Chapter III Lao P.D.R.

1 Reasons for Transition to the Market Economy (1975 - 85)

--- Drastic Changes from the Socialist Revolution to the Market Economy in Laos ---

1-1 The Centrally-Planned Economy : Established?

--- Socialist Revolution, Poor Economic Performance ---

In Laos, in the aftermath of the political changes of Vietnam and Cambodia in April 1975, the monarchic government was abolished. The following December, “Laos” was proclaimed. Laos then moved to a centrally planned economy, and targeted rapid development of the material and technical bases. All industrial and foreign trade sectors were nationalized, and collectivization was introduced in the agricultural sector under consultation with the former Soviet Union and its allies. However it is reported that cooperative farms covered only 40 percent of the total cultivated area.[1]

Prices were officially decided, and the exchange rate was determined artificially. Following the birth of the socialist political power, most of the assistance from Western countries was interrupted. The IMF’s “Foreign Exchange Operating Fund” that supported the budget deficit and the difficulties of the international balance of payments was also stopped. Therefore, the budget deficit, and the international balance of payments deficit were financed by the assistance of the former Soviet Union. At the end of 1976 a time of almost no development, socialism was introduced rapidly. At the same time, the severing of relations with the Western countries including Thailand brought about the remarkable economic difficulties in the initial several years.[2] The rapid formulation of a socialist economy created hyperinflation (400 percent in 1976) and massive unemployment in urban areas. To make matters worse, a series of natural disasters were followed, such as the heavy drought from 1976 to 1977, and the flood of in 1978.[3]

In 1979, the Central Committee of the Lao Communist Party announced economic reform as a revision of socialism and permitted commercial activity by individual persons and private enterprises. This economic reform was implemented through 1980s.

The First Five Year Plan starting in 1981 emphasized the following four points as follows:

(1) Self-supply of foods.
(2) Establishment of transportation and telecommunication networks.
(3) Promoting industrialization of sectors whose materials are domestically supplied.
(4) Improvement of public sanitary and human resources development.

Because Laos started from a level of practically no development, the annual average growth rate through the period reached 7.6 percent (Government of Laos “The Third Five Year Plan”). In particular, rice production and the commercial sector achieved big growth. The annual average growth rate of the latter reached 18.4 percent.[4] But in basic problems like the budget deficit (see Appendix 13) and trade deficit (see Appendix 7), there was no progress. Therefore a socialist centrally planned economy emerged from the deadlocks.

The Second Five Year Plan was started in 1986. The main points of this plan were as follows:

(1) Self-supply of foods.
(2) Establishment of transportation and telecommunication networks.
(3) Improvement in the international balance of payments.
(4) Expansion of the agricultural and forestry sectors.
(5) Reducing slash-and-burn agriculture.
(6) Improvement of administrative ability.

The annual average growth rate through this five-year period was only 4.6 percent. One of the major reasons of such a lower growth rate was the drought in 1987-88 which gave a serious blow to the production of the agricultural sector and the electric power sector. The GDP growth rate of the agricultural sector fell by 1.2 percent in 1987, 4.2 percent in 1988. The growth rate of the industrial sector also fell by 1.6 percent in 1987, 2.4 percent in 1988. Also the transition to the market economy created major confusion because the legal and administrative systems had not adjusted to the drastic policy change. The basic problems again were left unsolved in this five year term.

1-2 Deadlocks in the Centrally Planned Economy (-1985)

After the revolution in 1975, need for economic reform had been argued because of the economic stagnation in Laos. The deadlocks of the Lao economy were caused by two things : the introduction of centrally planned economic management, and geo-economic factors.

The introduction of centrally planned economic management created twin deficits, budget and trade. Which have caused considerable distress for Laos.

1-2-1 Economic Difficulties Caused by Centrally Planned Economic Management

--- The Twin Deficits ---

(1) The Budget Deficit

After the socialist revolution in 1975, Laos has been distressed by the chronic and expanding budget deficit. The budget deficit was 300 thousand kips in 1976, but it rose to 93 billion kips in 1985 (see Chart 2-III-1). Even considering that the jump in consumer prices in this period was about 40 times, this deficit increase was extremely rapid. The main part of the total budget deficit was the deficit in capital spending. This capital spending could not be carried out without assistance from abroad.

The problem of the money-losing state enterprises was also a cause of the increasing financial burden. Because state enterprises decide prices without considering costs, the increase of product just to achieve the norm caused the expansion of deficits. Tax revenue accounted for only 14 percent of the total revenue (see Table 2-III-2), showing the weakness of the financial base. There was hardly any possibility of increase in tax revenue nor transfer from state enterprises, so the necessity of tax reform is becoming urgent.

(2) The Trade Deficit :

The trade deficit also increased (see Chart 2-III-2). In 1985, imports totalled 193 million dollars ; exports came to 54 million dollars. Exports accounted for only about 30 percent of imports (see Table 2-III-2). Because Laos had no export goods other than electric power, logs and coffee, and most goods, including fuel, machinery, raw materials, and other goods of daily necessity, were import-dependent, structural deficits occurred.[5]

External debt also increased, it climbed from 64 million dollars in 1975 up to 478 million dollars in 1985 (see Table 2-III-2).

The economic development strategy led mainly by state enterprise activity collapsed by the beginning of 1980s. It produced only the expansion of twin deficits (budget and trade), which has become a huge burden on the overall economy. The failure of state enterprise was a mirror of inefficiency of the socialist production system. This inefficiency was a common problem in socialist countries in general. There were no incentives for growth under the socialist ownership and management system which were controlled from above under centrally planed economic management. Under the system of equal income distribution regardless individual performance, economic agents just tried to meet the numerical target quotas. This system deprived any independent initiatives from economic activity for the economic agents. On the other hand there are problems peculiar to Laos, such as the lack of governmental leadership ability.

In January 1986, at the COMECON economic cooperation committee in Vietnam, the Soviet Union and other countries' chairmen of the state planning committees gathered. At that time the chairmen of the Soviet Union, East Germany and Hungary visited Laos, argued about the state of the country through 1986-90 and promised future cooperation. At that time, it was supposed that these countries pointed out the inefficiency of their assistance to Laos, and they consulted on economic reform.[6]

1-2-2 Geo-Economic Factors

--- Conditions that Obstruct Development ---

The big factors that obstruct Laos development are, in addition to the economic difficulties caused by the centrally planned economic management, geo-economic in nature. They include :

(1) landlocked conditions : Laos is an entirely landlocked tropical state located at the center of the Indo-China peninsula, bordered by China to the north, Vietnam to the east, Cambodia to the south, and Thailand and Myanmar to the west. Because it has no open sea, it must use Thai or Vietnamese ports.

(2) insufficient infrastructure : infrastructure of Laos, including electricity, water supply, telecommunications, roads and airports are not yet developed, geographical factors also created structural difficulties in Laos.

(3) shortage of human resources and educational base: During the period of social and economic instability caused by the socialist revolution, large numbers of refugees fled into Thailand and other neighboring countries. People of means boarded planes and fled the country. Therefore, Laos is very poor in human resources, such as people with administrative and political skills in both quality and quantity. School attendance and literacy rates remain low. Laos lacked the fundamental conditions for the education needed to develop these skills.

2 The New Economic Mechanism Introduced in 1986

--- A Way to The Transition to Market Economy ---

The economic reforms of the Indo-china countries in the 1980s share a common factor : these reforms were from not-fully established central planning, and took place just ten years after the socialist revolutions. The reform of Laos was "Transition to a new consideration of economy and policy," and were developed as measures to solve the problems rooted in central planning itself, namely ownership, economic management by state, and relations with neighboring countries. Moreover, the reforms were significant as "an experiment" of reform in Indo-china countries ; they proved to be a kind of "touchstone."

"The New Economic Mechanism (NEM)" was endorsed on The Fourth Congress of the Lao People's Revolutionary Party (LPRP) in November 1986. NEM and "Doi-Moi" (in December 1986) in Vietnam were introduced at the same time.

2-1 The Outline of "The New Economic Mechanism (NEM)"

Laos embarked upon an economic reform called "the New Economic Mechanism" in November 1986. The aims were the rapid transition of its socialist control economy and the transition from an autarchic economy to a market economy. The basic political aims of "the New Economic Mechanism" were 1) open market policies and 2) introduction of market economic principles. The contents of NEM are described below.

2-1-1 Budget Reform

Balancing the budget has been one of the most important targets.

(1) Renovation of Government Expenditures

(a) <u>Reduce the number of officials</u> : Payment to government officials consumes most of current expenditures in Laos. All government staff were paid in cash from 1988, and in 1990 the number of officials was reduced to 80 percent of the 1988 total.[7]

(b) <u>Abolition of subsidies</u> : Petroleum subsidies for the difference between the international and domestic oil price was abolished. Donations of agricultural machinery and fertilizer to "Cooperative Farms" were suspended.[8] Subsidies towards state enterprises were abolished altogether.

(2) Increasing Revenue

(a) <u>Tax reform</u> : By government ordinance number 47, "The National tax system" of June 1989, a system of transfer from state enterprises was abolished and a profit tax was introduced. Due to it, most revenues changed from non-tax (mainly transfer from state enterprises) to tax. And by government ordinance number 12, "The Revised national tax system" of February 1991, all enterprises, both state and private, had been taxed by profit tax (45 percent) uniformly. Tax rates were simplified from 5 levels (3, 6, 10, 15, and 20 percent) to 2 levels (5, and 10 percent).[9]

(b) <u>Revision of public utility fares</u> : Electricity, water and telephone were not privatized because of high costs. In order to strengthen the finance of these enterprises, electric power rates were raised by 43 percent on average, while postal and telephone fares were raised by 80 percent on average.[10]

2-1-2 Supply Side Reform

(1) <u>Liberalization of Domestic Trade</u> : By government ordinance number 12, "Promotion of goods and money circulation." the circulation of goods was liberalized within country.[11] Buying and selling restrictions of agricultural products was eased, and were soon sold

everywhere within the prefecture.

(2) Liberalization of Foreign Trade : By government ordinance number 18, "State monopoly on strategic export and import goods," import duties were reduced and customs procedures were revised. Government ordinance number 18 was revised in 1990 : the number of restricted items on the list of strategic goods was reduced. The strategic goods that state enterprises had exported monopolistically were reduced to only coffee, logs and mineral resources (plaster and tin).[12] People have also been able to engage in trade by getting a licenses, quantitative restriction of import goods was abolished in substance, all necessary goods could be imported.

(3) Introduction of Market Principle of Price Determination : By government ordinance number 14 "Price policy," price control on both goods and services were abolished. All prices except logs and public utility fare became "free." So far the government has bought agricultural products by lower prices, but its purchase prices were raised up in order to close the gap in international prices.

2-1-3 Monetary Reform

(1) Revision of Banking System and Implementation of Central Bank Law :

The banking system was revised in order to increase the national financial supply with positive deposit interest rates in order to channel the money into industry. So far there was only the Central Bank, but by government ordinance in March 1988, it was divided into the Central Bank, commercial banks, foreign trade banks and local banks. Though this, a saving promotion policy was adopted. The Laos Central Bank raised the official discount rate, and took a high-interest policy.[13]

2-1-4 Foreign Exchange Rates

(1) Rectifying Foreign Exchange Rates : Laos created a single official exchange rate that was nearer to the market exchange rate, and did it earlier than Vietnam or the other socialist countries. The existing seven exchange rates were unified into single official rate. The commercial exchange rate was 35 kips = 1 dollar until 1985. By 1986, a dollar was worth 95 kips ; 350 kips in 1987 ; 470 kips in 1989, and then official exchange rate and market exchange rate met at around 700 kips to the dollar in 1990 and around 720 kips in February 1994.[14] With the help of export promotion as well as a reduction in unnecessary imports, the stabilization of foreign exchange was expected.[15]

2-1-5 Reform of State Enterprises (Privatization)

By the government notification in January 1991, a "Disengagement plan" was established. This plan emphasized : (1) privatization of superior enterprises except strategic sectors, such as military affairs, police, electricity, telecommunication and post service ; (2) closing hopelessly profitless enterprises that could not operate without subsidies and loans ; (3) strengthen the finances of enterprises that remain in government property.

By government ordinance number 17, "Change of state enterprises ownership form state to others," privatization of well performing state and public enterprises (except strategic sectors) was promoted.[16]

2-1-6 Foreign Investment

(1) Promoting Participation of Private Sector Including Foreign Investment:

The Foreign Investment Law was enacted in 1988 to encourage foreign investment, and promote capital inflow and external economic activity. 100 percent foreign investment was permitted, with a guarantee that foreign capital affiliated enterprises would not be nationalized. Foreign investors have to invest at least 30 percent of a gross investment. Because capital in Laos is needed, the Lao government even welcomes 100 percent foreign investment.[17] To provide convenient conditions for foreign investment, “The Foreign Investment Management Committee (FIMC)” was established in 1989. Investment promotion policy was introduced with investment guarantees, such as reduction or exemption of duties, to promote investment.[18]

2-1-7 Legal System

A legal system coming economic activity such as “Foreign Investment Law” (first established in 1988), “Ownership Law,” “Labor Law,” “Insurance Law,” “Audit Law of State Public Enterprise” etc. was established. And in 1991 the “Constitution of Lao PDR” was established.

2-1-8 Ownership and Management

The centrally planned economy was put to an end, and decentralization, (i.e, all districts and enterprises take responsibility for their own economic activity) was promoted. Autonomous management was promoted : state enterprises began deciding production amounts, buying prices, selling prices, employment, wage and dismissal policies, etc. They also became free to use their profits as they saw fit.

2-2 Execution of Public Investment Program (PIP)

“The Second Five Year Plan” ended in 1991 in the midst of the economic reform, and was followed by “The Third Five Year Plan (1991-1995).” But The Third Five Year Plan has not gained the approval of Parliament, since the socialist long term plan had had little practice effect. Instead the Public Investment Program (PIP) was established. This program is based on support for the establishment of infrastructure in order for the private sector to operate smoothly.[19]

3 Evaluations and Economic Reform

--- Macroeconomic Stability and Achievements of Economic Reform ---

3-1 The Achievements of Reform

--- Objective Result ---

3-1-1 Macro Economic Stabilization

(1) GDP Growth Rate

In 1987 and 88, GDP growth was negative because of drought and the confusion of policy changes. But during the period from 1989 to 92, GDP growth rates were stable. For each year growth rate was 11.5 percent, 5.9 percent, 4.0 percent, 7.0 percent respectively (see Appendix 1). It is expected that the GDP growth rate will have reached 4 percent in 1993. The growth rate of per capita GDP in this 4 years period was 8.5 percent, 3.6 percent, 1.6 percent, 4.1 percent respectively (see Table 2-III-3).

