too will an increasing number of state-owned enterprises when their attempts to retain underemployed workers become financially-unsustainable. Other SOEs may simply reduce monthly wages, forcing some families into more austere conditions. While rural/urban migration may slow, many of those who do migrate to the cities may find themselves unemployed. The return of some workers from other countries in the region will add to the gradual rise in unemployment. Reliable data on unemployment are unavailable in Viet Nam, but estimates suggest that unemployment in the major urban areas has increased from around 6% to 8% over the past twelve months, and estimates of under-employment in the rural areas range as high as 30%.

Unskilled rural migrants, working in sectors like construction, will likely continue to be most negatively impacted. Judging from the experience of other countries in the region, where a policy of "last in, first out" has been applied, **female workers** may also be particularly **vulnerable** to layoffs. This in turn implies a gradual rise in urban poverty and increased vulnerability to urban social problems. **Currency depreciation, although healthy for the country as a whole, will put upward pressure on prices of food and imported goods, and be felt more in urban than rural areas, as farmers should be compensated by increased revenues.** This in turn risks increasing hardship for the more vulnerable in urban areas, and increasing vulnerability to social strains in the cities, and in areas recently afflicted by drought or severe flooding.

Judging from the experience of other countries in the region, **the rural sector in Viet Nam is likely to be less severely affected by the regional crisis.** The agricultural sector could well gain from changes in the terms of trade resulting from exchange rate depreciation — that is, if the Government ensures that state-owned monopoly trading companies pass on these gains to farm families and rural households. Exports like rice, coffee, tea and rubber are priced in world markets in US dollars and sold largely through state-owned trading companies. Hence, at a depreciated dong exchange rate, the agricultural sector will receive much more dong, for example, for every ton of rice sold. Increased farm incomes will mitigate the impact of the regional crisis in rural areas where 80% of the population and 90% of the poor live. (However, as mentioned earlier, increased rice production in Thailand, Indonesia and other countries in response to higher prices and better weather may bring down prices in 1999 and offset some of these gains to farm incomes.)

Partly offsetting increased agricultural incomes in rural areas are a number of potential negative factors. Some reduction in worker remittances and transfers can be expected from other countries in the region as well as from urban to rural areas. Similarly, reduced net migration from rural to urban areas, and some reverse migration, will increase farm underemployment and stretch traditional family social safety nets. Slower growth in government revenues resulting from the economic slowdown may also affect transfers to poorer provinces and the provision of basic social services.

Fortunately, through appropriate policy actions, **Viet Nam can still avert sinking into the kind of crisis conditions being experienced by a number of other countries** in the region. However, without further reforms, Viet Nam will most surely eventually experience a significant decline in export revenues, a flood of cheap imports (including smuggled goods), further declines in FDI disbursements, increasingly scarce foreign currency, slower growth in real incomes and higher unemployment. According to the UN's analysis in 1996, this would have eventually happened even without the regional crisis, for largely internal reasons.[24]

Viet Nam can respond to these external and internal challenges in a number of ways in order to avert crisis, and resume strong growth and development. First, Viet Nam can learn from the policy successes and failures of other countries in the region, and more resolutely pursue the related reforms. Second, the Government can initiate some contingency planning in order to cushion the expected gradual rise in unemployment and worsening social impact of the regional crisis over the next twelve months. The policy implications of all of this are outlined in the next section.

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[24] See *Catching Up*.

VI. Policy Implications for Viet Nam

In light of the positive and negative lessons learned in East Asia over the past forty years, and the challenges currently facing Viet Nam, this section outlines some of the most important policy implications for averting crisis, preserving stability and resuming strong and sustainable development.

1. There is still an **urgent need in Viet Nam for greater transparency and reliable information**, particularly in **the country's banking and corporate sectors**, in order to lower the risk of serious government policy failure and related market failure. Taking the right decisions requires having the right information. Some significant progress has been made on information availability in these areas over the past year. However, much more needs to be done to improve the reliability and quality of such information available to the market place to avoid the kind of *market failures* witnessed recently in the region.[25] While there has been a proliferation of new statistics on SOEs, many of these have been inconsistent and incomplete, and have not enabled a reliable assessment of the real profitability and financial health of individual SOEs and banks. A major reason for the lack of reliable data has been inconsistent and incomplete accounting practices in past years. Most recently available survey data suggest that 60% of SOEs are unprofitable, which is already quite serious, and that non-performing loans (NPLs) for some banks may be higher than 20% of total loans. Therefore, broad-based **urgent action is needed in undertaking reliable and independent audits of SOEs and banks,** so that that the State has reliable information on which to base its reform decisions and development strategy, and so that domestic and foreign investors can make informed investment decisions and serious

[25] As a reflection of this fact, Viet Nam is one of the few countries in the world that does not as yet provide basic economic statistics for publication in the IMF's monthly *International Financial Statistics (IFS)*. In contrast, more than 160 other countries, many of which are far less developed than Viet Nam, regularly publish basic economic statistics in the *IFS*. Similarly, Viet Nam is one of the few countries in the world that does not publish the state budget, although a strong official commitment has been made to do so in early 1999.

market failure is avoided. To be useful for both the State and the market, such independent audits should be based on international accounting criteria and standards. Without reliable information on the real financial health of the SOE sector and on the related quality of banking sector loans, there remains a serious risk of over-investment in financially-unviable ventures, eventual financial crisis and instability.

