

## **CHAPTER 1:**

### **INTRODUCTION**

#### **1.1 Study background: Vietnam's industrialization and economic integration into AFTA, APEC and the WTO**

Economic reforms in Vietnam have, unlike most Eastern European countries<sup>1</sup>, been characterized by a gradualist or “step by step” approach carried out since the late 1970s and early 1980s within the existing constitutional framework. Yet, since the middle of the 1980s, the world has witnessed rapid and historic changes throughout the former socialist bloc: the collapse of the socialist systems in Eastern Europe and the Soviet Union has led to the disintegration of centrally planned or command economies and related international economic, trade, political and security systems that had prevailed for almost half a century, and to the integration of these economies into the dominant international trading system (Drabek 1998; Michalopoulos, 1998; Pietras, 1997; Drabek, 1997; World Bank, 1996; Kaminski, 1996). This was why, at the VI National Congress of the Communist Party of Vietnam (CPV) in 1986, Vietnam's economic reforms were developed into a radical and comprehensive economic renovation policy, which was to be first realized through changes in Vietnamese modes of thinking and perception (see Vu Quoc Tuan, 2001; Le Van Toan, 1995; Nguyen Sinh Cuc, 1995; CPV 1991; Institute of Economics, 1990; CPV, 1987).

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<sup>1</sup> For example, see Poland's case (Kulig and Lipowski, 1997)

The Vietnam government perceives that (i) the fundamental principle in Vietnam's renovation policy is to pursue benefits, using market mechanisms of the world economy; (ii) under state management, the market mechanism has been bringing dynamism to socio-economic development, overcoming the weaknesses of the old bureaucratic centralized mechanisms, stimulating positive aspects of economic competition, and concomitantly, stimulating economic dynamism; (iii) Vietnam's market economy remains nominally socialist-oriented, and to some extent, has undergone qualitative changes to promote commodity production and exchange; (iv) the economy has to open gradually, both internally and externally. External economic relations have to be diversified and multilateralized: import and export relations have to be enlarged and intensified, more FDI and official development assistance (ODA) have to be attracted from other economies and international organizations; (v) comprehensive and radical renovation focusing on economic aspects has gradually influenced the political system, resulting in noticeable democratization of socio-economic life, while political and social stability has been maintained.

This renovation policy has been followed by a number of radical, profound and simultaneous reforms in all fields of Vietnam's socio-economic life. Although carried out in an unfavourable international context, economic reforms in the first phase (1986-1995) of renovation policy concentrated on economic liberalization, growth and structural change, while attempting to maintain political stability, have led to unprecedented achievements that nobody can deny.

Vietnam has recorded important achievements, contributing to the growth of the economy and people's living standards. These achievements were expressed in the main economic indicators, e.g. rates of growth, domestic savings, foreign trade and FDI have

been high. Vietnam enjoyed high economic growth of over 8% per annum for five years from 1992 and has reduced inflation rate to single digits (down from three digits), stabilized foreign exchange rates, expanded and diversified foreign trade activities, produced sufficient food for the people, and even become the third largest rice exporter in the world (Chapters 5 and 6). Most importantly, Vietnam has made the initial steps towards the two economic goals of stability and growth. The country got out of crisis situation and created conditions for subsequent development towards Vietnam's industrialization and modernization (Tran Dinh Thien, 2001; Dang Duc Dam, 1997; Nguyen Anh Tuan, 1996b; Fforde & Vylder, 1996; Dang Duc Dam, 1995).

However, since the end of the 1980s, the process of international economic integration (see chapters 2, 3, 4) has been promoted rapidly and deeply. The world economy and the "dictates" of international economic integration loom much larger than ever before. This process has aimed at promoting liberalization and facilitating trade and investment by eliminating tariff and non-tariff barriers to trade and investment to harmonize member countries' domestic regulations, practices and procedures and to seek a higher degree of policy coordination (Anderson, 2000; Amsden, 2000; Yamazawa, 2000; Dunkley, 2000; Ariff 1996; UNCTAD, 1996; Ariff, 1995; Shafaddin, 1994; Edwards 1993). The degree of liberalization and facilitation of trade and investment is subject to agreements with each economic bloc.