In the agricultural sector, the growth rate was negative: -1.2 percent, -4.2 percent in 1987 and 88 respectively because of drought, and -1.7 percent in 1991 (see Table 2-III-4). These unstable rates reflect Laos's agriculture characteristics that depend on rain water, and have poor irrigation. The agriculture share of GDP in 1993 was 60.0 percent, the industry rate was 17.5 percent, and the services rate was 22.5 percent. The agriculture sector account for just 60 percent of GDP (see Appendix 2). Owing to these condition, the weather determines the whole country's economy and makes the economy fragile. The rice yield in 1992 reached 150 million tons, seemingly quite large compared to 1991's 122 million tons. But rice yield could not reach the goal of 160 million tons in 1992. (1) New changes in plain field agriculture have appeared since the reform in 1986, including expansion of area under cultivation of dry season rice by improvement of irrigation, (2) appearance of farmers that adopt method of modern rice cultivation such as seed selection and utilization of chemical fertilizer and agricultural chemicals, (3) increase of manufacturing crops and commercial crops, etc.[20]

As for the industrial sector, the growth rates in 1987 and 88 were negative, -16.0 percent and -2.4 percent respectively. From 1989 to 93 positive growth was seen : 35.0 percent, 16.2 percent, 19.9 percent, 7.3 percent, 11.0 percent respectively (see Table 2-III-6). Drought also decreased industrial production in 1987 and 88 because electricity generation volume decreased, followed by stagnant overall economic activity. After 1989, economic growth began to recover because of foreign investments in the construction sector and clothing industry, but the growth rate from 1992 was 7.5 percent, 11.0 percent, lower than the 9.9 percent rate of 1991.

In the service sector, growth rates in the period from 1987 to 92 were volatile:8.0 percent, 4.1 percent, 4.5 percent, -4.2 percent, 8.0 percent, 4.3 percent, 9.2 percent, respectively for each year. The growth rate in 1993, 9.2 percent, was higher than 1992's 4.3 percent. (see Table 2-III-6).

(2) Inflation Control

The inflation rate was 75.9 percent in 1989, 19.6 percent in 1990, 10.4 percent in 1991 and 6.0 percent in 1992 (IMF statistics), and 6 percent in 1993.[21] Inflation was controlled because of currency control : the central bank stopped financing for profit-losing state enterprises, set interest rates higher than inflation rates and stopped printing money to finance the budget deficit.[22]

(3) Budget of the Central Government

Current expenditures were 14.8billion kips in 1986, and 67,839 million kips in 1990. The average annual growth rate was 46 percent during this term. Capital expenditures were 11.7 billion kips in 1986, and 66,080 million kips in 1990. The average growth rate was 54 percent during this term. By individual expenditure items, wages showed remarkable growth among current expenditures, increasing from 4,760 million kips in 1986 to 35,439 million kips in 1990, with 65 percent annual average growth. Among capital expenditures, transportation and telecommunication were given high priority, increasing from 4,491 million kips in 1986 to 29,126 million kips in 1990 with 60 percent annual average growth. This trend was consistent with the goal of The Third Five Year Plan (see Table 2-III-7).

On the other hand, tax revenue increased from 1,755 million kips in 1986 to 37,644 million kips in 1990, showing 115 percent average annual growth. Non-tax revenue was 16,748 million kips in 1986, 23,316 million kips in 1990, showing 62 percent annual average growth. Among tax revenue, profit tax revenue jumped from 195 million kips in 1986 to 7,956 million kips in 1990 because of the introduction of the profit tax. Tax on international trade revenue also increased sharply from 197 million kips in 1986 to 18,035 million kips in 1990 because of trade liberalization. Transfer from state and public enterprises, one of non-tax revenue, totalled 13,890 million kips in 1986, but it was abolished and hence brought in no revenue in 1990. Introduction of profit tax could not take over the role of the abolished transfer from public enterprises. "Miscellaneous" non-tax revenue increased from 1,808 million kips in 1986 to 12,427 million kips in 1990.

Non-tax revenue is divided into two revenues by the character, "revenue from sate property" and "revenue from privatization." The former includes interest payments, and the rent of land, building and construction to the government by the state enterprises. The latter consists mainly of sales of state enterprises and dividends, stemming from the fact that the government participates in joint enterprises with foreign private sector. Due to the start of the IMF / World Bank Structural Adjustment Loan (SAL), expansion of the proportion of "miscellaneous" revenue is expected.

Although the budget deficit has been decreasing (20.1 percent, 16.8 percent, 13.8 percent, 10.8 percent, 9.5 percent through 1988-92), and the ratio of deficit to revenue was still at a high 43 percent in 1992, the deficit was still sharp. Though non-tax revenue accounted for around 90 percent of total revenue by 1987, tax revenue accounted for around 70 percent after the tax reform. But the proportion of total revenue in the ratio of total revenue to GDP has grown very slightly, at 8.4 percent, 10.2 percent, 10.5 percent, 10.9 percent in the period from 1989 to 92 (see Table 2-III-2). Total revenue, composed of tax and non-tax revenue, is not enough to finance even the current expenditure without foreign assistance. Capital expenditure is still heavily dependent on foreign assistance. This is exactly same situation as before the reform.

(4) External Trade

Trade deficits has been huge : export growth rates from 1989 to 93 were 9.5 percent, 24.3 percent, 22.7 percent, 37.3 percent, 10.6 percent each year. Imports, after a negative growth of -4.3 percent in 1990, increased to 13.1 percent in 1991, and 16.5 percent, 20.5 percent in 1992 (see Appendix 5, Appendix 6). In 1992 export totalled 132.6 million dollars, imports equalled 265.6 million dollars, creating a deficit of 133.0 million dollars. The deficit stayed about the same level as the previous year, 131.4 million dollars. Export values decreased due to the reduction in volume of sales of electric power caused by increasing domestic demand and of the lower export prices from Thailand. The main export item were : logs and wood products (42.7 million dollars in 1992), electric power (17.0 million dollars), industrial production, such as metals and textiles, (29.5 million dollars), and coffee (2.4 million dollars). Exports to Thailand amounted to 26 million dollars, most of which was of logs and electric power.

(5) Employment

In 1990, the employment structure broke down as follows : agriculture employed 1.545 million persons (79 percent), industry had 37.3 thousand persons (1.9 percent), construction had 15.6 thousand persons (0.8 percent), in transportation 15.6 thousand persons (0.8 percent), in trade 48.9 thousand persons (2.5 percent), and civil servants-public employees totalled 293.4 thousand persons (15 percent). The figures show that privatization has not yet progressed.

3-1-2 Supplyside Reform

(1) Price Liberalization

By government ordinance number 12, "Promotion of goods and currency circulation," goods circulation within the country was liberalized. And by government ordinance number 14, "Price policy", price control on goods and service was abolished, with the exception of logs and public utility.

(2) Reform of State Enterprises (Privatization)

Privatization of state enterprises has been underway. By June 1992, 105 out of the listed 604 State Owned Enterprises (SOEs) have already been privatized in different degrees and forms, such as leases, sales, contracting to workers, jointventures etc.. However, only 13 SOEs were actually sold out, most of which were by foreign enterprises. The reason is that the domestic private sectors have neither capital nor technology, because the private sector had been excluded from individual activities since the revolution. In the privatization procedure there are two criticisms. One is that deficit enterprises are "selected" but not well performing enterprises ; the other is corruption caused by insufficient evaluation of the asset liabilities situation and by unfair bids. A common but simplified assumption is that privatization solved out all the difficulties. However as GDP figures show the privatized enterprises have not yet produced good results, and have contributed little to the growth manufacturing and service sectors.[23]

The government's state enterprise privatization program also contributed to the strong rate of foreign investment. In 1993 two major state firms, Lao Brewery and the Soft Drink Company both drew in fresh equity from Thailand's Loxley group to the tune of more than 12 million dollars. Two state garment factories and a tannery were also partly sold to foreign investors for renovation and revival. One case which created problems during 1993 was that of state carrier Lao Aviation. The government moved to push out Del-Chang Co., the firm which had been given a contract to resuscitate and operate international services, but that left it with a Peking-controlled Hong Kong firm, China Travel Aviation Services Ltd, in the pilot's seat. The airline, operating both international and domestic services, was believed to be losing money heavily and suffering extensive internal pilferage of funds and materials.

But trying to attract new cash and management into the carrier raised another, increasingly prominent challenge to the government. Lao Aviation's foreign investors, as well as investors in the tourism area, were pressing the government to liberalize its process for granting visas to visitors. All were complaining of losing money because they could not get enough customers. Visitor arrivals had doubled in 1992 to 80,000 and appeared to be growing slightly from that level for 1993.[24]

(3) Monetary System Reform

Although the nominal interest rate (1 year term deposit) in January 1990 was as high as 36 percent, real interest rates were negative. But now real interest rates turned thanks to inflation control. This success was the result of monetary policy. Further more, domestic capital should be increased through boosting the domestic saving ratio.[25]

The three branches of the former central bank became independent as commercial banks in which the government invested 100 percent. The three banks were Bank Sethathirath, Bank Nakhoneloung and Banque pour le Commerce Exterieur Lao (BCEL) ; all deal in foreign exchange and specialize in the foreign trade sector. Joint Development Bank (JDB) is a commercial banks established under joint management between Thailand's private sector and the Bank of Laos. As for local banks, Phak Tai Bank exercises jurisdiction over the southern region, Lao Than Bank that exercise jurisdiction over the mid-south resign, and Alun May Bank controls the mid-east region.[26]

(4) Foreign Investment

Because of promotion of foreign investments, together with various investment promoting policies, foreign direct investments have increased steadily. The number of foreign investments that Laos permitted was 280 in the period from 1988 to 1992, the total amount of which was 491 million dollars. Thailand was at the top with 93 investments valued at 138 million dollars in value. USA was second, with 13 investments totalling 72 million dollars in value. This shows the large influence Thailand has on Laos.[27]

Broken down by sectors, manufacturing led with 58, trade had 49, and textiles had 47. On a value basis, tourism took too honors with 107 million dollars, followed by manufacturing (64 million dollars) and trade (60 million dollars). Recently foreign investment in the garment sector is increasing rapidly, mainly from Taiwan, Hong Kong and Thailand, who have set up 29 garment factories, up from only three in 1990. But the amount of investment did not meet the expectations of Laos.[28] The investments have been stopped or have been discontinued owing to poorly enforced laws and a not-fully established infrastructure.[29]

Garment exports reached 6,800 dollars in the first quarter of 1992, according to the Commerce Ministry estimations. At least ten more garment factories are planned.[30]

3-2 Lessons and Unfinished Agenda

3-2-1 Problems Attached to the Reform Programs

--- Slow Progress in Conquest of the Twin Deficits ---

(1) Fiscal Side

Government total revenue was 7.9 billion kips in 1991, a 30 percent increase over the previous year, thanks to new taxes, more efficient tax collection and an increase in public utility fares. However this amount covered less than half the state's expenditures of nearly 18.3 billion kips.[31] A balanced budget is still far away. As a part of economic reform, a cut in the number of the government officials was carried out, but retirement payment and annuities pushed up wages and pay expenditures. If more drastic cuts of government officials go forward, it is estimated that unemployment will increase sharply because of the relative inability of the private sector to absorb these people. Social policy, like unemployment insurance, needs to be established. The deficit of current expenditures is expected to increase as well. The increasing deficit of current balance in the short-term is unavoidable, therefore the government must come up with a long-term fiscal plan endeavoring to balance the budget deficit. To tackle the structural impediments creating the budget deficit, drastic restructuring of the state enterprises is needed. Money-losing state enterprises are becoming not only a burden to government finance, but they also obstruct privatization. If management of the state enterprises becomes efficient, privatization can be promoted. If privatization is advanced and economic activity of the private sector is enhanced, tax revenue will rise. But during periods in which revenues can not finance capital expenditures, Laos will have to depend on foreign assistance. In a while, the financial base should be established enough to absorb foreign assistance efficiently. In addition, it is important to give high priority to capital expenditure.

(2) Monetary Side

Although monetary systems have been formulated gradually, monetary function does not work well for economic activity. The reasons are as follows. In rural areas, the money economy is not prevailing. There no custom of bank deposits, even in urban areas. Also, the savings of the private sector are not utilized toward investment because of defects in the banking system. The essentials are monetary function promotion and establishment of a monetary system, which help the lack of capital.

(3) Legal Aspects

In order to promote economic activity in the private sector, and to invest in Laos with confidence, the legal establishment of laws such as “Commercial Law,” “Civil Law,” and “Bankruptcy Law” are needed.

(4) External Trade and Foreign Investment

The trade deficit has not changed ; there is no hope for its decline because imports demanded by both the private and public sectors, continue to expand without an equivalent expansion in exports. On the other hand, trade balance deficit has no hope of recovery now because there are no export goods that are expected to grow remarkably. Most of the foreign capital provided by the Western countries and international organizations are spent on government capital expenditures and for financing the budget deficit. Because of the inefficiency of public investment, lower investment efficiency will create a larger excessive investment over savings, which brings about a larger balance of payment deficit. Eventually Laos external debt burden will increase. Considering the sharp increase of debt, more efficient allocation of foreign assistance is required.[32]

(5) Development of Manufacturing Sector

As mentioned above, manufacturing in Laos accounts for very little of the whole economy ; it remains underdeveloped. Therefore, a wide array of goods -- from daily necessities to fuel and machinery -- are dependent on imports. In order to develop the manufacturing sector, it is important that the privatization of state enterprises should have good results : the environment for industrialization must be improved. On the financial side, proper utilization of foreign assistance and appropriate management of fiscal policy are needed, in order to finance the burden of investment projects and maintenance costs of the projects. In addition, it is important for banks to raise the inspection ability and finance to only highly profitable projects.[33]

Laos is in a disadvantageous situation, because of the small market within country (sparse population - 4.4 million), lack of good quality labor because of a less-developed educational system, a landlocked condition which makes import-export difficult and existence of strong neighbors. Laos has few advantages for foreign investment.

(6) Privatization

It is desired that criteria and procedure are transparent regarding the sale of state enterprises. The activity of the Privatization Committee should also increase the transparency as well as openness of its information, which will boost confidence in investment. It is important that competition should be promoted on the supply not only by privatization of state enterprises but also by new entries.