Similarly, greater transparency is needed in the state budgetary process, and publishing of the state budget, to guide and encourage efficient public expenditures. A strong official commitment has been made to publish the budget in early 1999, which will improve transparency if sufficiently disaggregated data is offered. **Greater transparency and access to reliable information would also greatly limit the scope for corruption**, which has been of growing concern to both the Party and the Government in recent years. As was learned in the region, corruption has contributed to some high cost and unviable investments in the crisis countries. In general, reliable information is urgently needed in many other areas critical to rational decision-making by both the State and the private sectors in Viet Nam.[26]

2. **State-directed new lending to state-owned enterprises in commercial sectors needs to be sharply curtailed and carefully rationed**, based on reliable audits, and only to such SOEs where genuine profitability and viability are proven. Based on lessons learned in the region and elsewhere, urgent action is needed here to lower the growing risk of government failure and *moral hazard* through excessive state-directed lending and investment in Viet Nam's SOE corporate sector. SOE's continue to receive well over half of available credit in the formal sector. There is clearly a high risk that the related

[26] In the case of Viet Nam, even the State does not appear to have sufficient financial information on SOEs and banks because of past incomplete and highly questionable accounting practices (which evolved under the former central planning model) regarding issues of depreciation of "free" capital provided by the State, reporting of interest on an actual payments basis rather than on an accrual basis, and other unique accounting practices.

debts may reach dangerous proportions, eventually setting back the country's development process below its already generally impoverished level. As recommended below, all such SOEs in commercial sectors should eventually be privatized in an orderly manner while they are still profitable, or before they become more of a burden on the country. SOEs that were not genuinely profitable on average over the past five years of high economic growth are unlikely to be profitable over the slower growth years ahead. Hence, the State should avoid compounding existing financial imbalances with new unrecoverable debts.

3. Similarly, **state-guaranteed lending needs to be sharply curtailed, minimized and carefully monitored**. A recent banking decree enabling SOEs to borrow from banks on the basis of state guarantees (from Government Ministries and People's Committees) and without the need to pledge collateral should be dropped in light of the lessons from the current regional crisis (as well as past regional debt crises). Similarly, in order to avoid *misunderstandings by the market* about the degree of state protection of private investments and *moral hazard* situations, the Vietnamese State should publicly and widely declare a clear and highly restrictive policy on sovereign guarantees, both explicit and implicit guarantees. Otherwise, there is a danger of excessive debt-related foreign investments with SOE joint ventures based on misunderstandings about the State's willingness or ability to back such investments in a financial crunch.

4. Moving closer to a **competitive *dong* exchange rate** will be unavoidable and inevitable in order to promote exports, discourage a flood of cheap imports, encourage rational financial planning of any new foreign borrowing, and avoid a general drying up of foreign currency. The dangers of over-valued exchange rates were clearly demonstrated by the developments leading up to the regional crisis. **Currencies can become over-valued due to direct government intervention, or unknowingly, if substantial capital inflows temporarily support a currency at unrealistically high levels, but the capital is poorly invested or suddenly withdrawn.** Fortunately, Viet Nam's still relatively low inflation rate of around

10% (albeit up from recent years) provides scope for absorbing a significant further depreciation of the *dong*, while maintaining relatively low inflation through tight monetary and credit growth. Moreover, since Viet Nam's currency is not yet freely convertible, not even for foreign trade transactions (which has considerable inefficiency costs), managing this particular adjustment should be relatively easy. The *dong* already appeared significantly overvalued before the regional crisis erupted in July 1997.[27] With the substantial depreciation of many competitor country currencies in the region, Viet Nam will increasingly experience great difficulty in competing in export markets as well as with imports (smuggled or otherwise) in the domestic market.[28] While the dong has been significantly devalued since July 1997, there remain large competitive gaps with other currencies in the region despite some positive upward correction of these currencies in the latter half of 1998 (see Appendix Table 3). **True, a further devaluation will increase the *dong* cost of servicing existing foreign debt obligations, but it will also** fortuitously further improve exports, restrain imports, increase foreign investor confidence, encourage more rational valuation of new foreign borrowing, and **generally increase foreign exchange availability and liquidity for servicing existing foreign debts. In addition, it will further improve the terms of trade in the agricultural sector and cushion the impact of the regional crisis in rural areas.**

5. Clearly Viet Nam's low **domestic savings rate** of just under an estimated 20% of GNP **will need to increase substantially more** to over 30% (as has been the case in other successful East Asian countries) to avoid excessive reliance on foreign savings, particularly foreign debt. Achieving this higher savings rate will require an improvement in the overall enabling environment and incentive framework for saving, and as was the case in most other successful East Asian countries at early stages of development, an export-led development strategy to achieve higher levels of income.

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[27] See *Catching Up*, pp. 27-28.

[28] See appendix Table 3.

In addition, as outlined earlier, the state also has an important role in maintaining an environment with positive real interest rates; legally guaranteeing the long-term integrity of property rights and wealth ownership; rational inflation and exchange rate management so that savers can have confidence in the long-term value of the currency; a sound and healthy banking sector in which depositors can have long-term confidence; and a reasonable and fair tax system that does not threaten to confiscate savings and wealth some day in the future.

6. **Maximize openness to opportunities offered by globalization while minimizing the risks from liquid global finance.** In light of lessons learned in the region, and the current stage of Viet Nam's development, **an export-led development strategy** based on agricultural processing and labour-intensive manufactured exports would **still appear by far the best development strategy for Viet Nam.** The country's greatest comparative advantage in the region remains its disciplined, literate and potentially low-cost labour force.[29] Moreover, the purchasing power of Viet Nam's domestic market is still far too low to sustain protected import substitution (reflected by an average income per capita of only around $300 per annum). In such a low-income market, few consumers will be able to purchase "protected" high-cost locally produced goods (e.g. automobiles), which because of their relatively high cost, can neither be successfully exported at a profit. In addition, the international trading environment has become much more