This process, therefore, poses opportunities and risks for developing as well as developed countries. On one hand, it has created more opportunities for improved prospects for improving industrialization and eradicating global poverty in the first decades of the next century, and for building new international partnerships to achieve sustainable development on a global scale. On the other hand, it has also taken more risks

involving heightened economic insecurity and inequality, political instability, and uncertain consequences for economic development, democracy and social harmony. As a consequence, new and creative policies and partnerships will be required if the benefits of international economic integration are to be maximized and risks minimized (Chapter 9).

Besides that, important components of stability - involving agriculture, macro-economic aspects, and the government - began raising concerns outlined below that could lead to instability in the future when Vietnam would fully integrate into global and regional economies:

(i) Although the proportion of agriculture and forestry in Vietnam's GDP declined, rural society still played an essential role in economic growth since 80% of the population live in agricultural districts. Moreover, rice and other farm products are important export items that can earn foreign exchange for the country. On the other hand, shortage of capital among farmers and underdeveloped agricultural processing and breeding technologies are apparent. Another problem is the gradually widening differences in income between the North and the South, and between the urban areas and rural villages. The inability of industrialization in Vietnam to absorb surplus labor from farm villages will also be a key issue.

(ii) Macro-economic stabilization was partly achieved in 1993 when inflation abated, but this indicator jumped back up to double-digits in 1994 and 1995 and then in 1997 and 1998, due to the impact of the Asian financial crisis; in 1999 the economy experienced deflation. Moreover, the reform and restructuring of state-owned enterprises (SOEs) have been carried out inefficiently because subsidies in various forms continue to persist. The role of SOEs has been developing faster than the private sectors in recent

years, with the growth of the oil sector, that has contributed to macro-economic stabilization. Certain groups remain reluctant to have the SOEs privatized.

(iii) So far, Vietnam government has promoted industrialization, but there have been conflicts among top leaders on economic management, particularly on a critical issues that could determine whether the industrialization policy will become inward or outward (Packard, 2002 and 2001; Anderson, 1999; Anderson, 1998; Kokko & Zejan, 1997; Kokko, 1997; Fforde, 1996; UNDP, 1996a; UNDP, 1996b; Gates & Truong, 1994; IDE 1995).

In these circumstances, with the disadvantage' appearance of three important components of stability, the process of international economic integration has sharply altered the context in which the Government of Vietnam is thinking about policies for industrialization and economic development. That is the reason why the second phase of the renovation policy in Vietnam since 1995 focuses on strengthening the institutional, legal, economic as well as social frameworks so that the economy can continue industrializing rapidly and achieve sustainable and equitable growth.

The inevitable result of greater openness to the world economy is more international economic integration, which can be a source of many economic benefits. The importation of investment and intermediate goods that may not available domestically at comparable prices, the transfer of know-how and technology from more developed nations, and access to foreign savings can help Vietnam overcome some traditional obstacles to rapid growth. But these benefits are only potential. They will only be realized in full when complementary policies and institutions are in place domestically to improve the competitiveness of both Vietnamese products and enterprises.

Another focus of the second phase of Vietnam's renovation policy was to improve legal and institutional frameworks and to build capacity to further integrate the national economy into regional and global economies, meaning further economic integration into AFTA, APEC and the WTO (see more in Appendices 1, 2, 3). That is why after normalization of comprehensive relations with the US (in July 1995), Vietnam became a member of ASEAN in 28 July 1995, subsequently joining AFTA in 1 January 1996, APEC in November 1998 and, possibly, the WTO in 2005. Therefore, it can be said that, nowadays, international economic integration has become a catch-word for the leadership in Vietnam and efforts have been made toward these goals as Vietnam perceives that she can not stand out of the mainstream of international economic integration, and must participate in emerging rules-based multilateral trading system and eliminate tariff and non-tariff barriers to trade and investment essential for economic development and industrialization<sup>2</sup>.

However, AFTA, APEC and the WTO have their own rules and regulations which countries outside have to fulfill to join. To do so, these countries have to elaborately prepare for their integration. Appropriate preparation is also crucial to benefit from participating in AFTA, APEC and the WTO, to minimize the inevitable costs of rapid economic, social, and political changes. Consequently, the key challenge for Vietnam's decision makers is to design and adopt a set of policies that will ensure Vietnam can seize the opportunities created by international economic integration. In other words, at present, the regulations and rules of AFTA, APEC and the WTO become important factors that influence making economic policy, particularly industrialization policy, in Vietnam.