(7) Capacity for Efficient Utilization of Foreign Assistance

With an improved relationship with the USA, loans from the IMF or the ADB have been carried out smoothly. In June 1992, IMF admitted the third Structural Adjustment Loan in 1992 (around 8 million dollars) to support the economic reforms toward the control of inflation. The ADB announced that an industrial development capital loan equivalent to 3 million dollars will be provided in the period from 1993 to 96.[34]

A crucial issue today is capacity of efficient utilization of foreign assistance. This capacity consists of the financial situation and administrative ability. Laos is lacking in both. Ministry of Foreign Affairs, Ministry of Finance and Ministry of Planning and Cooperation share responsibility for foreign assistance. The division of labor is as follows : The Ministry of Foreign Affairs is in charge of requests of assistance as a whole. The Ministry of Finance is dealing with accepting bi-national assistance, and The Ministry of Planning and Cooperation is in charge of accepting multi-national assistance.[35] But the lack of human power in the government is becoming a serious problem in each Ministry, which restricts efficient utilization of foreign capital. The government needs to formulate a human resources development plan, and implement it quickly.[36]

(8) Improvement of Administrative Structure

The central government organization of Laos is too enormous in size, too excessive in the number of officials, and functions are excessively duplicated. Also division of labor is not clear. Laos government wants to reduce the number of the government officials from 200,000 to 70,000 but it is difficult for the dismissed 130,000 persons to find jobs. Dismissal of government officials also means a big loss of the supporters of the LPRP, because most of the government officials are LPRP's supporters.[37]

(9) External Policy

Economic cooperation among ASEAN, Laos and Vietnam will contribute to the economic development within this region. A larger ASEAN that includes the Indochina countries expands its regional market. Countries within this region will make profits from production capacity increases and expansion of trade because of the differences in development stages. Most of the ASEAN countries export consumer goods that Indochina countries need. Conversely, The Indochina countries can provide raw materials. In addition, The ASEAN countries will be able to carry out foreign direct investment and technology transfers that are necessary for Laos.[38]

3-2-2 Basic Problems to be worked out

--- Insufficient Basic Conditions for Social and Economic Development, and Relationship with Neighbors ---

(1) Infrastructure

(a) Set up of transportation network

Laos has little resources within the country along with undeveloped industries ; therefore the construction of a transportation network is an essential target. The Lack of a transportation network obstructs free and smooth circulation of goods, a basis for commodity market economy, which has detrimental effects upon the agriculture sector, manufacturing sector and money circulation. The establishment of a transportation network should receive the highest priority.

(b) Education system, human resources development

There is a shortage of teachers conventional educational institutions largely because of their low payment. Thus many teachers have side businesses. This brings about a low quality of education in Laos. In order to raise it, an educational basis needs to be developed urgently.

(c) Social aspects (medical care, housing, waterworks and drains)

The social indications of Laos show that subsistence rate of new born baby, number of nurses and doctors per capita and the average lifespan are extremely low. (Life expectancy is around 50, and the infant morality rate (per 1,000 live births) was 105 in 1988.) Medical institutions need to be improved quickly. Waterworks facilities are, with the exception of urban areas, in poor condition and the supply shortage is serious. Drains also remain under developed, except in some urban areas. These conditions create a high death rate of children and bad conditions of public sanitation.[39]

(2) Relation with Thailand

Economic relations with neighboring Thailand are now very important for Laos in order to strengthen its economy. There is some economic conflict with Thailand : price negotiation of export logs and electric power are important foreign currency sources for Laos ; passenger tax when Laos cargoes pass through Thailand ; and an import tariff on Laos manufactured goods. Strengthening economic ties with Thailand is one effective development strategy for Laos. The market economy must be advanced by introducing foreign capital, as well as developing human resources and technology in both the public and private sectors of Laos. Private investment from Thailand is quite substantial, and brings technology transfer and job creation. It is also expected that Thailand's experiences of economic development will be a good reference case for Laos, in particular in the area of fiscal policy, and receiving assistance and investment.

3-3 Direction and Strategy of Future Development of Laos

The lessons and unfinished agenda of Laos are as mentioned above. The future direction of Laos from a long-term prospect determines strategy in the transitional period. Two points will be considered. One is how to utilize the resources (electric power, agriculture, forest) and the other is how to overcome the geographic conditions.

3-3-1 Electric Power

Laos is rich in water resources. Only the Nam Ngum Dam covers most domestic demand. Electric power export is 30 percent of the total export of Laos. But assuming a 10 percent increase per year in future domestic demand, an essential source of export revenue--the sale of electric power to Thailand--will decrease. Electric power demand in Thailand will continue to increase in the future, and the demands of Vietnam and Cambodia are also expected to expand. On the other hand, Laos intends to export electric power to China or Myanmar for the future development of Laos. The construction of the Second Nam Ngum Dam is becoming a substantial project. The Second Nam Ngum Dam (Nam Theun 2) was supposed to have been a development project of a large scale hydroelectric power station with 600 megawatt output (four times the Nam Ngum Dam). Because of problems with the large construction costs (estimated around 500 million dollars) and poor negotiation with the customer (Thailand), this project has been suspended after a pre-feasibility study in 1987. Now, it is observed that an Australian consultant has committed to revising the F/S, including a reexamination of the possibility of fund raising. When Prime Minister Chuan (Thailand) visited Laos in 1993, both countries exchanged a memorandum in which both countries will advance mutual cooperation to expand the electric power capacity up to 1500 megawatts by the year 2000. The present capability is only 165 megawatts. Achievement of the goal with Thailand has tremendous difficulties, including both quality and quantity of the staff : severe restrictions regarding electric power development ; and the exceedingly long periods of negotiation among the resulted ministries over policy. Also, cooperation in the private sector over development of electric power is not expected. The most important thing for energy development in all of Indochina is to establish basic conditions which should compare the cost-benefit of the construction, technology transfer, management of energy supply system and environmental protection. After Laos builds up enough electric power capacity, Laos can take a strong position in price negotiation through an expanded customer base. Laos may be able to gain leverage over its neighbors through the use of electric power as a weapon.

3-3-2 Forest and Agriculture Sector

(1) Present Conditions of Rice Production

The area seasonal rice paddies that depend almost wholly on rain water accounts for 16 percent of the total rice field in the northern part, and 50 percent in the southern part. On the other hand, the irrigated dry season farming paddy fields concentrate around Vientiane. The area of slash-and-burn upland rice accounts for 74 percent, a high rate in the northern part. Production share among the yields of raining season paddy, dry season paddy and upland rice, are 68 percent, 1 percent and 31 percent respectively, up to 1984. After that the rate of upland rice decreases. However the area under cultivation of upland rice accounts for 40 percent of total rice fields.

(2) Agriculture Items

Glutinous rice accounts for more than 80 percent of all rice in Laos. The only noteworthy agricultural product besides rice and timber is coffee. Diversification of products is advanced in the northern mountainous districts that are short of rice, but in the middle-southern district tobacco is virtually the only crop. In the mountainous areas agriculture development including settlement is very underdeveloped.

(3) Irrigation

Around 50 percent of irrigated fields are concentrated in the Vientiane area. Irrigation in other areas is underdeveloped because of an insufficient electricity supply necessary for irrigation and the lack of a road network essential for transportation of materials. Meanwhile, there is a situation that the farmers, because of a narrow market for selling their products, can not earn the cash necessary for them to pay the electric power fees.[40]

(4) Livestock Industry

There are plains that are good for cow pasturage and 1,700,000 cows are bred in the whole country. Laos has experience in exporting beef. In the near future Laos investigate exporting to Honk Kong. Therefore, modernization of the livestock industry is necessary.

(5) Subject of Agriculture

The instability of agricultural production is a problem Laos needs to overcome. The government of Laos established the following goals of agricultural development with the basic principle of expanding the domestic market for agricultural production:

(a) Development of infrastructure including irrigation equipment in order to streamline production, and establishment of organizations and systems.

(b) Establishment of economic policies for the domestic distribution system and export promotion in order to support the expansion of agricultural production.

(c) Creation of a sufficient financial surplus to stimulate and expand the economic activity of other sectors.

To realize these goals, the following basic strategies were formed.

(a) Production expansion of basic food crops and surplus export.

(b) Promotion and support of efficient farms.

(c) Promotion of agricultural production activity that considers environment protection.

(d) Introduction and spread of new technologies in order to stabilize the annual yield.

It is important that a system for self-sufficiency system is established first. A surplus of rice relieves the pressure on slash-and-burn cultivation, and promotes diversity in culture crops. Now, plant breeding, improvement of cultivation methods, effective usage of manure and agricultural chemicals, mechanization and intensive agriculture are all remarkably underdeveloped. It is desired that profit-oriented farmers will appear.[41] The lack of personal ownership rights is an important problem for agricultural development. Although people do not have legal ownership, "the sale of land" is actually permitted. Clause 17 of the Constitution does not approve the ownership of land, but "the right of usage," "the right of succession" and "the right of transfer" are permitted; "the sale of land" means sale of "the right of usage".[42] In order to commercialize agriculture, the lack of clear ownership is a significant problem.

3-3-3 Two Alternatives of Long Term Development

From a geographical point of view, two strategies might be open to Laos.

(1) Strategy 1 : Towards "Regional Cooperation" with Neighboring Countries

This strategy is not keen to the establishment of a national economy that will be closely networked with other countries. Before setting up one national economy, relations with neighbors should be promoted. At present, there are three local economic areas : Luang Prabang, Vientiane and Savannakhet. Luang Prabang has a close connection mainly with China, Vientiane forms a close connection with Thailand, and Savannakhet has a close connection with Thailand and Vietnam. These three areas have developed economic activities under individual economic relationships with these neighbor countries. The economy of Laos can not develop without friendly relations with neighboring countries. Also Vietnam has interests in promoting relations between Da Nang and Laos. This strategy for developing ties with neighboring countries is very important.

(2) Strategy 2 : Towards "Formulating One Nation Economy"

The other strategy promotes the formation of a domestic economy. But there are difficulties in financing because the establishment of infrastructure throughout the whole country is extremely expensive. Actually Laos may not be able to decide on either strategy. However it is important that Lao PDR emphasizes the strengthening of relations with the neighbor countries first. Also, they should promote infrastructure within the country.

"Mitraphap Bridge" was opened in April 1994. This is a friendship bridge over Laos and Thailand. It is also one test of whether the "new age of cooperation and development" will come in Indochina after the achievement of Cambodian peace. But Laos is cautious regarding regional cooperation, because it may not gain benefits from this, while only Thailand gains big profits. Laos may be swallowed up by such capitalistic countries as Thailand. Laos needs more leverage in its relationship with neighboring countries. Also, Laos should make efforts to develop partners other than Thailand, and create a multi-dimension economic strategy.

4 Conclusion

(1) The economic reforms of Laos are a survival mechanism as a minor power country in Indochina. The problem is how to develop under the difficult conditions that geographical and structural bottlenecks have caused. Laos can not develop without utilizing the power of its neighboring countries. An open-door policy is indispensable for Laos : the transition to a market economy is the only way to promote this strategy.

The speed of the reforms is fairly reasonable. Inflation was curbed and production increased. Electric power and loges have supported the economy even in the transition period. But from now on Laos has to create a long-term prospect for its manufacturing and agriculture sectors.

(2) Macro stabilization has been achieved, with the exception twin deficits. The budget is a most significant problem. The reform of state enterprises is needed by all means to reduce the budget deficits. The important thing is not only privatization of state enterprises but also achievement of international competitiveness.

(3) In addition, it is also important that Laos has a long-term development strategy. Besides a general open-door, a more specific trade strategy by items is needed. And it is necessary to protect these strategic domestic industries by setting up high import tariffs.

(4) "The separation of politics and economy" in Laos

Today the trend to stick to socialist thinking is losing ground in Laos. In addition, the crucial problem is not socialist thinking itself, but the national economy. The LPRP and the government as one body are struggling for international cooperation and economic development. It is generally supposed that Laos is learning from Vietnam about the transition to a market economy.

After the death of Mr. Kaysone and Mr.Poun, it is said that no "theorists" remain in

Laos. Today there is a solid consensus that close economic relations with neighboring countries alone can make economic development possible in Laos. The government is going ahead in its training of administration staff in order to accept smoothly the direct investment from neighbor countries and former Western countries, as well as its organization of the bureaucratic system. To sum up, "how not to fall behind" is as important an issue as "the separation of politics and economy." It is true that among Lao people there is anxiety about corruption and a rapid increase of crime flow into Laos from mainly Thailand after opening of the Mekong bridge. Based on this criticism there is some argument that the government staff seriously delays the procedure regarding permission of foreign investment. But the strongest reasons are the shortage of human resources and a poorly functioning decision-making channel. Laos is a low developed country rather than a socialist country. However because Laos is also a socialist country institutionally, sooner or later it will face the problems of "the separation politics and economy" and "democracy" even if it may not be as serious as China or Vietnam. But if the transition to a market economy does not induce the collapse of the present political power soon, the transition may be able to stabilize the present political order through economic development and increase of public welfare. Actually in Laos today political thoughts have not yet been diversified. Under the poor media situation, it is not expected that they will have hot arguments about political issues like democracy or the multi-party system. Even if these issues are not aired, considering that the political leaders of Laos are very old, natural generation changes will contribute to the smooth achievements of liberalization. That may turn into an opportunity for new political liberalization and openness. (*Hosaka*)

FOOTNOTES

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3/ SUZUKI, [1993, p.36]
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Table 2-III-1 Economic Reform Chronology of Laos

	Price	Finance	Monetary	Enterprise	Agriculture	Exchange	Trade/Investment
1979	*Rise of supply price for farmers *Abolition of subsidy at retail *Permission of farmers direct sale in market, etc.				*** Agricultural collectivization was not yet realized.		
1980							
1981				*Improvement, adjustment and strengthening of enterprise management			
1982							
1983							
1984				*Reconstruction of enterprise			
1985							
1986							
1987						*Fixed rate of exchange system	
1988	*Liberalization of goods circulation within country *Abolition of price control	*Pay in cash	*Monetary reform *Rise of discount rate *Establishment of Sethathirath Bank and Nakhoneloung Bank				*Reduction of duty and revision of customs formalities *Foreign investment law