[29] Actually realizing this *potential* comparative/competitive advantage in Viet Nam would require greatly simplifying a range of regulations impeding investors (e.g. the new employment decree, land regulations, foreign exchange regulations, business license approvals, trading quotas and licenses, etc.) all of which add to the cost of doing business in Viet Nam, as well as more realistic employment taxes and fees. For example, a Vietnamese worker earning "take home" pay of $1,000 actually costs an employer in the order of $5,000 due to employment related taxes and fees paid to the State (and this does not include the cost of the employer's investment in local staff training). All of this would appear to more than wipe out Viet Nam's most important competitive advantage, and discourage labour intensive industry and related job creation, especially in light of more competitive costs now available in other countries in the region.

demanding in recent years (which rules out significant scope for protectionism if access to export markets is to be maintained and developed.) Therefore, a much more aggressive shift towards export-led development and away from protected import substitution, in both policy and concrete action, would appear prudent (and urgent) in order to further lower the high financial risks attached to protected import substitution in costly capital intensive industries. This may entail the outright cancellation of some ongoing projects in order to minimize risks and future costs. **A competitively-valued exchange rate is a more neutral and economically-efficient means of protection from excessive imports** than is maintaining an over-valued exchange rate along side distortionary import controls, which in turn distorts relative prices and costs, and the flow of investments. Moreover, **increased openness to international trade and the negotiation of increased access to new export markets, particularly outside Asia,** will be essential to ensuring Vietnamese producer access to competitively priced imports of raw materials and intermediate products needed to underpin export competitiveness as well as for maintaining and developing access to export markets. A competitive exchange rate, state incentives along the lines of the export-neutral incentives applied by the more successful NIEs in the past, further reductions in administrative impediments to exports by the non-state sector, and effective use of the World Wide Web for promoting Viet Nam's exports of goods and services would also underpin an effective strategy. **An eventual but carefully managed openness to international finance would complement this strategy.**

7. **Minimizing exposure to the potentially damaging volatility caused by liquid global capital can be achieved in less costly ways to the economy in Viet Nam than the existing set of broad-based controls and regulations on the currency, foreign trade transactions, and long-term foreign equity investment.** Minimizing volatility from liquid global capital can be achieved by promoting the further development of and reliance on domestic savings for development, building up official foreign exchange reserves and reducing reliance on foreign savings, especially debt. **An incentive framework that discourages the use of short-term foreign debt and other types of highly liquid global**

capital might also be prudent in light of experiences in the region. Other innovative approaches might also be explored along the lines of high withholding taxes on short-term foreign investments and loans, and deposit schemes (as in Chile). Occasional direct regulation of such liquid global capital inflows may also be sometimes unavoidable.

8. Much more **pro-active state promotion of the non-state sector** will be essential to Viet Nam's successful development in light of lessons learned both inside and outside the region. As indicated earlier**, in all successful developed and developing economies**, both inside and outside the region, **the private sector has been the main engine of sustainable growth and development**. This was the case **whether a country was effectively a one-party state or a multi-party state**. Notably, **no country in the world has successfully developed with an SOE-led development strategy, although many countries have tried and failed** (e.g. the former Soviet Union, the former Comecon countries in Eastern Europe, North Korea, and others.) Again, despite very significant progress in China over the past twenty years, the country cannot yet be considered a development "success story" given its continued low income per capita, widespread poverty and highly vulnerable SOE and banking sectors. Moreover, the main sources of China's success to date have been the export-oriented Special Economic Zones (SEZs) and the private or quasi-private sectors, particularly the dynamic town and village enterprises (TVEs). In this regard, the Party leadership in Viet Nam should be more pro-actively promoting the private sector.[30] This would involve concrete rationalization of SOEs to free up resources for the non-state sector;

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[30] In the run up to the National Party Congress in June 1996, the desire was expressed in the Party's Draft Political Report that the State would account for 60% of GNP by the year 2020, up from around 40% in 1996. While this quantitative objective was absent in the Party's final Political Report, many observers felt that it remained the unwritten desire of many senior officials in the Party. Moreover, the country's official Public Investment Program (PIP) document covering the five years from 1996-2000, implies that up to 80% of total planned investment spending will be state-related, including around half of the planned $7.5 billion of ODA for the five years which was earmarked for the development of SOEs via state credits. See *Catching Up,* pp. 19-23.

the reform and development of the financial sector to better service the non-state sector; a more reasonable income tax system which does not constrain or discourage production by the non-state sector; a legal and regulatory system which clearly guarantees the integrity of property rights and wealth ownership including freedom to use such property as collateral at full-market value; and greater access to useful and reliable information among others. Level playing fields with SOEs exist mainly in theory and in textbooks. In the real world, ownership matters and heavily influences commercial enterprise efficiency.

9. **Further reform of state-owned enterprises (SOEs)** will be essential to developing an export-led development strategy, financial sector reform, development of the non-state sector, and even rural development and sustainable poverty reduction. For example, developing an export-oriented growth strategy, essential to the financial sustainability of Viet Nam's economic growth, implies trade liberalization, including import liberalization. However, without prior reform of SOEs, such import liberalization would likely result in an import boom, a significant widening of the trade deficit and an unsustainable accumulation of foreign debt and financial crisis. Similarly, banking and financial sector reform are also dependent on SOE reform, since the quality of bank portfolios in Viet Nam remain heavily determined by the quality of SOE investments, because SOEs remain heavily dependent on state-directed banking credits. (As indicated earlier, latest government survey data suggest that 60% of SOEs are unprofitable.) Furthermore, the development of the non-state sector, essential to the successful development of any country, is being "crowded out" by SOE's preferential access to land, credit, business licenses, quotas, and other monopoly privileges. Even rural development and poverty reduction have been held back in the past by low prices received by rice farmers, which in turn results from rice export quotas being allocated largely to monopoly state trading companies.