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<sup>2</sup> See "Resolution of Politbureau of Central Committee of CPV (IX Tenure) on International Economic Integration", 27 November 2001.

Indeed, nowadays, there are many policy changes in Vietnam to meet the requirements of AFTA, APEC and the WTO. These changes should be seen in broader context, meaning that they contribute to Vietnam's comprehensive economic reforms, as well as the common ASEAN endeavor of for taking part in wider economic groupings.

Simultaneously, the process of economic reform and integration into regional and other multilateral arrangements and the globe is not without difficulties and challenges. Economically, costs and benefits have been more tangible with Vietnam joining AFTA, APEC and the WTO. The country's economy, which is still small in size and weak in comparative advantage, is vulnerable to trade and investment liberalization, thus, making some leaders more receptive to protectionism. Yet, majority view in Vietnam is that the country should anticipate challenges in joining AFTA, APEC and the WTO as short-term difficulties and necessary costs are paid for ostensibly long-term benefits. In other words, the process of economic reform requires controversial efforts towards more liberal trade and investment policies, even if joining AFTA, APEC and the WTO have not been questioned. From their perspective, these organizations are seen as "blessings in disguise", to encourage Vietnam to further integrate into regional and global economies, and catalyze greater and more effective changes in the economy.

However, at the present time, there are many countries competing with Vietnam for foreign markets and to attract capital from outside to industrialize their own economies or to transform them into "knowledge economies". Therefore, Vietnam should find ways to develop its economy by fully mobilizing domestic forces and effectively utilizing foreign factors to industrialize and modernize its own economy and to catch up with neighboring countries. The key question now being debated by Vietnam's policy makers and scholars is how quickly Vietnam should open the economy to unrestricted

flows of trade and investment in order to promote economic growth. To answer this question, I proposed to study the impacts of economic integration into AFTA, APEC and the WTO on Vietnam's industrialization and economic growth<sup>3</sup> (Chapters 7 and 8).

According to Rodrik, there is no evidence to back the claims of many that integration into the global economy will, in and of itself, improve economic performance. There is no convincing evidence that openness, in the sense of lower tariff and non-tariff barriers to trade and capital flows, systematically produces economic growth. In practice, the links between openness and economic growth tend to be weak, and contingent on the presence of complementary policies and institutions (1999: 137) (also see in Khor 2000; UNCTAD, 1999; Shafaeddin, 1994; Matsuyama 1992; Grossman & Helpman 1991; Feenstra, 1990). In other words, openness does not work except in conjunction with an effective domestic development strategy. It requires a complementary set of domestic policies and institutions for investment, macro-economic stability, human resources, and good governance to overcome obstacles to economic integration, meaning that:

(a) Vietnam needs to create an environment conducive to private investment. In the long run, investment is key to economic performance. Recent studies on the sources of economic growth in East Asia, including China, have highlighted the overwhelming importance of capital accumulation for countries in the region. While opening up to the

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<sup>3</sup> Vietnam's rapid integration into the regional and global economies has been accompanied by a large and growing body of research analyzing the macroeconomic and social implications of external liberalization. While the World Bank finds positive effects of Vietnam's accession to AFTA and of United States granting MFN to Vietnam by using CGE model (Fukase and Martin, 1999), Nguyen and Tran (2000) point out that with combined tax and tariff reforms, the economy got modest economy-wide efficiency gains, accompanied by a sharp redistribution at the expense of rural and poor households and in favor of the richest urban households.



world economy, investment can sometimes be stimulated, but it is a mistake to believe that there is a determinate relationship between openness and investment. As a consequence, Vietnam's government should complement its outward-oriented policy with a coherent domestic investment strategy that raises returns to capital and should kindle the animal spirits of entrepreneurs. There is no single way of raising the private returns to capital to start this process. Vietnam's government has to be imaginative in devising investment strategies that exploit a country's resource and capability, while respecting administrative and budgetary constraints (Chapters 5 and 6). A useful starting point is to acknowledge that openness can only be part of a development strategy and cannot substitute for it.