Table 2-III-1 Economic Reform Chronology of Laos

	Price	Finance	Monetary	Enterprise	Agriculture	Exchange	Trade/Investment
1989		*National tax system (abolition of transfer)	*Establishment of Joint Development Bank and BCEL			*Foreign exchange and precious metal control	*Establishment of foreign investment management office *Detailed rules of foreign investment law
1990		*Cut the number of government staff	*Central bank law *Establishment of clearing house	*Labor law *Insurance law *Audit law of state public enterprise *Privatization of superior enterprise except strategic sector	*Ownership law	Revise foreign exchange and precious metal control	*Reduction of the number of restriction items on the list of strategical goods *Liberalization of dealings
1991		*Revised national tax system (tax uniformly etc.) *Raise the public utility rate	*Central bank starts "window guidance" *Issuance of the first central bank bond				

Table 2-III-2 Calculations of Laos Economy

	(unit)	1975	77	80	84	85	86	87	88	89	90	91	1992
1. Macro Economy	(%)												
Growth rate of Nominal GDP					7.2		4.8	-1.1	-1.8	11.5	5.9	4	7
Growth rate of Real GDP					7.2								
Rise rate of Consumer Price Index				61.9	52.7	65.7				62.9	35.1	13.4	
Current Balance / GDP					-10	-3.9	-6.9	-12.8	-14.7	-16	-8.9	-4.6	-5.6
2. Financial Policy (percent of GDP)	(%)												
Current Revenue					17	12.2	14.9	12.5	12.3	8.4	10.2	10.5	10.9
Tax revenue		62.5	36.6	13.1	33.7	13.6	9.5	9.8	75.3	77.1	61.8	68.8	70.8
Nontax revenue		37.5	63.4	86.9	66.3	86.4	90.5	90.2	24.7	22.9	38.2	31.2	29.2
Current expenditure					14.2	11.2	11.9	10	12.3	9.3	11.4	11.3	11.1
Defence													
Education						2.6	6.6	8.4	4.6	4.3	4.8		
Health						5.9	6.1	6	3	0.4	1.3		
Housing & community amenities													
Economic services						71.8	69.3	67.2	78.6	79.4	85.3		
Others						19.7	18	18.4	13.8	15.9	8.6		
Overall surplus/deficit					-11.8	-11.1	-6.5	-5.8	-20.3	-16.4	-13.5	-9.5	-8.9
3. Monetary Policy	(%)												
Money supply (M2)					0	34.8	70	308.7	37.1	89.3	7.8	15.7	49
4. Industrial Structure (percent of GDP)													
Agriculture	(%)					53.8	56.3	57.1	59.1	59.9	60.7	53.3	
Mining	(%)					0.4	0.2	0.1	0.2	0.2	0.1	0.1	
Manufacturing	(%)					11.6	14	11.8	10.2	11.6	12.8	17.2	
Service	(%)					34.1	29.4	30.9	30.5	28.3	26.4	29.3	
5. External Trade	(Million US$)												
Import (total)		42	58	92	162	193	186	216	193	197	276	292	
(growth rate)	(%)		38.1	58.6	76.1	19.1	-3.6	16.1	-10.6	2	40.1	5.8	
Export (total)		3	9	28	44	54	55	62	63	63	146	113	132
(growth rate)	(%)		200	211.1	57.1	22.7	1.9	12.7	1.6	0	131.7	-22.6	16.8
6. Balance of Payments	(Million US$)												
Trade balance		-39	-49	-64	-118	-139	-131	-154	-105	-147	-123	-131	-133
Current balance				-66.4	-82.8	-93.7	-90.5	-114.3	-83.8	-118	-77.1		
7. External Indebtedness	(Million US$)												
		64	163	295	433	478	599	728	822	946	1073	1121	
8. Population	(Million												
		3.43	3.53	3.2	3.53	3.62	3.72	3.83	3.94	4.05	4.14	4.25	4.36

*Source : Calculations from data published by ADB

Table 2-III-3 Growth Rate of Per Capita GDP

(Per cent per annum)

	1988	1989	1990	1991	1992	1993	1994	1995	Per Capita GNP (US$) 1992
Cambodia		1.0	-1.2	5.2	1.7				
China	9.4	2.5	1.5	6.4	11.5	11.6	8.6	8.1	380
Laos	-4.5	8.5	3.6	1.6	4.1				250
Mongolia	2.9	1.8	-1.6	-12.2	-9.8	-3.6			
Vietnam	2.8	5.9	2.8	3.5	5.9	5.7	6.8	7.8	220

Table 2-III-4 Growth Rate of Value Added in Agriculture

(Per cent per annum)

	Average 1971-80	Average 1981-90	1988	1989	1990	1991	1992	1993	1994	1995
Cambodia			5.9	7.1	1.2	6.7	1.9	3.2		
China	3.0	5.5	2.5	3.1	7.4	2.4	4.0	4.0	3.7	3.8
Laos			-4.2	9.9	8.7	-1.7	7.9	0.0		
Mongolia	2.0	3.0	2.4	13.8	-1.9	-5.1	-3.9	-7.0		
Vietnam		6.8	4.0	7.0	1.5	2.2	6.0	3.3	6.5	5.6

Table 2-III-5 Growth Rate of Value Added in Industry

(Per cent per annum)

	Average 1971-80	Average 1981-90	1988	1989	1990	1991	1992	1993	1994	1995
Cambodia			15.0	1.7	-2.1	8.9	15.6	10.0		
China	9.1	11.7	14.5	3.8	3.2	13.3	20.8	20.9	13.5	11.0
Laos			-2.4	35.0	16.2	19.9	7.3	11.0		
Mongolia	10.2	5.8	5.1	11.1	-4.7	-13.2	-13.1	-5.5		
Vietnam		6.8	2.3	-2.8	2.9	9.1	11.7	11.3	11.5	13.2

Source: Asian Development Outlook 1994
Note: Date for 1993 are Preliminary. Those for 1994 and 1995 are estimates

Table 2-III-6 Growth Rate of Value Added in Services

(Per cent per annum)

	Average 1971-80	Average 1981-90	1988	1989	1990	1991	1992	1993	1994	1995
Cambodia			13.6	-1.1	2.7	8.5	11.1	7.2		
China		12.4	13.6	6.8	2.1	5.5	9.3	9.4	8.5	9.0
Laos			4.1	4.5	-4.2	8.0	4.3	9.2		
Mongolia	7.8	3.2	5.3	5.7	-4.3	-11.6	-12.0	2.7		
Vietnam		7.6	8.8	16.5	10.8	8.2	8.7	10.5	9.7	11.9

Source: Asian Development Outlook 1994
Note: Date for 1993 are Preliminary. Those for 1994 and 1995 are estimates

Table 2-III-7 National Budget of Lao PDR

(unit: Million Kips)

	1987	1990(forecast)
	26,536	133,919
	14,804	67,839
[*Budget Expenditure*]	4,760	35,439
1. Current Expenditure	9,875	23,150
1.1 Wages and Salaries	45	4,850
1.2 Materials and Supplies	124	4,400
1.3 Annuity	11,732	66,080
1.4 Accrued expenses	780	3,146
2. Capital Expenditure	714	851
2.1 Education	1,993	8,696
2.2 Health	1,208	18,535
2.3 Agriculture and forestry	4,491	29,126
2.4 Industry, energy and mines	442	
2.5 Transportation and communications	654	
2.6 Commerce and cooperatives	1,450	5,726
2.7 Public works	20,156	79,301
2.8 Others	18,503	60,961
[*Budget Revenue*]	1,755	37,644
1. Tax Revenue, Nontax Revenue	195	7,956
1.1 Tax Revenue	14	234
1.1.1 Tax on industrial and Commercial profits	450	1,520
1.1.2 Tax on Wages and Salaries	10	1,160
1.1.3 Agricultural tax	870	7,145
1.1.4 Business licence	197	18,035
1.1.5 Turnover tax	146	5,364
1.1.6 Tax on international trade	51	12,671
A. Import tax	19	1,594
B. Export tax		0
1.1.7 Others	16,748	23,316
1.1.8 Commodity tax	13,890	0
1.2 Nontax Revenue	1,050	4,589
1.2.1 Transfer from state enterprises	1,808	12,427
1.2.2 Accumulated depreciation		6,300
1.2.3 Others	1,653	18,340
1.2.4 Charge of lease		
2. Assistance without compensation (except material assistance)	-6,380	-54,618
[*Overall Balance*]	6,380	54,618
[*Cover of Financial Deficit*]	211	6,217
1. Loan from within country	211	4,312
1.1 Loan from bank		1,905
1.2 Loan from except bank	6,591	48,401
2. Foreign assistance with compensation (net)	7,379	52,811
2.1 Project, Program assistance with compensation (gross)	-788	-4,410
2.2 Yearly installment repayment		

Source: Raosu no Shinkeizai Mekanizumu - Toriren Kokufuku, 1993

Chart 2-III-1 Overall surplus/deficit

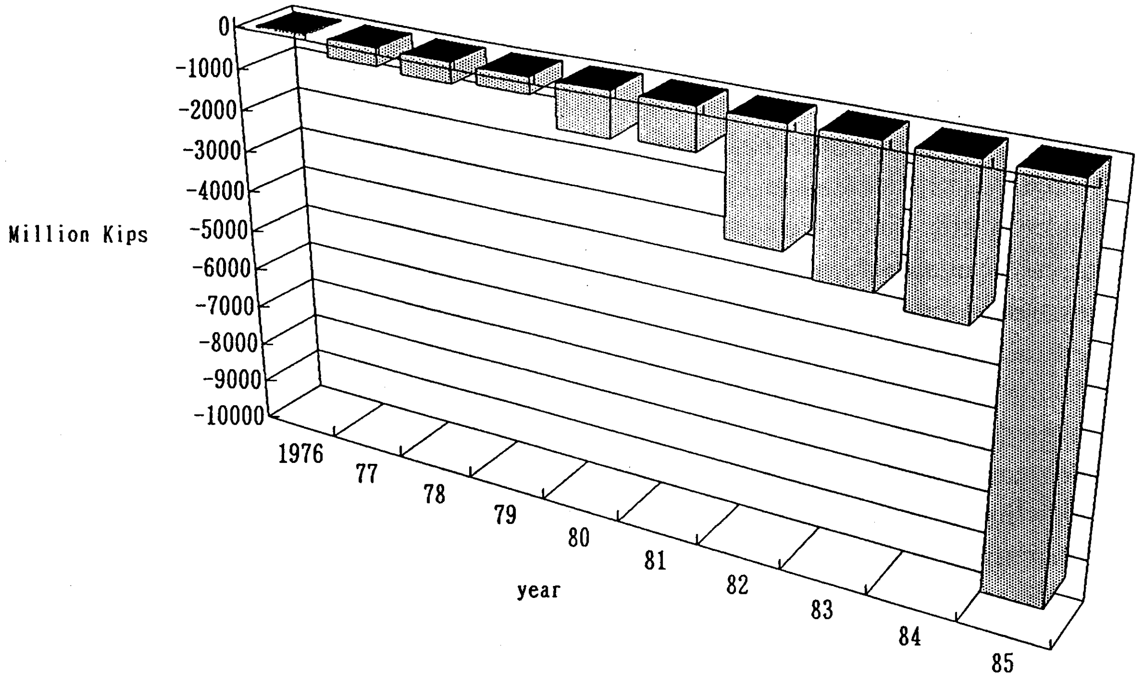
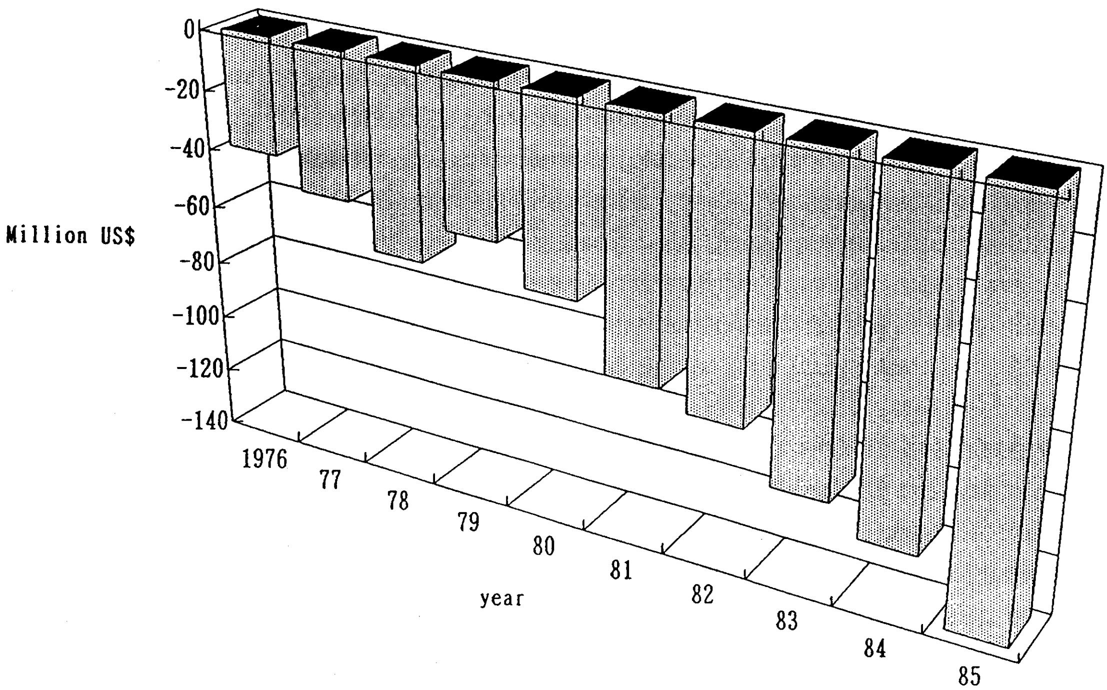


Chart 2-III-2 Trade Balance



Source : Key Indications of Developing Asian and Pacific Countries, ADB

Chapter IV Mongolia

1 Start of the Transition to a Market Economy
1-1 A Way to the Transition to a Market Economy
1-1-1 Geographical Features

Mongolia was the second oldest communist country after the former Soviet Union. It is a landlocked country located in Central Asia, bordered by the Russian Federation to the north and northwest, and China to the southeast and southwest. It has a total area of 1.6 million square kilometers, about four times the size of Japan, with a total population 2.2 million. Population density, at 1.3 persons per square kilometer, is one of the lowest in the world.