Effective reform would first involve a rationalization of new credit and other resources to SOEs, and secondly, an orderly process equitizing all SOEs in commercial areas. While it is true that the Government has ceased providing state budget subsidies to SOEs, the same is not true of state-directed bank credits. SOEs still receive over half of bank credits. As we have learned in recent years, yesterday's credits have become today's subsidies as they are written off as non-repayable by SOEs. Similarly, today's credits will become tomorrow's subsidies. Therefore, a genuine hard budget constraint would also include stringent limits on state directed credits to SOEs, and only to SOEs that have proven to be profitable on average over the past five years based on reliable audits. Some 38 of 6,000 SOEs have been equitized during the past five years. The Government is planning to equitize some 1,400 SOEs currently being registered for equitization over the next two years, which represent some 23% of the existing nearly 6,000 SOEs. All SOEs in commercial sectors should eventually be privatized in an orderly manner while they are still profitable or before they become more of a burden on the country.

10. **A transitional social safety net should be set up to minimize any potential human hardships resulting from deeper SOE reform** via the provision of temporary income supplements and retraining for any workers laid off. Fortunately for Viet Nam, in contrast to Russia and China, SOEs are still much smaller, less capital intensive, and potentially much more flexible and adaptable. SOEs employ only around 1.8 million workers or 5% of the labour force according to official statistics. Therefore, the social impact of deeper SOE reform in Viet Nam would likely be limited, especially since only a fraction of such SOE workers might face job redundancy. In contrast, SOEs in the former Soviet Union employed more than 50% of the labour force, partly explaining why adjustments there were so painful. Similarly, in China, SOEs formerly employed more than 20% of the labour force. Given the much smaller number of potential layoffs likely in Viet Nam, such a social safety net should be quite affordable and well worth the investment in improving the sustainability of the country's development process and in minimizing human hardships.[31]

[31] A proposal to develop an effective and affordable social safety net for SOE reform to be cost-shared by both the Government and ODA was initiated by UNDP at the Consultative Donor Group (CG) Conference in Tokyo in December 1997 See UNDP's official statement at the CG on *SOE Reform with Social Equity and a Human Face*, UNDP Viet Nam, December 1997.

11. **Reform and development of the financial sector** will be essential to avoiding a dangerous buildup of non-performing loans, improving the efficiency of capital allocation, supporting the development of the non-state sector's productivity, and enabling a further gradual opening to international financial flows. Again, reliable audits of both SOEs and domestic banks will be essential to objectively assessing the quality of existing investments and related loans, serve as the basis for determining capital adequacy and prudential loan loss provisioning, and help avert a banking crisis. Available data suggests that non-performing loans are in excess of 20% for a number of banks. In terms of developing and deepening domestic financial markets, the use of land user rights and other assets as legal collateral at full market value needs to be facilitated, clarified in law and fully respected. Reliable national and provincial registries for land user rights, mortgages and other types of assets and liabilities need to be set up to provide essential information for the further development of financial markets. As a transitional measure to overcome immediate problems of collateral and foreclosure, the environment for leasing needs to be further deregulated and promoted. Similarly, reputable foreign banks should be allowed to have a much more active role in domestic lending and in transferring knowledge and expertise to domestic banks. The State should generally refrain from directing credit except perhaps to a limited degree in a broadly neutral manner (see point #4 in Section III) to enable further investments by clearly successful and profitable exporters until local financial markets are better developed (ie. err on the side of exports).

12. **Far better foreign debt management** is clearly needed in light of lessons from the region as well as prolonged difficulties in Viet Nam in honoring basic letters of credit, which are an essential instrument for facilitating international trade and development. Far better information is needed on the amounts and term structure of the country's total foreign debts (including in the SOE and joint venture sector), as a basis for any policy adjustments needed to help avert future balance of payments crises. Similarly, better information is needed on state guarantees of domestic and foreign loans to the banking and corporate sectors, and any other such contingent obligations which could ultimately impact on future state financing and the

balance of payments. Viet Nam's foreign debt is already sizeable. According to available statistics, hard currency debts alone now exceed 40% of GDP and 120% of export revenues in 1998, and continue to grow. A reported imminent debt reduction and conversion agreement with Russia on old soft currency debts would push these hard currency debt ratios closer to a sizeable 50% of GDP and 140% of export revenues.[32] While current debt servicing on this stock of debt is quite manageable thanks to low interest rates, the eventual repayment of principal could be more onerous at future exchange rates. Therefore, increased reliance on domestic savings and reduced reliance on foreign debt, particularly commercial and short-term debts, would appear prudent, if not essential to ensuring financial sustainability. Judging from lessons learned in the region, the least volatile and least onerous source of foreign commercial financing by far remains long-term foreign equity investment. The portfolio investment which typically accompanies emerging stock markets open to foreign investors and free from foreign capital controls tends to be more mobile and volatile, and requires very careful macroeconomic and financial management, particularly in countries with under-developed and shallow financial markets.

13. **Viet Nam should say no to easy money, especially debt, that cannot be effectively invested.** Foreign finance is often "supply" driven, as demonstrated by the ongoing regional crisis, as well as the regional crises in Latin America and Eastern Europe during the early 1980s. Foreign bankers and institutional investment fund managers in search of "easy" returns and expanded portfolios have proven to be sometimes over-enthusiastic in lending and investing on the basis of limited information. Similar enthusiasm results if foreign bankers and investors believe that governments in developing countries will eventually bail out, if need be, troubled domestic banks and companies (ie. moral hazard). Foreign direct investors have also proven willing to make long-term investments on the basis of personal relationships with host country

[32] For example, this compares with June 1997 pre-crisis foreign debt to GDP ratios of 62% in Thailand, 63% in Indonesia, 64% in the Philippines and 49% in Malaysia, and debt to export ratios of 125% in Thailand, 209% in Indonesia, 109% in the Philippines and 92% in Malaysia.