(b) The ability to maintain macro-economic stability in the face of turbulent external conditions is the single most important factor accounting for the diversity in post-1975 economic performance in the developing world. Countries that were unable to adjust their macro-economic policies to the external shocks of the late 1970s, early 1980s and late 1990s ended up experiencing dramatic collapses in growth. The countries that fell apart did so because their social and political institutions were not adequate to bringing about the bargains required for macro-economic adjustment (they were societies with weak institutions of conflict management) (Rodrik, 1999). In the absence of institutions that could effectively mediate conflict among social groups, the policy adjustments needed to re-establish macro-economic balance are delayed, as labor, business and other social groups block implementation of fiscal and exchange rate policies. The result is that the economy finds itself confronted with high inflation, foreign currency scarcity, and a myriad of other bottlenecks.

Vietnam - with deeper cleavages in term of ethnicity (between majority and various minority ethnic groups) and income (between urban and rural areas, and between provinces and localities) that are particularly susceptible to policy paralysis - should pay special attention to institutions of conflict management, because these institutions are important, both for managing external turbulence in the world economy and for countering possible widening of inequality that openness can bring (Chapters 7 and 8). As a result, Vietnam needs to improve its institutions of conflict management - largely guaranteed civil liberties and political freedoms, social partnership and social insurance - so that Vietnam can maintain macro-economic stability and adjust to rapid changes in external circumstances (see Chapter 9).

(c) It is not realistic to expect that national development efforts will converge on a single model of “good economic behavior”, nor is it desirable to do so. The lesson of history is that, ultimately, all successful countries develop their own brands of national capitalism. The economies that have done well in the post-war era have all succeeded through their own particular brands of heterodox policies. Macro-economic stability and high investment rates have been common, but beyond that, many details have differed. Therefore, Vietnam should also focus on training human resources so that can create good government with good governance to be able to develop her own economic development model, in the same way that countries such as Japan, Germany, Korea, and Taiwan have evolved their own different models.

In sum, implementing these requirements is the key challenge, but this must be achieved in a manner that reduces poverty. From the experiences of East Asian economies as well as transition economies, in the absence of a complementary set of domestic policies and fundamental institutions as part of a strategy of external liberalization,

openness alone will not yield much. At worst, it can cause instability, widening inequalities and social conflict. Consequently, the second objective of the thesis is to make suggestions for complementary domestic policies and institutions in the face of external conditions to guarantee high and sustainable economic growth, and successful industrialization in light of East Asian and transitional countries' economic integration experiences (Chapter 9).

## **1.2. Thesis structure**

This thesis is divided into nine chapters. Chapter 1 is the introduction, which will highlight the study objectives, sources of data, methodology and techniques of analysis. Discussion of the general background of the study in chapter 2 will review theories of international economic integration. Chapter 3 will examine import substitution industrialization (ISI), involving infant industry protection policies. External liberalization and export oriented industrialization (EOI), including definitions, measures, debates and evidence on liberalization effects, and models of East Asian industrialization will be viewed in Chapter 4.

Chapter 5 will examine role of Vietnam's government in economic development and industrialization since 1954. Chapter 6 will review international economic integration since 1995 to satisfy the requirements of AFTA, APEC and the WTO. Chapter 7 will estimate the actual impacts of externalization on Vietnam's economic growth. Chapter 8 will analyze the simulation impacts of economic integration into AFTA, APEC and the WTO on Vietnam's industrialization, using a CGE model for the Vietnamese economy will be applied.

The last chapter provides a summary, conclusion and policy suggestions. The fundamental problem for Vietnam is to establish appropriate economic development and industrialization policies. The key question is whether the right direction is the acquisition of the international competitiveness through openness of the economy in combination with sound domestic policies and institutions.

### **1.3 Methodological Remarks**

This thesis analyzes industrial growth in Vietnam in comparative and inter-temporal perspective. The analysis employs a variety of simple statistical and graphic techniques ranging from proportion methods to time trends, projections and regression analysis. In addition, the following methods are used: correlation analysis, multiple regression analysis, and projections using shift-share analysis. Apart from that, qualitative and quantitative analysis will be adopted to understand the impact of economic integration into AFTA, APEC and the WTO on Vietnam's industrialization and economic growth.