1-1-2 Foreign Relations

There was a brief period in the 1950s and early 1960s when Mongolia maintained a friendly relationship with China as well as with the former Soviet Union. However, the socialist-fraternal relationship with China, which began in 1949, became severely strained after the 1960s, when Mongolia took a pro-Soviet stance in the Sino-Soviet border and ideological disputes. Mongolia thus became even more closely allied with the former Soviet Union. After that, the relationship with China deeply deteriorated through the Great Proletarian Cultural Revolution and the former Soviet Union's criticism against the top party officials of China. But as reform and open door policies were developed in China after 1979, the relationship between Mongolia and China improved little by little. On the other hand, Mongolia has been closely related with the former Soviet Union since the Mongolian Revolution. The deterioration in China-former Soviet Union relations in the 1960s strengthened economic and political links between Mongolia and the former Soviet Union. Mongolia joined the Council for Mutual Economic Assistance (COMECON, CMEA) in 1962. Until 1991, when COMECON was dissolved, its foreign economic relations were closely integrated with, and dependent on, this group. With the advent of "perestroika" in the former Soviet Union and the development of normalizing Sino-Soviet relations, Mongolia's political, economical, diplomatic, and socio-cultural milieus have been transforming. After 1989, the country's international orientation has dramatically shifted from COMECON toward China, East Asia and the West. In January 1992, when the constitution was amended drastically.

1-1-3 Development of the Command Economy

After World War II, the shift toward a command economy intensified, and development proceeded on the basic of five-year plans, starting from 1948. In the First Plan (1948-52), policies with overriding priority were agriculture and stock raising, and measures were introduced to prepare the private herdsmen for the collectivization of livestock and private property. Private ownership of livestock was formally restricted, and all production was reserved for the state. The main production units in agriculture were integrated to agricultural cooperatives (negdels) and state farms. At the same time, emphasis was placed on light industries, meat processing industries production of consumer goods, coal mining and the energy sector. After the Fourth Plan (1966-70), assistance from China was halted ; consequently, economic development in Mongolia was implemented by the assistance of COMECON countries. Mongolia's role in the COMECON system was virtually that of supplier of mineral resources and stock farm products. Soviet technical and financial assistance facilitated Mongolia's large-scale industrial development, such as the Erdenet copper mine. Sectoral share of industry in GDP increased from 26.3 percent in 1970 to 33.0 percent in 1993 (see Appendix 2). Although a sustained industrialization was certainly developed, its industrial structure turned in an undesirable direction. Mongolia's commodity pattern of trade is similar to that of other low-income economies : exporting land-intensive primary products (wool, cashmere, meat, skins, and copper, molybdenum) and importing manufactured (petroleum, foodstuffs) products. Mongolia imported almost all products, from gasoline, machinery, spare parts, to foodstuffs and daily consumer products, from COMECON countries, especially from the former Soviet Union. On the other hand, Mongolia exported primary industry products, such as wool, cashmere, meat, hides, and copper, molybdenum.

1-2 Reasons for Transition to a Market Economy

1-2-1 Mongolia under the COMECON System

The transition of Mongolia's international trade is shown in Tables 2-IV-2 and 2-IV-3. Mongolia's trade was overwhelmingly with the COMECON countries (96.1 percent of exports, 99.0 percent of imports in 1985), particularly with the former USSR (around 80 percent of exports, 85 percent of imports throughout 1980s). Mongolia became a member of COMECON in 1962 and had trade relationships with the Eastern European countries. Former Czechoslovakia was the second largest trade partner, with a share of only 4 percent of exports and 3 percent of imports. The degree of dependency on the former Soviet Union was absurdly high : the corresponding figures are 40-80 percent of exports and 50-75 percent for the Eastern European countries. Mongolia was dependent heavily on the former Soviet Union in comparison with the Eastern European countries. This pattern of excessive dependence on the former Soviet Union explains the collapse of international trade activities beginning January 1991 when COMECON switched to new trading arrangements based on world prices and hard currency settlements. Eastern European countries were heavily dependent on the former Soviet Union as a supplier of natural resources, especially oil. On the other hand, the former Soviet Union was the largest market for machinery, equipment and light industrial products exported from EEc. That is, the former Soviet Union supported EEc's state-owned companies, which did not have competitive positions in the world market. Mongolia's commodity-pattern of trade is similar to that of other low-income economies : exporting land-intensive primary products --- minerals (mainly copper and molybdenum) animal-based raw materials (mainly wool, meat and hides) --- and importing manufactured products --- fuel, machinery, equipment, spareparts and manufactured consumer goods --- with COMECON countries, especially former Soviet Union. Mongolia's economic system had relied entirely on the former Soviet Union. This is why Mongolia is the 16th republic in the former Soviet Union. This foreign trade structure, however, came under great strain in 1990 and finally collapsed in 1991.

1-2-2 Collapse of the COMECON System

The Mongolian economy is characterized by international trade and national finance occupying the majority of its national income. The striking feature of the Mongolian economic structure is that international trade and national finance have an extraordinarily large share in the national economy. In 1988, the budget deficit as a share of GDP amounted to 19.5 percent (see Appendix 13). The budget deficits were entirely financed by Soviet aid. However, with the cessation of Soviet aid in 1991, Mongolia has had a huge debt problem to the former Soviet Union. The degree of dependency on foreign trade ((exports+imports)/ national income) amounted to 65 percent in 1989. This means that the Mongolian economy had a frail structure, and was heavily dependent on the former Soviet Union. Under the influence of the democratization of the Eastern European countries, a multi-party, democratic, general election was implemented in July 1990, and in September a democratic new government was created. Economic and political reforms were carried out extensively. A transition to the market economy from the centrally planned economy was declared. The peculiar economic structure of the Mongolian economy was strongly influenced by three events : 1) the general confusion resulting from the transition of an economic system ; 2) the collapse of COMECON system ; and 3) the disintegration of the former Soviet Union, the Mongolian economy rapidly fell into a serious depression. From the beginning of 1991, Soviet aid basically stopped, and the previous COMECON trading arrangement was replaced with world-market pricing and hard-currency settlements. These two external shocks plunged the economy into turmoil. Imports from former Soviet Union dramatically decreased; the shortage of oil, materials, machinery, equipment and spare parts was the greatest factor in the damage to the transportation system and production activity. For example, combine harvesters for wheat did not work, and could not transport them to the factories. Production and transportation of coal were also damaged. This was connected directly with the power shortage, and led to the drop in copper production. Finally, exports were reduced.

2 Economic Reform

With the advent of Perestroika in the former Soviet Union in the mid-1980's the government of Mongolia embarked on a series of economic reforms designed to limit the role of state planning and give greater autonomy to the state-owned enterprises. The reform process gained momentum towards the end of the decade with the aim of improving the efficiency of the command economy. Although Mongolia experienced growth in the 1980's the economy suffered from the inefficiencies and distortions associated with a centrally-planned economic system. Since the 1930's virtually the whole economy, from agriculture to heavy industry, fell under the control of state and central planners, and the private sector was limited to the ownership of a small number of livestock. The economy was closely integrated with, and dependent on, the economies of the former Soviet Union and COMECON members. Large former Soviet Union investment and loans also fuelled the development of Mongolia' s industrial sector. As s result of popular demonstrations in March 1990 Mongolia's first multiparty elections were held in July of that year. The new coalitiongovernment pledged to create a market economy and embarked on a comprehensive series of economic reforms.

At the same time as the nascent reforms were being imposed the external environment began to deteriorate rapidly. First, due to its own domestic economic difficulties financial and technical support from the former Soviet Union was terminated in 1991. Second, the COMECON system, on which Mongolia was so dependent, collapsed in the same year resulting in a severe disruption of external trade.

2-1 Financial Reform

As explained earlier, in the past the budget deficit was entirely financed by COMECON aid, mostly from the former Soviet Union. But the financial situation deteriorated rapidly after the second half of the 1980s. Import prices went up, but domestic prices remained unchanged ; reducing budgetary expenditures was not sufficient. In 1988, the budget deficit as a share of GDP increased to 20.5 percent. Behind these problems, the tax structure and subsidy system have their own problems.

2-1-1 Revenue

The two major sources of revenue were profit taxes from state-owned enterprises arising from the fixed price structure and import price differentials, deriving from the wide disparity between import and domestic prices for consumer goods, many of which are imported. In the second half of 1980s the former Soviet Union raised export prices, causing import prices to jump in Mongolia. This meant that import price differentials decreased, while profits from state-owned enterprises stagnated. Individual tax rates were low, its share of total revenue was small, and the tax collection system was insufficient.

2-1-2 Expenditure

State budget expenditure consists of the current expenditures, which include wages, subsidies, social security, defense, capital investment, etc. Various kinds of subsidies, covering the deficit of state-owned enterprises and the increase of capital investment caused by the 8th five-year plan starting from 1986 led to the large fiscal deficit. It became apparent that the tax system needed to be completely restructured. A price-rigged, profit-transfer system has no place in a market economy. The traditionally dominant “turnover tax” would need to be restructured as a value-added tax. The “import-price differentials” which were previously collected through state -owned enterprises would become irrelevant. A completely new system was targeted for introduction in 1992. These included administrative strengthening over both revenue collection and expenditures, a review of the structure of government to identify areas for further possible cuts, and the holding of wage and salary increases below the rate of inflation. Additional measures under consideration to strengthen both sides of the budget include the introduction of user fees and increased charges for public services ; and, for education and health services, cost recovery through a proposed national health program financed by contributions from employers and employees.

2-2 Monetary Reform

Until 1991, Mongolia had a monobank system : all central and commercial banking activities were carried out by the State Bank of Mongolia. In May 1991, under a new Banking Law, the State Bank was divided into a central bank, called the Bank of Mongolia (or

Mongolbank), and two state commercial banks. The Bank of Mongolia's chairman is responsible to the legislature, thus making the central bank independent of the government. The commercial banking activities of the former State Bank have been transferred to seven new commercial banks, which have taken over most of the former State Bank's branches. The interest rate on central bank loans to commercial banks has been increased to 35-60 percent in August 1992. Mongolbank imposes tight restrictions on lending to commercial banks. All commercial banks enjoy the right to set interest rates according to their own policies and commission for money deposits and credits. Although the separation of the central bank from the commercial banks has been the centerpiece of reform in the financial sector, the speed of reform has made it difficult for the new commercial banks to become competitive and adapt to the environment of the market economy. Initial steps have been taken to improve supervision of the commercial banks but they still are ineffective. Weak loan portfolios inherited from the former State Bank have resulted in the unhealthy financial conditions of some of the banks. Delays in raising interest rates to attract new deposits, together with a deterioration of public confidence with the new banks, have led to some liquidity problems.

2-3 Price Liberalization

Under the planned economic system practically all prices were controlled by the government. For instance, with the 1978-price as the base (=100), wholesale prices have risen to 138.0 in 1985 and 165.4 in 1989. In the meantime, retail prices changed little : 103.1 in 1985 and 102.1 in 1989 (see Table 2 -IV -4). In Mongolia retail prices of main consumer goods were unchanged from 1960s. Wholesale prices were set according to the cost of production or importation and transportation. Over the last three years important strides were made in price liberalization. These measures were implemented in several steps. As a first step, the government liberalized 60 percent of state-controlled prices. The second step was made in October 1991. The number of commodities subject to price control was reduced to 17 at the retail level, including basic necessities sold under the ration system, key goods for rural areas, and items for children. Energy prices, rents and tariffs for public utilities and services remained under control. Third and fourth steps were made in October and December 1992, and the last, decisive step was made in June 1993. The introduction of a floating exchange rate system at the end of May 1993 represented a major step toward the creation of prices consistent with market forces. In June 1993, prices of electricity and tariffs for public utilities, including urban public transportation in Ulaanbaatar, housing and services, which had remained under administrative control, were freed. At the same time, ration systems of meat and flour were abolished. State control of the wage level was also abolished, with the exception of the minimum wage. At present, the average wage per month is 5000 Tugriks, compared with 539 Tugriks in 1989.

2-4 Enterprise Reform and Privatization

Mongolia's privatization program was initiated in May 1991. According to the government program, 60 percent of the country's fixed assets, amounting to 24 billion Tugriks, will be privatized. This figure represents 18 billion Tugriks of assets under major privatization and 6 billion Tugriks under minor privatization. This program was accelerated and proceeded quite rapidly. The government privatized practically all small enterprises and more than 400 large scale industrial companies. Also, about 90 percent of the entities of the trade and service sectors (shops, hotels, etc.) were privatized. In the agricultural sector, the privatization process is continuing more rapidly. Almost all livestock (about 25 million) is under private ownership whether by herdsmen, family farmers, or privatized agricultural enterprises. The method of privatization is not by sales but by a transfer scheme with use of vouchers. The vouchers were distributed in summer 1991 to each citizen (of any age). There are two kinds of vouchers : “pink” vouchers for small-unit privatization and “blue” vouchers for large enterprises. Each citizen is given three pink and one blue vouchers valued at 1000 (each) Tugriks and 7000 Tugriks respectively. The former is sellable while the latter is not. The blue vouchers are to be used to bid for equity shares in large enterprises ; equity shares are then to become tradable at the stock exchange which was newly established in February 1992. The private sector is playing an increasingly important role in Mongolia’s economy. In 1992 the private sector produced approximately 43 percent of industry output, 99 percent of agriculture and 62 percent of overall GDP.

2-5 Liberalization of Foreign Trade

2-5-1 Foreign Trade Reform

Under the central planning system, Mongolia’s export and import trade were handled, predominantly through barter arrangements with COMECON countries, by state-owned foreign trading corporations. A new law on customs duties went into effect in March 1991. The government eliminated export taxes and introduced a uniform import tariff of 15 percent. By the end of May 1993, all quantitative export and import controls were eliminated, the scope of import licensing reduced to cover only four categories of goods (drugs and narcotics, firearms and military equipment, explosives, and chemicals), and export registration was abolished. In addition, the private sector was permitted to import goods for internal sale or export. Virtually all areas of economic activity (except for the production of military equipment) were opened to local and overseas private sector participation.

2-5-2 Foreign Exchange Reform

In the past, official exchange rates between the Tugriks and the “transferable rubles” for trade with the COMECON area existed. Trade with convertible currency countries was based on the rate between Tugriks and U.S. dollars. For each, a differentiation was made between the “commercial rate” and “noncommercial rate.” In March 1992, the commercial and noncommercial rates for the dollar have become unified (40 Tugriks to a dollar). The Tugriks was further devalued to 150 Tugriks = 1 dollar in January 1993. Both the parallel and official rates were unified under a floating rate regime in July 1993, and at present the rate is approximately 400 Tugriks = 1 dollar.