governments, tacit "guarantees" and special protectionist deals that eventually hurt a country. Similarly, the effectiveness of ODA depends upon effective reform and careful investment to develop sustainable national capacities. Viet Nam should say no to any ODA that risks holding back the development of national capacities or risks unintentionally slowing genuine reform. **Easy money today can be very difficult and destabilizing tomorrow unless effectively invested to generate sufficient returns for its repayment.** Again, Viet Nam's foreign debt levels are already significant, hence increased reliance on domestic savings, long-term foreign equity investment, and other non-debt sources of financing appears essential to financial sustainability. Prior to the regional crisis, foreign money was quite easily available to Viet Nam, and these easy money conditions could soon return once the region begins to pick up. **As demonstrated in recent years in East Asia, the apparent benefits of low interest rates on foreign money today, can be more than offset by adverse exchange rate changes tomorrow.**

14. **Accelerate the pace of reform with stability, or reduce the pace of debt financing** to better ensure the sustainability and stability of Viet Nam's development process. The pace of economic reform appears to have slowed significantly following the period of dramatic reforms during 1989-93.[33] Initially following this period, there was

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[33] During 1989-93 SOEs were rationalized from some 12,000 to around 6,000, including well over 2,000 closures with the remainder merged; direct budget subsidies to SOEs were eliminated; the collective system in agriculture was largely dismantled and land returned to farm family management; most prices were largely liberalized; exchange rates were substantially devalued and unified; a dual banking system was created; the door was open to FDI; the military was rationalized by some 500,000 soldiers; foreign trade was made easier; more than 1 million laid-off workers were provided with income supplements, retraining or credits, and absorbed into the subsequently fast growing economy; and many other significant reforms were implemented. Notably, this series of dramatic reforms was implemented with little outside assistance. There have since 1993 been many other kinds of softer reforms related to important new laws, decrees, implementing guidelines, etc. that create the "institutional software" for implementing more concrete kinds of reforms on SOEs, trade, banking, the non-state sector, but this software has yet to be effectively implemented. Also, steps forward on reform like tariff reductions or some SOE equitizations have often been largely offset by tighter direct import controls and invisible barriers to trade, and substantial increases in credit to enable the expansion of the SOE sector.

probably a need for consolidation of the many changes to better ensure stability. Consolidation appeared to have been well achieved by 1995, especially following the strong supply side response to the reforms and high economic growth rates. However, the supply side response in terms of additional high growth rates was already weakening in early 1997 before the regional crisis, judging from data on SOE inventory stock piling and other growth indicators. The regional crisis may have created a new compelling concern about the pace of reform on the external side of the economy and the desire to minimize the risk of importing instability. Nevertheless, there were and remain plenty of needed internal reforms particularly related to further improving the enabling environment for the non-state sector, SOE reform and banking sector reform that could be accelerated. Moreover, the regional situation appears to be stabilizing and should soon enable more rapid reform on the external side. More rapid reform is essential given that Viet Nam's hard currency foreign debt has more than doubled since 1993, and now amounts to a significant 44% of GDP. Any additional debt financing will need to be invested very carefully so that debt servicing capacity as measured by GDP and exports more than keeps up. **The pace of economic reform is clearly a sovereignty issue. Nevertheless, the pace of reform will need to stay well-ahead of the pace of debt financing if sustainability and stability are to be preserved.**

15. Judging from recent experiences in the region, **greater transparency and accountability** by the State, and **an equitable distribution of both the benefits and costs of development**, will be important to minimize the risks of social instability in times of economic downturn. This can be achieved through more balanced geographical development (particularly through a further shift in the public investment programme to basic infrastructure in rural areas); increased investments in human resource development (especially universal basic education and vocational training); improved access to basic social services for the poorest and most vulnerable; and more efficient and targeted poverty reduction support. The Government's planned poverty reduction programme aimed at assisting the poorest 1,715 communes in the country could make a major contribution in the coming years if effectively defined and implemented. Similarly, greater efforts in fulfilling the 20/20 commitment made by both the Government and donor countries at the World Summit for Social Development in Copenhagen in 1995 on basic social services is needed. According to UNDP data, ODA allocated to basic social services remains extremely low at a meager 5.5% of total ODA, while government expenditures on basic social services are in the order of only 9%. Clearly greater efforts and innovation by both Government and donors are needed to overcome institutional constraints and biases in order to increase investments in basic social services.[34] **More transparent government budgetary and public investment processes, combined with greater participation by the people in these processes at the local levels, would improve the efficiency and equity of state expenditures.**[35] All of this would be facilitated by public administration reform and increased institutional and human resource capacity development at the provincial and sub-provincial level.

16. **Strengthening contingency planning and the social policy response for major economic downturns, natural disasters and exceptional crisis situations.** As a still very poor low-income country, it would be unrealistic to expect Viet Nam to soon develop an elaborate and well-financed welfare and social security system. Nevertheless, there appears to be considerable scope for improving existing social security systems and existing allocations of social expenditures in order to better assist the poorest and most vulnerable, and ensure continued access to basic social services during economic downturns, natural disasters and other exceptional crises. Within the

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[34] The 20/20 commitment implies that at least 20% of ODA and 20% of government expenditures should be on basic social services such as primary health care, primary education, access to clean water and sanitation, etc.

[35] The Government is reportedly planning to publish such budget information in early 1999, but the level of disaggregation of expenditures will determine its usefulness.

existing budget for social expenditures, reallocation towards commune health centres and primary education within the poorest districts and communes, would improve access by the poorest to basic social services**. In general, the initial basis should be further developed for an equitable, efficient and financially-sustainable social security system that will grow and develop with the overall economy.** The central Government should also be vigilant that inter-provincial transfers for social expenditures aimed at the poorest and most vulnerable are allocated effectively by provincial governments in order to assist the poorest and most vulnerable communes. Government policy should also ensure that layoffs occur in the most equitable manner possible, based not only on seniority, performance and gender equity, but also sensitivity to workers who are single-heads of households with children. Layoffs should be conditioned on equitable severance pay packages except in the case of bankruptcy, when government assistance may be required. In rural areas, the Government should be vigilant that state-owned monopoly trading companies pass on to farm families the gains from agricultural exports resulting from recent and further depreciations of the dong exchange rate.