The thesis uses the methodology of Berg and Taylor (2000) to calculate the actual impacts of Vietnam's external liberalization on economic growth and industrialization (Chapter 7). The thesis also presents a Computable General Equilibrium (CGE) model<sup>4</sup> of

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<sup>4</sup> This kind of model is also referred to as an Applied General Equilibrium (AGE) model. The CGE model is derived from micro-economic optimization theory and has begun to incorporate dynamics. The treatment of dynamics varies considerably across CGE models. Some are very simple while others are integrated, more completely into behavior. Given the focus on individual optimization, the key parameters in this type of model are expenditure shares and elasticities of substitution of household and firms. With the focus on micro-economic theory, CGE models are particularly well suited to analyzing questions in tax policy and

the Vietnamese economy, calibrated to production and household data to evaluate the simulation impacts of external liberalization satisfying the requirements of AFTA, APEC and the WTO (Chapter 8).

Apart from that, the thesis utilizes the Three-Gap Macro-Economic (ME)<sup>5</sup> model of the Vietnamese economy to analyze macro-economic constraints relating to Vietnamese growth based on 1996 data. This exercise usefully characterizes an economy's macro-economic status, abstracting from year to year trends in setting elasticities and identifying a consistent set of ingredients required for future macro-economic stability (Appendix 5, Chapter 6, Section 6.1.1).

An empirical study of the economic situation in general and industrialization in particular must necessarily be exploratory. Lack of information requires a broad search for relevant data. One reason for information difficulties in Vietnam is that the reform process is ongoing and has only received little documentation. In addition, Vietnam has a tradition of secrecy in particular financial sector, and, the dubious quality and limited availability of statistical data is a well known phenomenon in many centrally planned

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international trade. In addition, they have played an important role in the literature on economic development (see the survey by Melo, 1984). The structure of the CGE model in this thesis is fairly standard along the lines of Shoven & Whalley, 1984; Dervis, 1985; Robinson, 1989; Devarajan & Lewis, 1990; Shoven & Whalley, 1992; Harrison, Rutherford & Tarr, 1993; Hertel, 1995; and Ghosh, Hutton & Whalley, 1999.

<sup>5</sup> ME models are firmly based on macro-economic optimization theory and on aggregate behavior, with reliance placed heavily on correlations found in time series of aggregate data. In contrast to the approach taken in CGE models, the standard approach in macro-econometric models developed during the 1960s and 1970s was for macro-economic theory to be used as guide to the appropriate variables to use in regression equation. These variables were then tested and either included or excluded based on various tests of statistical significance.

economies, and Vietnam is no exception, although in recent years, much statistical transparency progress has been made in Vietnam.

Arguments in this thesis are based on secondary materials such as books, articles, official documents, official statistical data as well as on a large number of interviews and talks with my colleagues. The data for the production side of CGE model are for 17 commodity sectors aggregated from the latest available 97 sub-sector Input-Output Table for Vietnam. For the consumption side, the data come from the recent Vietnam Living Standard Survey (VLSS) for 1997-1998, in which 10 household groups (5 rural and 5 urban) are identified. In addition, several other sources of data are also used for constructing the benchmark data set for the model.

Statistical figures should be viewed as fairly rough estimates and measures. They are more like indicators of possible trends and magnitudes, rather than exact numbers or definite truths. Lately, quite a few statistical publications have appeared in Vietnam, the quality of which is difficult to assess. Comparing with the uncertain figures reported in official publications, data obtained through interviews and private talks with my colleagues, and information in various newspapers and journals, it seems fair to say that a lot of effort has been made but the quality still leaves much to be desired.

The interviews are of two types. One complements and partly substitutes for the lack of written information on the situation in Vietnam. The second type is of fairly standardized interviews and talks with economists in Vietnam's economic institutes and economic departments of various universities and with colleagues<sup>6</sup>.

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<sup>6</sup> From Ministry of Trade, Ministry of Finance, Ministry of Planning and Investment, State Bank of Vietnam, Ministry of Industry, Ministry of Foreign Affairs, Ministry of Agriculture and Rural Development and so on.

Given the rapid changes taking place in Vietnam, this thesis, although referring to the situation in the late 1990s, can be regarded as an historical account of a particular period in the Vietnamese transition process. The situation is changing. For each obstacle overcome, the transformation process is being taken another further step.