2-6 Promotion of Foreign Direct Investment

Although the government has stated that foreign investment is a priority, the 1990 Foreign Investment Law has not been effective. Difficulties include the lack of investment and tax incentives, guarantees and protection measures, and the existence of investment promotion zones. The New Foreign Investment Law went into effect in July 1993. In this law, foreign investors were given the same rights compared with Mongolian enterprises, along with incentives of tax and remittances to overseas countries. An announcement was made in February 1991 of the government's intent to establish "free customs (economic) zones" for the purpose of promoting "border trade." Although little progress was made, the approach may conceivably become the first step in establishing Mongolia as a trading center for Central Asia. The four announced sites are as follows (three are near-border towns, one is the second largest city in Mongolia):

(1) Dolnod (east area of Mongolia)
(2) Zamyn-uud (near the Chinese border)
(3) Suknbaatar (near the Russian border)
(4) Darkhan (the second largest city)

3 Lessons, Unfinished Agendas

3-1 Recent Economic Development

3-1-1 Current Trends in the Major Economic Sectors

(1) Agriculture

The agricultural sector employs approximately 30 percent of labor force, and produces 20 percent of GDP. Within agriculture, 70 percent of net product derives from livestock production, while 30 percent derives from land cultivation. The economic crisis has been strongly felt in the agricultural sector. Due to the decrease of cultivation areas caused by the privatization program, lack of seed and fertilizers, lack of fuel and farm equipment, and because of cold weather, crop production has fallen. On the other hand, the fact that the number of newly born livestock shows a 12.4 percent increase in the first half of 1993 should be interpreted with caution. First, the increase in the number of livestock can easily be accounted for by reductions of exports of meat and other animal products to the former Soviet Union ; second, climatic conditions (for example a heavy snowfall in March 1993) are well known to affect the number of livestock in very significant ways.

(2) Industry

Industry employs around 26 percent of the labor force and accounts for nearly 33 percent of GDP. Due to the foreign exchange resulted in the shortages of imported raw materials and spare parts, almost all factories are currently operating well below capacity ; in some cases, production has stopped altogether. Reduced coal production has curtailed electricity supply and heat generation. But the production of copper and molybdenum, which accounted for over 50 percent of exports in 1991, increased as compared with the previous year, and is a good magnet for acquiring foreign currency. In light industry, the production of wool, leather jackets, matches, candles and confectionery has changed for the better. The construction sector has suffered from many of the same problems as the industrial sector. The value of construction and maintenance work in 1992 was 65.8 percent lower than the previous year.

(3) Other (service sector)

This sector employs around 44 percent of the labor force and accounts for nearly 41 percent of GDP. The total value of freight transported fell by 30.5 percent compared to 1991, because of the same problems. The communication and transportation network systems requires substantial overhail and expansion to enable them to meet demand and play a proper role in the transformation to a market economy.

3-1-2 Economic Indicators

The real growth rate of GDP fell 1.3 percent in 1993 (see Appendix 1). It reflects a fall in livestock output. The declines will continue for four years, and the level of GDP is the same as that of 1983. Price liberalization and the shortage of supply have been major causes of the high rates of inflation, officially announced fourteen times since the beginning of price liberalization. The price of bread increased from 3 to 60 Tugriks.

3-1-3 Finance

The tax law adopted in 1991 was suitable at the time, but, given the background of privatization, price liberalization and the new legal environment for businesses, it has become necessary to establish a new tax system. And in order to keep government expenditure under control and limit inflation, all subsidies given to enterprises from the state budget were stopped in 1992. Also, expenditure in the administrative, cultural, educational, social and health sectors has been reduced by 5-10 percent. In 1992 the deficit stood at 9.9 percent of the GDP, and government expenditures have been sharply reduced from 64.1 percent of the GDP in 1990 to 39.4 percent in 1992 (see Appendix 11). This decline resulted mostly from cuts in subsidies and purchases of goods and services. Further reforms came into effect with the passing of new tax laws in 1993. The old “turnover” taxes on the price differentials have been eliminated. Under the new Customs Law, exports are not taxed and imports pay uniform 15 percent tax. A 10 percent sales tax on imports and domestic production has been introduced. The Tax Law introduced income taxes for individuals and for enterprises (and cooperatives), replacing then-existing profit transfers. However, income taxes have barely been collected because (1) no system of tax collection has yet been set up ; and (2) because of very bad economic conditions, enterprises have no “taxable” incomes.

3-1-4 Foreign Trade and Balance of Payment

A large decline in the value of both Mongolia’s exports (by 44.1 percent) and its imports (by 51.0 percent) compared to the previous year was seen in 1991. In 1992, imports fell by 20.2 percent, but exports increased by 2.7 percent (see Appendix 5,6). This indicated some weak growth tendency as the result of the undertaken policy measures towards trade liberalization and devaluation of tugliks against US dollars. However, the Russian Republic remains Mongolia’s largest trading partner and the prospect of exports is still negative, owing to the breakdown in the Russian economy, changes in the COMECON trade and payments system, and declining world prices of copper and cashmere, and the recession in the industrial countries. Imports from the former Soviet Union also sharply decreased, (by 63 percent in 1991) and domestic production was seriously curtailed by the shortage of imports such as fuel, energy, spare parts and raw materials. The reduction of the trade deficit in 1992 was caused by the decrease of imports, not by the increase of exports. Foreign currency reserves also reduced. Foreign external assistance from the donor countries and international institutions was played a crucial role in overcoming the critical situation in Mongolia, particularly in financing essential import needs and in further stabilizing the economy.

3-1-5 Actual Condition of Infrastructure

(1) Electricity

Electricity, generated with domestically mined coal and imported diesel fuel, is the principal source of energy in Mongolia. Industry accounted for 90 percent of total electricity consumption and residential and office use consuming the rest. In 1993, electricity production fell by 12.3 percent compared with the previous year. This has been the result of breakdowns arising from plant obsolescence, and from difficulties encountered in obtaining spare parts and fuel from Russia due to a lack of hard currency. Overhaul and upgrading of existing power plants and distribution networks are needed to reduce inefficiency and pollution and to improve conservation.

(2) Railways

The railway is a Mongolia-former Soviet Union joint venture with equal ownership. It has about 1,800 kilometer of rail line. Rail transport played a significant role in foreign trade and economic relations, but encountered the following problems. The gauge is the same as in Russia, but wider than in China. Soviet-made locomotives and wagons are comprised of rolling stock. Repairs used to be made in Soviet facilities but are now carried out in ill-equipped depots in Mongolia. Spare parts and fuels, imported from the former Soviet Union, are in short supply. Signaling and telecommunication systems are insufficient.

(3) Road Transport

Mongolia's road system is relatively undeveloped. Despite its large territory, Mongolia has only 49,000 kilometer of roads, of which only 3 percent are paved; most are in poor condition. Road transport accounts for approximately 70 percent of freight tonnage. It has been estimated that poor road conditions raise transport costs. In addition, motorized vehicles total only 40,000 units, of which many are antiquated, inefficient, or idle for lack of spare parts.

(4) Air Transport

Mongolia's extensive domestic air transport network links major population centers throughout the country. But runways and ground equipment are outdated. A system of receiving international aircraft, and the monitoring and navigation of flights via through Mongolian territory will have to be created and conform to world aviation standards. International and domestic airports will be built or renewed. Runways and ground equipment will also be rebuilt to world standards.

(5) Telecommunications

Mongolia's telecommunications system requires substantial overhaul and expansion to enable it to meet demand and play a proper role in the transformation to a market economy. Most of the communication equipment is outdated, having been imported from the former Soviet Union during the 1960s and 1970s. As a result, the quality of long distance and international telephone services is not satisfactory and the availability of telex, facsimile, data transmission and value added services are limited. The telephone density was 3.4 telephones per 100 persons in 1991. However, new telephone lines, satellite connections and receivers are being installed.

3-2 Problems Attached to the Reform Programs

The economic collapse in Mongolia is severe. There are two primary reasons for collapse : one is the abrupt deterioration in economic relations with the COMECON countries, especially the former Soviet Union. This includes : the end of Soviet financing, a deterioration in the terms of trade between the two countries, a collapse in the volume of trade and a shortage of spare parts. The another reason is the hardships encountered as an economy moves from a centrally planned system to a market system. Price liberalization and privatization are typical examples. On the other hand, a social crisis has become clear. The main point is how long Mongolia can bear economic difficulties without losing morale.

Decline of production activities combined with a population increase has resulted in high unemployees. According to the government statistics, 60 thousands are registered as unemployment as of July 1993. The number of unofficially unemployed is much higher. The unemployment rate is estimated to be around 15 percent. Many youths are desperately drinking alcohol in the daytime, depressed over a hopeless future. Job creation is essential not only for economic recovery, but also for moral protection. The devastation of education is an important problem. Mongolian education level was considerably high, and has lead to a literacy rate of over 90 percent. But now students and teachers tend to leave their schools because of high expenses and low salaries respectively.

In rural areas, problems are more serious. Owing to the privatization of livestock, one herdsman had to raise various kinds of livestock and suffered from a labor shortage. As a result, children are used as labor and cannot go to school. The private sector has developed rapidly in the past three years, with the creation of new private economic entities in addition to the privatized enterprises. As of June 1993, the number of functional private entities is estimated at around 9000. But in over 90 percent of privatized enterprises, the presidents are the former factory managers. Their management is not competitive in a market economy ; mainly because equipment and technologies are outdated and productivity is very low. But the basic reason is a lack of entrepreneurship. After privatization, management efficiency has not improved. The real target of privatization has not been achieved yet.

A market economy is alien to the Mongolian people. Mongolia had no history of private business and entrepreneurship. The country was the second oldest Communist country. The adjustment period is likely to become prolonged and painful as the society and its constituents must learn the new rules of a market system. Moreover, the following development problems should be pointed out:

(1) Mongolia is a landlocked country, with high transportation costs for foreign trade. Competitive forces in export prices are weak;

(2) Population size is very small (approximately, 2.2 million) and the level of income is quite low. The domestic market and demand are extremely small. The size of the country is an economic plus in one respect and a minus in another. Mongolia has a lot of mineral resources, considering its small population. This means that its small population size has the possibility of relatively easy economic development. A very significant handicap, on the other hand, is Mongolia's vast territory. Its infrastructure is now extremely poor, and though urgently

needed, would be extraordinarily expensive to build ; and
(3) Cashmere and leather are the most important export goods, despite its fierce neighbor competitor, China.

3-3 The Direction and Strategy of Mongolia's Future Development

Despite recent progress in economic reform, Mongolia continues to face severe economic difficulties that reflect deeprooted structural weakness, inexperience with new indirect methods of macroeconomic management, and the magnitude of external shocks since 1990. The direction and the strategy of future development of Mongolia are considered as follows:
(1) Mongolia is dependent on capital goods (machinery), investment goods (iron, chemical), consumer goods (cosmetics, medicine, processed food, drinks, cotton, paper, stationery) from other countries. However, it has a strong background in industrial development, and is a great supplier raw materials. Therefore, Mongolia has to enhance the present industrial structure. First, it has to extend the export competitive force of the copper industry, which can earn foreign currency. Second, it has to invite other industries and technologies from other countries. Third, it has to promote industrial infrastructure (transportation, telecommunication, energy, water) to stimulate private investments.
(2) Mongolia has a long history as well as rich tourist resources. At present the number of tourists from foreign countries is only about 15,000 per year. Tourism is expected to develop in the future. Regular flights with developed countries will stimulate not only tourism but also export of commodities. Foreign direct investment also drastically increases the accessibility of information.
(3) As mentioned above, Mongolia has a high-level labor force. It is important to use these labor forces because (a)it is effective to develop food and leather industries which can procure their materials in domestic market, and (b) Mongolia must develop an import substitute industry (soap, toothbrush etc.) which can produce on a small scale.
(4) Mongolia is rich in rare metals, such as molybdenum, tungsten etc. These resources have the possibility to become one of the most important industries.

4 Evaluation of the Transition to a Market Economy

It is said that the transition to a market economy is divided into two types. One is the "big bang," the other is "gradualism." Most of the Eastern European countries followed the Big Bang type. Mongolia's reform too, is apparently not gradualism. Mongolia's transition is different from the other Asian transition countries. Moreover, Mongolia's economic structure is different from the Eastern European countries' structure. Mongolia was dependent heavily on the former Soviet Union in comparison with the Eastern European countries. And the Eastern European countries were suppliers of the processed goods to the former Soviet Union, yet on the other hand, Mongolia was a recipient of the former Soviet Union. And Mongolia has been hit by severe external shocks at the same time as it is seeking to bring about a radical transformation of its economy. Stabilization was necessary with or without structural reform, because the source of the shocks was external. Mongolia did not have the time in advance of choosing when to reform, how fast to reform, and how to carefully sequence various components of reform. There is, essentially, an absence of "prerequisites" in installing an entirely new system to replace the second-oldest socialist system. The damage had already been done by the chaos caused by the external shocks. (*Tsunekawa*)

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Table 2-IV-1 The Economic Reform Chronology of MONGOLIA

	Price	Finance	Monetary	Enterprise	Agriculture	Exchange	Trade/Investment
1989				Wage system reform			
1990					Privatization of livestock		Foreign investment law
1991	Price liberalization (1) Price liberalization (2)	Financial reform Tax law Reduction of subsidies	New banking law Independence of central bank Establishment of commercial bank	Privatization of state-owned enterprises Bankruptcy law Antitrust law	Privatization of agricultural cooperatives		Customs duty law
1992	Price liberalization (3) Price liberalization (4)	Abolition of subsidies		Establishment of stock exchange		Unification of foreign exchange rate	
1993	Price liberalization (5) Abolition of ration system	New tax law				Floating exchange rate system	New foreign investment law

Table 2-IV-2

Origin of Imports and Destination of Exports

(in percent of total at current prices)

	1970	1980	1985	1988	1989	1990	1991	1992 (1-5)
Exports	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Socialist or Former Socialist countries	98.2	98.4	96.1	94.3	93.1	94.2	91.7	76.6
CMEA countries	93.5	96.5	94.4	92.0	90.3	90.0	-	-
of which : FSU	-	79.4	77.0	75.6	73.2	-	-	-
Nonsocialist countries	1.8	1.6	3.9	5.7	6.9	5.8	8.3	23.4
Industrial countries	-	-	-	5.4	6.7	5.6	-	-
Developing countries	-	-	-	0.2	0.2	0.2	-	-
Imports	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Socialist or Former Socialist countries	99.2	98.5	99.0	97.9	95.6	91.6	83.2	50.0
CMEA countries	96.9	96.8	97.5	95.7	92.5	87.7	-	-
of which : FSU	-	85.8	86.9	85.0	82.8	-	-	-
Nonsocialist countries	0.8	1.5	1.0	2.1	4.4	8.4	16.8	50.0
Industrial countries	-	-	-	2.1	4.1	7.9	-	-
Developing countries	-	-	-	0.0	0.3	0.5	-	-