17. **A "social contingency fund" or "human development fund" should be built up during periods of relatively high growth in order to reinforce traditional social safety nets during periods of major economic downturns, natural disasters and exceptional crisis situations.** As was painfully learned in the crisis countries, setting aside some savings during high growth periods as a contingency to help finance social relief in response to sudden dire circumstances would be prudent and humanitarian. Such funding should be set aside to be readily available for emergency food relief, clean water, medicines, and other basic necessities of life. During times of financial crisis, new money is scarce to non-existent. Hence, such a social reserve fund would need to be accumulated mainly during periods of high growth. Such a social reserve fund might be financed by value-added based taxes on luxury goods (eg. motorbikes, automobiles, air conditioners, etc.), "sin" taxes (eg. on cigarettes, liquor, beer, etc.) and perhaps also by proceeds from SOE equitizations. **Similarly, a**

significant share of quick-disbursing official development assistance (ODA) might be deposited in such a fund to better ensure that it is spent when genuinely needed and to assist those in most dire need following dislocations caused by structural and balance of payments adjustments.[36] Such a fund could be used for transitional income supplements and for the retraining of displaced workers, emergency social relief in response to natural disasters, etc. Such a contingency fund would need to have a well-defined separate legal status to ensure that it could only be accessed under certain well-defined conditions and for well-defined emergency social relief, and not for general budgetary or balance of payments financing.

18. **Ensuring Stability with Openness:** Judging from all of the positive and negative experiences and lessons learned in the region, a considerable degree of openness to outside opportunities is essential to rapid and sustainable development. A high degree of openness to international trade, trade-related finance, long-term foreign investment and related technology, and global information and knowledge, appears essential to rapid poverty reduction. In this context, **stability is best preserved through effective national governance** including:

- **sound economic and financial management**, especially regular orderly adjustments of financial variables (eg. exchange rates, interest rates, loan loss provisioning) in line with evolving conditions;
- **diversification** of development in general, but particularly with respect to exports**;**
- **maximum reliance on domestic savings for development and minimal reliance on foreign savings, particularly short-term debt and other liquid global capital;**

[36] The meeting of “conditionality” related to SACs and ESAFs does not always result in immediate large new financial needs. If such quick-disbursing ODA debt financing is spent before it is really needed and for import expenditures that are unnecessary or inefficient, it will be unavailable for those in greatest need following real financial and structural adjustments.

- **enabling the non-state sector and markets to play the dominant role in the allocation of resources in commercial areas**; and
- **an equitable sharing of both the benefits and costs during the development process**, including during periods of financial and structural adjustments.

No country can completely avoid some degree of financial volatility in an ever-changing world, but the risk of crisis and instability can be minimized through effective governance and capitalizing on past lessons learned. Even a relatively closed economy, as was the case of Viet Nam in the mid-1980s, can experience financial and economic crisis. (North Korea is the most closed economy in the world, but experiencing one of the deepest and most protracted economic and financial crisis. Admittedly, **North Korea has maintained** political stability, but **stability in extreme poverty**.) Most successful developing countries, both inside and outside the region, have enjoyed long-periods of stability with openness and rapidly growing prosperity, despite occasional short periods of correction and adjustment to redress imbalances. The choice can be seen as one between stability in poverty (eg.North Korea) or stability in prosperity (eg. Taiwan). In addition, as expressed by a participant at a recent conference in Hanoi, there is a certain paradox in resisting change to maintain stability.

> **The Paradox of Stability:** *"In an ever-changing world, governments that impose policies aimed at resisting change in order to maintain the stability of the status quo, create eventually unsustainable imbalances that lead to widespread instabilities and abrupt change".*[37]

Despite the current temporary contraction of real incomes in some of East Asia's newly-industrialized economies (NIEs), the vast majority of people in most of these economies continue to enjoy a

[37] Participant's comment at CIEM/UNDP Conference on *Globalization, Governance and Stability: Key Lessons for Viet Nam*, 31 August-1 September, Hanoi, Viet Nam.

much higher level of prosperity and social well-being than in those economies that have remained relatively closed to the outside world. Moreover, most of East Asia's newly-industrialized economies are expected to emerge even stronger and resume building upon past achievements following a few years of effective restructuring. Most importantly, **the resumption of strong development in East Asia will likely continue to be based on the many opportunities offered by globalization, while minimizing the risks through effective governance.**

There are, of course, numerous other lessons from the East Asian development experience that are relevant to Viet Nam's future development. Moreover, issues of **public sector financial reform, public administration reform, legal reform, social sector reform, environmental management and others, cut across the above policy recommendations and are equally important**. However, the purpose of this paper is to highlight those that have become particularly pressing at the current juncture of Viet Nam's development process in light of regional developments.

VII. Summary and Conclusion

There have been many impressive development achievements in East Asia over the past 40 years that remain largely intact in most of the countries concerned despite the ongoing regional financial crisis. Incomes have grown dramatically and poverty has been substantially reduced. These achievements have been built on sound macro-economic and financial policies; high savings rates; state-leadership in pro-actively promoting private sector development; export-led development in most cases; and heavy investments in human resource development and basic infrastructure. **Considerable openness to the opportunities offered by globalization, while minimizing the risks from liquid global capital, was also essential to the rapid pace of development in the most successful East Asian economies over the past forty years.** Moreover, in most of the countries concerned these achievements will be further built upon following a period of sufficient restructuring. Notably, even with the current contraction of real incomes in a few of the East Asian newly-industrializing economies (NIEs), the vast majority of people in most of these economies continue to enjoy a much higher level of prosperity and social well-being, and lower poverty, than in those developing Asian economies that pursued alternative development paths and remained relatively closed.