Source : “Mongolia, Toward a Market Economy” A World Bank Country Study

Table 2-IV-3

Composition of Exports to and Imports from Socialist Countries

(in percent of total at current prices)

	1970	1980	1985	1987	1988	1989	1990
Exports	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Foods tuffs	9.6	19.0	9.4	10.6	8.1	8.7	6.6
Consumer goods	5.9	9.6	16.8	15.8	15.7	17.5	20.0
Fuels, mineral and metals	5.4	26.4	42.2	39.7	41.7	42.8	49.7
Chemicals	0.0	-	-	-	0.1	-	0.6
Building materials	0.9	0.4	0.7	4.5	3.4	4.0	3.9
Agricultural goods	19.5	13.4	6.1	7.6	8.1	6.5	5.3
Others	58.7	31.2	24.8	21.8	22.9	20.5	13.9
Imports	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Fuels, mineral and metals	12.8	24.1	28.7	30.8	33.5	27.3	27.2
Consumer goods	36.3	20.9	17.2	18.4	18.5	21.9	21.6
Chemicals	5.1	6.3	5.9	6.1	5.6	6.3	5.3
Agricultural goods	-	-	-	0.1	0.2	0.1	0.0
Engineering goods	25.9	33.1	36.3	32.2	30.2	29.6	31.1
Others	19.9	15.6	11.9	12.4	12.0	14.8	14.8

Source : “Mongolia, Toward a Market Economy” A World Bank Country Study

Table 2-IV-4

Composition of Exports to and Imports from Nonsocialist Countries

(in percent of total at current prices)

	1970	1980	1985	1987	1988	1989	1990
Exports	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Foods tuffs	-	-	0.0	0.5	-	-	0.1
Consumer goods	-	2.2	2.3	6.0	5.8	5.5	35.5
Fuels, mineral and metals	-	-	-	-	-	-	7.9
Raw materials	100.0	97.8	97.7	93.5	94.2	94.2	55.9
Others	-	-	-	-	-	0.3	0.6
Imports	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Fuels, mineral and metals	-	0.3	3.9	13.3	11.6	8.2	10.6
Consumer goods	33.3	33.4	5.3	5.3	5.1	20.3	24.8
Chemicals	55.5	14.0	17.1	12.4	12.3	13.9	14.0
Raw materials	-	1.3	30.3	21.2	21.3	19.3	9.3
Others	11.2	51.0	43.4	47.8	49.7	38.3	41.3

Source : “Mongolia, Toward a Market Economy” A World Bank Country Study

Table 2-IV-5

Private Sector Output

Sector	% of Total Output
Industry	43
Agriculture	99
Construction	46
Transport	66
Communication	0
Trade	64
Services	34

Source : Lkhagvagiin Demberel, "Economic Reforms in Mongolia"

Table 2-IV-6

Government Expenditures

(percent of GDP)

	1970	1990	1991	1993
Total	65.4	64.1	57.1	32.9
Current	50.2	51.9	51.7	21.6
Wages	8.4	8.6	9.8	5.5
Goods and services	14.8	17.8	11.2	7.0
Subsidies and transfers	23.1	24.3	26.8	7.9
Others	3.9	1.2	3.9	1.2
Capital	15.2	12.2	5.4	11.3
By function	10.2	64.1	57.1	32.9
Education	10.2	11.3	10.1	5.3
Health	5.1	5.4	5.5	2.9
Defense	5.6	4.5	3.8	1.8
Security	1.3	1.0	2.5	1.3
Economic affairs	23.1	21.8	8.7	1.8
Social security	6.8	7.7	11.5	4.68
Others	13.8	12.4	15.0	15.2

Source : Lkhagvagiin Demberel, "Economic Reforms in Mongolia"

Chapter V Vietnam

1 Process of the Transition in Vietnam

It is widely considered that Vietnamese economic reforms started with "Doi Moi (reform)" in 1986. And some may consider that "Doi Moi" started under the influence of "Perestroika," considering the time relation between these two.

However, if you look at reforms in Vietnam a bit carefully you will find that the reform had started much earlier. As a matter of fact most of the contents of "Doi Moi" were already included in the "New Economic Policy" approved in 1979, and several measures which gave some autonomy to state enterprises and farmers were actually implemented in 1981 (see Table 2-V-1).

However, though the application of market mechanisms was stated in the "New Economic Policy," those reforms went no further than the "reform within the framework of the planned system." Although the autonomy of enterprises and farmers increased to some extent, the system itself did not change at all. The same thing applies to "Doi Moi". Despite the announcement of "Doi Moi" policy, in reality almost nothing had been done in 1986 and 1987.

Actual "transition to a market economy" started around 1988-1989. Several measures were decisively implemented in this period. In particular, 1989 was remarkable with almost total price liberalization and the drastic stabilization of inflation. Several factors which caused the change can be pointed out; macroeconomic imbalances (hyper-inflation, huge budget deficits, trade imbalances, etc.) caused by halfway reform, direct and indirect pressures from the good performance of the neighboring Asian economies, the world-wide trend of transition to the market economy, etc.

Thus the process of reform in Vietnam can be summarized as follows.

1975	Unification of the North and South Vietnam
-1979	Collectivization
-1988	Reform within the Framework of the Planned System (with some fluctuation)
1989-	Transition to a Market Economy

An outline of the reforms in Vietnam is presented in section 2. An evaluation of the reforms is made in section 3 and 4. Section 3 mainly treats development-related aspects of reform, while section 4 treats the transitional aspects. Section 5 will present a conclusion synthesizing these two aspects of the reforms.

2 Summary of the Reforms

2-1 Fiscal Reform

2-1-1 Revenue

Before 1988, Vietnamese government revenue largely depended on transfers from state enterprises, accounting for three-quarters of the total revenue. Since 1989, its share has declined and the share of tax revenue has risen, as is clearly shown in Chart 2-V-1.

The decline in the transfer from state enterprises in 1989 reflects the deterioration in the state enterprises sector caused by monetary restraint to tackle inflation. The cessation of the subsidiary import of intermediate goods from the CMEA countries also worsened the financial condition of state enterprises.

Since 1990, the Vietnamese government has intentionally reduced its dependence on transfer and has made efforts to establish a uniform tax system suitable for the market economy. The basic framework of the Vietnamese tax system was established when a major tax reform took place in 1990 and 1991. The outline of the Vietnamese tax system is shown in Table 2-V-2.

It was expected the tax reform would have two kinds of positive effects on the economy: the establishment of a stable source of revenue and the encouragement of state enterprises reform. The abolition of transfers and the introduction of a uniform tax would increase the autonomy of state enterprises, and in addition the removal of the differences in tax treatment between state and private sector would encourage private sector development.

However, despite these efforts, because of the defectiveness of the tax administration, in reality the reform remains imperfect. Ad hoc tax concession is frequent; consequently, the actual tax rate differs from one company to another according to their bargaining power. Tax collection is poor: collection from the private sector is quite weak. Tax revenue from the private sector accounts only for about 14 percent while the share of the private sector in GDP is estimated at around two-thirds.[1] As the private sector is now expected to play an important role in the Vietnamese economy, it is of great importance to improve tax collection from the private sector.

Besides transfers from state enterprises and tax revenue, revenue from crude oil production is increasing, currently accounting for about 20 percent of total revenue.[2]

2-1-2 Expenditure

(1) Current Expenditure

Before 1989, three kinds of subsidies existed: export subsidies, food procurement, and production subsidies to state enterprises. All of these subsidies were abolished in 1989 with the exchange rate unification, wage reform, and price liberalization respectively.

The abolition of production subsidies to state enterprises was designed with two major objectives: reduction of government expenditures, and the separation of national finance and the finance of state enterprises. The latter serves to strengthen the independence of state enterprises. However, the reduction of government expenditure has shown little progress, and the effect of the separation of the national finance and the finance of state enterprises has been offset by subsidiary loans provided for state enterprises through the Bank for Investment and Development. In other words, the abolition of the subsidy to state enterprises was nothing more than the recourse of subsidies from the direct ones through the state budget to the indirect ones through credit system.

(2) Capital Expenditure

Capital expenditure has been suppressed in the government's effort to reduce the fiscal deficit. In addition, the cessation of assistance from the former USSR in 1991 strongly hit capital expenditure (see Chart 2-V-2). Nevertheless, with poor infrastructure, the need for public capital formation is extremely high. Although the restraint of government capital expenditure on the other hand somewhat facilitated the autonomy of state enterprises' investment financing, it is of essential need to increase public investment for economic development.

2-1-3 Fiscal Deficit

Fiscal deficit has been financed mainly by money printing; as you see in Chart 2-V-3, money supply has moved in parallel with fiscal deficit. Thus fiscal deficit has been a major factor of inflation.

Government expenditure has moved almost flat with some fluctuation during 1988-1992, while government revenue gradually increased from 13.1 percent in 1988 to 21.5 percent in 1992. Accordingly, the fiscal deficit decreased from 8.3 percent of GDP in 1989 to 1.8 percent in 1992 (see Appendix 11, 12, 13).

2-1-4 Relationship between Central and Local Government Finance

The tax collection system in Vietnam is relatively decentralized; a considerable part of tax revenue is collected at the local level. In contrast, the share of the central government is large on the expenditure side. In 1989, central government revenue accounted for only 27 percent of the total revenue while the expenditure share of the central government was 67 percent[3].

Thus the central government faces a huge imbalance between revenue and expenditure. In 1989, the central revenue covered only 26 percent of the central expenditure. Even after adding the net transfer from the local level, which was equivalent to 20 percent of central government expenditure, the revenue of the central government covered only 46 percent of its expenditure (see Table 2-V-3)[4]. The fiscal deficit at the central level is thus serious, and the imbalance between the central and local government finance gives rise to inefficiency in the budget allocation.

2-2 Financial Reforms

In the planned system, the financial sector played a minor role: it simply accommodated the economic plans from the financial side. In a market economy, an important role is required for the financial sector in achieving efficient allocation of resources. It is of essential need to establish the proper functions of the central bank and commercial banks.

The deficiency of capital is one of the most serious constraints for Vietnamese economic development. The gross domestic investment of Vietnam is quite low, even compared with other developing countries, and reflects low private savings as well as constraints from the budget deficit on public investment (see Tables 2-V-4 and 5). On the other hand, the need for investment is quite large, taking into account the poor infrastructure and the unequipped private sector.

Therefore it is of great necessity to establish an efficient financial sector to mobilize domestic capital and to improve the efficiency of the use of scarce capital.

2-2-1 Institutional Framework

In 1988, in addition to the previously existing two specialized banks (the Bank for

Foreign Trade and the Bank for Investment and Development) , two specialized banks (the Industrial and Commercial Bank and the Agricultural Bank) were separated from the State Bank of Vietnam and the function between the central bank and the specialized banks was divided. The differences in the functions of the four specialized banks were later removed, and those specialized banks are now operating as ordinary commercial banks. Thus the financial sector of Vietnam consists of the central bank, the four state-owned commercial banks and other institutions such as share banks, credit cooperatives, housing banks and several branches of foreign banks. The legal framework for the financial sector was established as the Law for the Vietnamese State Bank and the National Law on Banks, Cooperative Credit Institutions and Financial Institutions became effective in 1990.

2-2-2 Changes in Functions of the Financial Sector

(1) Central Banking

In the era of planned economy, the State Bank of Vietnam played nothing more than a negative role of accommodating economic plans from the financial side. The roles generally played by central banks in market economies -- management of the economy through monetary measures -- had been neglected. The distinctions between the functions of the central bank and commercial banks were not clear; the State Bank also engaged in commercial banking activities.

To complete the reforms toward a market oriented economy, it is necessary to establish the proper function of the central bank suitable for a market economy, or the function of the authority of monetary policy as well as a supervisory position of the financial system.

The Law for the Vietnamese State Bank provided legal bases for central banking for the State Bank of Vietnam. The State Bank was given the authority for reserve requirements control, open market operation, foreign exchange reserves management, bank supervision, etc. Commercial banking activities by the State Bank are prohibited under the law.

However, in reality, unskilled staff and pressure from the government prevents the central bank from carrying out its proper role. The importance of the independence of the central bank should be recognized.

(2) Commercial Banking

Despite the establishment of the National Law on Banks, Cooperative Credit Institutions and Financial Institutions, the actual function of these financial institutions remained undeveloped. Unskilled staff do not have the ability to assess the financial conditions of loan applicants. The bank’s right on mortgage is unclear because of the lack of a bankruptcy law and the legal basis of property rights. Pressure from the government to support the state enterprises which are losing money are strong, and subsidiary loans for such inefficient state enterprises still remain, although the equal treatment of state and private enterprises is declared in principle. To cover the loss caused by such subsidiary loans, higher lending rates are adopted for profitable firms. This kind of discriminatory treatment in lending is preventing the proper function of the capital market and causing a huge loss in resource allocation.

To accommodate such low-interest subsidiary loans, deposit rates are settled at low levels, making it difficult to absorb sleeping money into bank deposits. The banks’ incentives to acquire deposits are also discouraged by the high reserve requirement.

A large part of the financial credits goes to state enterprises. The private sector has little access to financial loans. Farmers generally have accessibility. To improve the accessibility of the private sector to financial credits, the Bank for Private Enterprises was established in 1994.

It should be noted that financial sector reform is only one side of the coin: it must be accompanied by the reform of enterprises, or the receiver of credits. Without improvement of the profitability of enterprises, there would be little room for capital mobilization.

2-2-3 Monetary Policy

To stabilize inflation -- which once marked over 400 percent[5] -- the Vietnamese government raised interest rates up to the level at which the real interest rate became positive in 1989. As a result, the inflation rate sharply declined (to 36.4 percent) in 1990 (see Appendix 3). It was also effective in increasing bank deposits (see Chart 2-V-4). The real interest rate had been negative since 1990 but again turned positive in 1993. The inflation rate in 1993 seems to have quieted down to one digit.

The undeveloped financial system in Vietnam on the other hand brought about the effectiveness of monetary policy. Since there is little created money in the economy, change in the amount of real currency directly affects the rate of inflation. You can see a high degree of correlation between the money supply and the inflation rate (see Chart 2-V-4).