An analysis of the factors leading up to the current regional crisis indicates that weak governance played a major role in the origins of today's regional difficulties. Poor governance contributed either directly to the build-up of structural and financial imbalances in a number of the crisis countries concerned, or indirectly, by impeding the ability of markets to function effectively and efficiently. Heavy state involvement for years in the allocation of investment resources in commercial areas considerably blurred state and private sector creditworthiness and related risks, and created a lending and investment culture very prone to "moral hazard" by which lenders and investors counted on governments to back up their risky investments. Risky lending and investment behavior by private sector banks, finance companies and corporations was also enabled by the lack of independent and effective prudential supervision and capital adequacy. This lending and investment culture became very quickly unsustainable following the liberalization of cross-border liquid capital flows in a number of countries during the first half of the 1990s. New liquid foreign debt flowed in and simply topped up already high debt/equity ratios (particularly in South Korea and Indonesia), built up in earlier decades via state-directed or -influenced lending and investments in commercial areas. In addition, state failure in either withholding essential information from the market or in failure to enforce legal requirements related to transparency, accountability and financial reporting in the corporate and banking sectors also helped set up "market failures" and the regional crisis. The general lack of transparency also facilitated corruption and the development of a large number of high-cost and financially unsustainable investments in both the state and corporate sectors.

At the same time, the origins of the crisis also clearly have elements of financial *market failure*, particularly related to excessive risk taking, over-lending and over-investment in some sectors in the countries concerned. Many over-enthusiastic foreign banks and investors appear to have naively invested on very limited positive information and speculation (eg. faith in the "miracle"), or faith in government bail-outs if ultimately needed. Following the first hint of bad news in July 1997, many foreign bankers and investors fled out of "fear of the unknown", and in so doing destabilized the already vulnerable financial situations in a number of East Asia countries (and subsequently Russia), in some cases damaging some formerly healthy companies following the general drying up of credit. The situation was exacerbated by the initially very austere monetary and fiscal policies implemented to address problems that were largely non-macroeconomic in nature. The lack of reliable and balanced information, combined with dramatic statements in the international media, led to contagion and a downward spiral of self-fulfilling prophecies. **Given that individual countries have little influence over globalization, the best protection from weak international governance is effective national governance.**

The resulting social impact and human hardship has been severe, especially in the formal sectors and urban areas. Rising unemployment and under-employment, reduced incomes, devalued savings, higher prices for some basic commodities and scarce government financing for social services, are all increasing human hardships in the crisis-hit countries. Layoffs in the formal sectors are reportedly being implemented typically on a "last in, first out" basis which has negatively impacted female workers more than male workers. All of this is, in turn, adversely affecting the health and education of children. In Indonesia and Thailand, child malnutrition has risen and school enrollment rates have declined substantially as parents have less income to pay school fees and related costs. All of this is creating new pressures towards child labor, as well as prostitution of women and children. This, in turn, will expose these vulnerable groups and the region to the further spread of HIV/AIDs. Those who had become dependent on formal sector employment over a period of years find themselves with less access to traditional family social safety nets following layoffs.**The governments of the countries concerned had not set aside savings nor developed sufficient social security systems during more prosperous times to mitigate the social impact of the ongoing downturn.**

Fortunately Viet Nam is in a position to capitalize on both the positive and negative lessons learned in the region over the past forty years. Maximizing openness to the opportunities offered by globalization, while minimizing the volatility and risks caused by liquid global capital, would appear essential to Viet Nam's rapid transition from poverty to prosperity in light of the regional experience. Given the current stage of the country's development and the international trading environment, an export-led development strategy still appears to be by far the best option for sustaining successful development. This in turn implies a much more aggressive effort on export development and promotion, as well as more rapid trade liberalization to negotiate access to new export markets and improve producer access to low-cost raw materials and intermediate goods. Viet Nam's generally poor domestic market implies that protected import substitution would be financially unviable. In order to be sustainable, pro-active state promotion of the private sector as the main engine of export-led growth will be essential in light of lessons learned in the region and elsewhere. This will require further reform of state-owned enterprises in order to free up resources for the non-state sector, as well as proactive development of the banking and financial sector to ensure efficient allocation of domestic savings. A considerable reduction in state-directed and -influenced lending and investment in commercial areas would appear urgent in light of lessons from the region. Increased reliance on domestic savings by improving the environment for savers and investors, and reduced reliance on foreign debt will be essential to ensuring financial sustainability. **In any case, given the already significant stock of foreign debt owed by Viet Nam, as well as significant problem loans to SOEs in the domestic banking sector, the pace of reform needs to stay well ahead of the pace of new debt accumulation if sustainability and stability are to be preserved.**

In addition, the State in Viet Nam has an important role to play in improving the enabling environment for markets to function much more effectively and efficiently, and in minimizing the risks of both government policy failure and market failure. In this regard, urgent action is needed in undertaking reliable and independent audits of SOEs and banks so that that the State has reliable information on which to base its reform decisions and development strategy, and so that domestic and foreign investors can make informed investment decisions and avoid serious market failure. Greater transparency and easier access to useful and reliable information are urgently needed so that markets can function efficiently, and resources are allocated more realistically. Again, a considerable degree of openness to outside opportunities, particularly trade, foreign investment, new technology, and global information and knowledge flows, will remain essential to Viet Nam's successful development. Sound economic and financial management, including the facilitation of regular orderly adjustments of financial variables like the exchange rate, will be essential to avoiding the build-up of large destabilizing imbalances. Facilitating broad-based participation in the development process, and an equitable sharing of both the benefits and costs of development, including during periods of economic downturn, will better preserve social stability. The further development of an equitable, efficient and financially-sustainable social security system that develops with the economy would appear prudent in light of recent regional experience. Similarly, setting aside some public savings in a "social contingency fund" during non-crisis periods to provide social relief during exceptional adverse conditions caused by financial and structural adjustments, or natural disasters, would appear prudent and humanitarian. In sum, much less state involvement in directing the allocation of resources in commercial areas and more state involvement in improving the enabling environment for the non-state sector and the Vietnamese people offers by far the most potential for Viet Nam's successful development, sustainable poverty reduction and long-term stability.

Table 1: Trends in Real GDP Per Capita for Selected Asian Countries

1a. 1996 USD Prices and Exchange Rates

	Japan	Korea	Taiwan	Singapore	Malaysia	Thailand	Indonesia	Philippines	China	Viet Nam
1955	4,785	1,098	1,340	n.a.	n.a.	443	n.a.	674	n.a.	n.a.
1960	6,951	1,121	1,579	2,970	n.a.	484	294	731	n.a.	n.a.
1965	10,284	1,337	2,040	3,388	1,291	584	285	813	n.a.	n.a.
1970	16,547	1,924	2,332	5,660	1,437	780	332	899	n.a.	n.a.
1975	19,210	2,691	3,201	8,168	1,793	889	430	1,056	155	147
1980	22,965	3,574	5,481	11,551	2,345	1,168	579	1,244	185	137
1985	26,667	4,999	6,162	15,564	2,631	1,379	654	1,026	279	198
1990	32,602	7,675	9,381	21,046	3,230	2,080	813	1,149	374	217
1996	35,884	11,149	12,576	30,195	4,597	3,012	1,164	1,193	678	309
1997	36,143	11,659	13,104	31,897	4,845	2,959	1,202	1,229	730	353
1998	35,261	10,896	13,799	31,897	4,554	2,740	1,045	1,222	770	367

1b. 1998 USD Prices and Exchange Rates

	Japan	Korea	Taiwan	Singapore	Malaysia	Thailand	Indonesia	Philippines	China	Viet Nam
1955	4,407	670	1,243	n.a.	n.a.	336	n.a.	471	n.a.	n.a.
1960	6,403	685	1,465	2,792	n.a.	367	133	511	n.a.	n.a.
1965	9,473	817	1,893	3,186	965	443	128	568	n.a.	n.a.
1970	15,240	1,175	2,163	5,322	1,075	591	150	628	n.a.	n.a.
1975	17,694	1,642	2,970	7,680	1,340	675	194	737	168	133
1980	21,153	2,181	5,085	10,860	1,754	886	261	869	194	123
1985	24,562	3,051	5,717	14,635	1,968	1,046	296	717	291	178
1990	29,924	4,684	8,703	19,790	2,415	1,578	367	803	390	195
1996	33,061	6,817	11,667	28,391	3,452	2,300	508	834	706	279
1997	33,299	7,128	12,297	29,992	3,639	2,260	525	858	761	297
1998	32,486	6,662	12,727	29,992	3,420	2,093	456	853	802	309

Sources: GDP per capita figures from: IMF, International Financial Statistics Yearbook 1997; 1997/1998 GDP, deflator from IMF, World Economic Oultook, October 1998; Exchange rates from The economist; UNDP computations.

Table 2: Debt Indicators for Selected East Asian Economies

	Korea	Malaysia	Thailand	Indonesia	Philippines	China
Total external debt % GDP						
1988	24.4	63.4	35.1	66.8	77.6	11.9
1992	20.0	49.4	38.7	61.1	64.3	17.6
1996	32.5	39.1	53.8	58.5	60.5	16.9
1997	34.9	48.9	62.2	63.4	63.5	16.4
Total external debt % of exports of goods, services & income						
1988	60.1	89.5	99.6	263.6	275.5	88.4
1992	67.5	61.3	100.8	223.5	196.6	87.6
1996	100.3	41.3	132.2	229.4	126.7	78.6
1997	91.5	47.0	125.4	209.0	108.9	71.4
Total short-term external debt % of total debt						
1988	43.3	9.4	20.2	11.3	18.1	31.4
1992	54.9	29.6	45.8	19.9	19.4	27.7
1996	63.5	28.5	58.5	24.2	15.9	27.1
1997	44.3	22.8	45.7	25.3	17.1	29.1

Source: IFS, November 1998 and IMF WOE, October 1998.

Table 3: Changes in Exchange Rates during the Asian Financial Crisis

	US Dollar			Versus VN Dong		
	% apprec. Dec 96-Nov 98	% apprec. Jun 97-Low	% apprec. Jun 97-Nov 98	% apprec. Dec 96-Nov 98	% apprec. Jun 97-Low	% apprec. Jun 97-Nov 98
Viet Nam	-26	-19	-19	-	-	-
Philippines	-35	-42	-35	-19	-39	-23
Malaysia	-33	-44	-34	-16	-41	-21
Thailand	-30	-53	-31	-12	-50	-18
Singapore	-15	-18	-13	7	-14	3
Indonesia	-70	-85	-69	-62	-84	-63
Hong Kong	0	0	0	26	5	19
China PR	0	0	0	26	5	19
Taiwan	-16	-20	-15	6	-4	2
Korea	-36	-49	-32	-19	-47	-20
Japan	-5	-22	-7	20	-7	11

Sources: UNDP computations based on IFS, The Economist, Asian Wall Street Journal, VN News.

Notes: *% apprec.: positive (negative) figure signals a nominal appreciation (depreciation) of the currency of countryindicated left*
Low: refers to lowest values of the various currencies since the first devaluation of the Thai Baht on 2 July 1997 as reported weekly in The Economist.

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