2-3 Price Liberalization

In Vietnam a dual-price system consisting of “official prices” and “free market prices” was in effect in the past. The official prices guided production under the plan and the free market prices were applied to production outside the plan, e.g. most of private sector production, excess production of state enterprises over the plan target, and other “minor goods”.[6] Mark-up principle was applied on inefficient and distorted production costs to determine the official prices. The official prices were settled in favor of industrial products relative to agricultural products, reflecting the government’s intention of heavy industry-led development.

In 1981 and 1985, Price Adjustment Policy took place. In 1986 the government introduced a new system of “official business price” with the intention of relating the official price structure to market forces. After several adjustments of official business price towards market price in 1987 and 1988, the distinction between “official business” and “free market” prices was formally abolished.[7] Thus an almost complete price liberalization was achieved, with a few exceptions such as electricity, oil products, public transportation fares, etc. Despite the abolition of price regulation -- as a consequence of the prior price adjustments and the simultaneous monetary restraint -- inflation conversely calmed down in 1989. The relative price between industrial and agricultural products moved in favor of the agricultural products.

Direct control over production of state enterprises through quantitative plans, which was the other side of the coin of price control, was also abolished. Thus all economic transactions came to be made on a market basis. However, it is questionable whether the proper market mechanism, which brings efficiency to the economy, is working or not. On the demand side, to some extent favorable conditions for the market mechanism have been established. Households have emerged as economically rational consumers. Stabilized macroeconomic conditions served the rational behavior of households.

However, because of the stagnation of state enterprise reform, the situation on the supply side remains unfavorable for the market mechanism. The remaining state enterprise monopoly in most sectors implies that the prices determined in such a market are not reflecting competition. The monopolistic situation also spoils the incentives of state enterprises to respond to the market. Moreover, because of easy access to subsidiary loans provided by state banks, the behavior of state enterprises are not bounded by hard budged constraints. Except a few sectors like agriculture or trade goods, in which the prices are considered to reflect the competition due to the progress of reform in such sectors, in most sectors the price mechanism is not working properly. Further efforts in state enterprise reform or structural adjustment in the supply side are required to make the most of the merits of price liberalization or to make the market function properly.

2-4 Enterprises Sector Reform

Major objectives of enterprises sector reform are; (i) to improve the efficiency of state enterprises by giving incentives, and (ii) to establish a competitive microeconomy on the supply side so that the market mechanism can function well.

To achieve such objectives, the following three directions are possible:

(a) state enterprise reform without transfer of ownership
(b) privatization of state enterprises, or transfer of ownership
(c) encouraging newly emerging private enterprises.

((a) includes the establishment of the autonomy of management, the division of monopolistic state enterprises, etc.)

In the process of the reforms that took place in Eastern Europe or in the former USSR, much stress was put on (b) privatization based on the assertion that the state enterprises would never change their behavior if there is no transfer of ownership. However, as you find several examples in the experiences of East Asian countries, even without (b) privatization, (i) improvement of efficiency of state enterprises can be achieved through (a) state enterprise reform, and (ii) establishment of a competitive microeconomy can be achieved through (a) enterprise reform and/or (c) encouragement of the private sector. Privatization is not the only way to reform the enterprise sector. Without a well-developed financial market, it is difficult to carry out transfer of ownership smoothly. Thus priority should be given to (a) state enterprise reform and (c) promotion of the private sector in the first stage of development.

Regarding the legal basis for enterprise in Vietnam, the government officially approved five types of ownership in 1989: state, collective, private, individual and family ("multi-sectoral commodity economy"). The Private Enterprises Law and the Stock Company Law came into effect in 1990; for foreign enterprises, the Foreign Investment Law was established in 1988. However, further development of a legal framework including laws on bankruptcy, accounting systems, intellectual property rights, etc, are required.

2-4-1 State Enterprise Reform without Transfer of Ownership

The Vietnamese government has implemented several reforms to enhance the autonomy of state enterprises such as transfer of management to the enterprises, abolition of plan targets, elimination of subsidies, reduction of transfer of profits to the state budget, the introduction of unified tax system, etc. However, even though autonomy increased, the monopolistic situation of state enterprises still remains, and there has been little competition among enterprises. Moreover, the autonomy of state enterprises has been spoiled by frequent ad hoc tax concession and easy access to low-interest subsidiary loans provided by state banks.[8] Consequently, the efficiency of state enterprises showed little improvement. Furthermore, managerial abuse of newly acquired rights to control state assets and frequent corrupt practices can be observed.[9]

To improve the efficiency of state enterprises and to establish a competitive microeconomy, the state enterprise monopoly should be attacked. Thus, not only the encouragement of autonomy but the division of state enterprises is strongly suggested. Also, it is necessary to establish a clear definition of the managerial rights and ownership to prevent the misuse of them by managers.

2-4-2 Privatization

Privatization in Vietnam is still in the experimental stage. The basic stance of the Vietnamese government about privatization is to keep the important sectors of the Vietnamese economy under state ownership while privatizing unimportant and unprofitable sectors.

In July 1992, the Vietnamese government announced a plan of the experiment of privatization. Seven enterprises were listed, based on the following criteria; (i) balance sheets must be in the black at that time, (ii) medium sized, and (iii) not important to the Vietnamese economy. However, six of them were struck off the list because of their resistance. At present, four companies, including the remaining one, are planned to be converted into stock companies. For the time being the stocks of the two companies among the four will be on sale.[10] The establishment of the stock market remains as a future issue.

2-4-3 Promotion of Newly Emerging Private Sector

Small private agents are rapidly increasing particularly in the trade and service sectors. In the industrial sector, the gap between state and private enterprises in their size, capital equipment and technology has worked as an entry barrier. Although in principle the difference in treatment concerning tax or credit between state and private was removed, in practice the favorable treatment for state enterprises still remains and thus discourages private sector development.

Introduction of foreign capital provides one way to strengthen the private sector, since it provides not only capital but also technology to the private sector.

2-4-4 Performance of Enterprises Sector

Chart 2-V-5 shows the change in industrial production share by private and state sectors. Although the private sector shows a much better response to the market opportunities than the monopolistic state enterprises, the share of the private sector has been declining in these years because the monetary restraint in 1989 and the drastic reduction of assistance from the CMEA countries in 1990 affected the private sector much more seriously, since it has a disadvantage in size and equipment compared to the state sector, which has easy access to direct/indirect subsidies from the government. Thus the increase of state share does not necessarily mean the improvement of efficiency in the state sector.

Charts 2-V-6 and 7 show the production share and the labor share by sectors. The private sector is dominant in food, forestry products, and other areas, while the state sector occupies a large share in electricity, fuel, metallurgy, etc. In general, the share of the private sector in labor is larger than that in production, indicating the lower labor productivity of the private sector. This is more clearly illustrated in Table 2-V-6. The labor productivity (production/worker) of central and local state enterprises surpasses that of non-state enterprises by six and three times, respectively. This can be attributed to the gap in their size and equipment. Measuring the size of the enterprises by the number of workers per enterprise, local state enterprises are forty five times larger, and the central state enterprises are nearly two hundred times larger than the non-state enterprises.

The government's intention to reduce employment in the state sector is reflected in Chart 2-V-8 and Table 2-V-7. The number of state enterprises has also decreased (see Chart 2-V-9). As a consequence employment in the private sector has increased. Considering the lower labor productivity in the private sector, this movement of labor into the private sector has brought down the productivity of the overall economy.

While labor productivity of the state sector is higher than that of the private sector, it is observed that the capital productivity of the state sector is lower than that of the private sector. The state sector accounted for 48.6 percent of the total investment in 1989 while it produced only 21.6 percent of the gross social products in the same year.[11] Thus, concentration of credit to the state sector and the remaining low-interest subsidiary loans to state enterprises implies inefficiency in credit allocation. The total productivity of the Vietnamese economy would largely improve if these credits went to the private sector, where capital equipment is poor and thus even small increases in available capital would bring about a large increase in production.

Thus, we can conclude that the movement of production factors in Vietnam — both labor and capital -- has had inverse effects on the productivity of the Vietnamese economy. Although it is justifiable to some extent that the government reduces state employees and gives subsidiary credit to state enterprises from the viewpoint of the improvement of the fiscal balance and of the stability of the economy, the government also should take into consideration the effects on the productivity of the economy when implementing economic policies. If a reduction of state-sector employees is an indispensable agenda in the state enterprise reform, the government should try improve the labor productivity of the private sector by encouraging capital flow into the private sector.

2-5 Agricultural Sector Reform

Agriculture is an important industry in Vietnam. It occupies about 70 percent of the labor structure and about 40 percent of total production (see Chart 2-V-10 and 11). Cooperatives performed important roles especially in the agriculture sector (see Chart 2-V-12). However, reforms have been carried out in the direction of reducing the cooperatives' roles and increasing the autonomy of households.

In the north, prior to the reforms of 1981, farmers were working for "work points" under the command of cooperatives. The same kind of collectivization was designed in the south after unification, but it resulted in the stagnation of production.

Agricultural reforms took place in 1981 and in 1988 in the direction of increasing the farmers' autonomy. Both of these reforms had positive effects on the production, as you can observe in Table 2-V-8 and Chart 2-V-13.

After the reforms of 1981, agricultural production activity came to be based on production contracts between each farmer and cooperative. Each farmer rented farmland from the cooperative and was required to supply the production norm. The products collected by cooperatives through such contracts were, after deducting production costs and taxs, re-distributed to farmers according to their work points. Any surplus over the norm was left to the farmers' discretion; thus farmers had incentives to increase production. There was also a rise in prices of agricultural products (up to five times) in 1981.

However, this reform was designed within the framework of agricultural collectivization. Cooperatives still continued to control most of the products. Important means of production remained in the hands of cooperatives. Fertilizer and other inputs were allocated through the national resource plan. There were frequent revisions of the norms, although they were declared to be fixed for five years in principle.

For a while, the reform produced good results and agriculture production increased temporarily. However, the remaining control by cooperatives or local authorities more or less spoiled the incentives of farmers and is obviously one of the factors which broight about the stagnation or the decrease in production in 1986 and 1987.

The reform in 1988 gave more decisive autonomy to farming households. Each farming household was formally identified as a basic unit of production, and Vietnamese agriculture shifted from a cooperative basis to a household basis. Most cooperatives reduced their size and function, and the means of production formerly owned by cooperatives was transferred to farmers. Simultaneously, agricultural products market developed in the overall trend of market development in Vietnam, and farmers acquired easier access to the market to sell their products. Furthermore, in 1989, compulsory procurement by the government at prices lower than the market price was abolished; the system of allocation of fertilizers and other inputs also shifted from subsidized distribution based on national resource plans to allocation through market transactions.

As a consequence of these reforms, agricultural production has again increased since 1988, and as is frequently referred to as one of the monuments of the Vietnamese reforms, Vietnam, which was a rice importer before the reforms, became the third largest rice exporter in the world in 1989.

However, the supply of input goods such as fertilizers or farm appliances dose not keep up with the increase of the demand for these goods. These input goods are produced by state enterprises, and the delay of the reforms in that field caused a poor response of supply of those goods. This poor supply of input goods, together with the weak agricultural infrastructure, might be future constraints for the development of Vietnamese agriculture.

The confusion concerning land-use rights is another issue. At present, long-term land-use rights (twenty years for annual crops and fifty years for perennial crops) are approved while the ownership of the lands is considered to belong to the entire people. Land-use rights can be transferred or inherited.

2-6 External Sector

2-6-1 Exchange Rate Adjustment

Until 1988, a system of multiple exchange rates -- in which exchange rates differ by transaction -- was in effect, and Vietnamese dong had been largely and deliberately overrated to enable subsidiary imports. The highly overvalued official rate and the inefficiency of the official market led to the development of a large informal market (parallel market).

After several adjustments of official rate towards the parallel rate, Vietnam unified its multiple official rates and moved to the floating rate system in 1989. With the intention of the authorities to establish foreign currency control, in principle the dong remains inconvertible and enterprises are required to deposit earned foreign currency in officially approved banks, retaining the right to use them in part. However the government's control over foreign currency remained weak and the parallel market continued to exist. Thus, Vietnam now has a dual exchange market consisting of the official and the parallel market. Since 1989, the dong has been stable at the level of around 10,000 dong/dollar and the gap between the official rate and the parallel rate has been kept within 10-20 persent, with the official rate still providing virtual subsidies to those who have access.

To supplement, the Vietnamese authorities should give sufficient consideration to the effect of the exploitation of oil resources on the exchange rate. Exportation of oil may bring about appreciation of the dong, which may discourage the development of export oriented manufacturing industries.

2-6-2 Foregn Trade

Until 1988, foreign trade was monopolistically carried out by the government within the framework of the economic plans. To encourage exports under the deliberately overvalued excgange rate, the government purchased export goods from the enterprises at higher prices than the international prices, and the differences were covered by export subsidies. Imports were regulated with licensing and quotas.

Vietnam became the tenth member of the CMEA in 1978, and trade with the CMEA countries accounted for about one third of total exports and two thirds of imports. This trade with the CMEA countries was done based on the mutual trade plans between the governments; the imports from these countries supplied input goods and intermediate goods at low prices.

Since the late 1980s, Vietnam has implemented several trade sector reforms and the Vietnamese economy has increased its openness.

(1) Reforms of Foreign Trade System

Until 1988, foreign trade was made only through a few state trading companies, each of which had a monopoly on certain commodities, under the control of line ministries or local asthorities. In 1988, the government's monopoly of foreign trade was abolished and the decentralization of trade has subsequently progressed. In 1988, the government eased restrictions on the establishment of trading companies to bring competition into the trade sector, and as a consequence the number of trading companies increased from 80 in 1987 to 600 in 1990. At the same time, direct trade (not through trading companies) was permitted of the state-owned firms, albeit with certain conditions.[12] In 1990 those conditions were removed, and all firms including private firms could trade directly.[13]

Consolidation of the restrictions on exports and imports was carried out in 1989, and the number of trade regulations or quotas was drastically reduced. In August 1993, the number of commodities under regulation was only ten.

The exchange rete reform of 1989 rationalized prices of trade goods and, accordingly, export subsidies were abolished. Prices applied to trade with the CMEA countries, which still remained irrational even after the exchange reform, were also rationalized as the CMEA collapsed in 1991.

As export promotion measures and import substitution measures, the Vietnamese government is offering preferential tax treatment to firms producing export goods or import substitution goods.[14]

(2) Structure and Balance of Trade

As for the composition of the trading partners of Vietnam, until the late 1980s the CMEA countries occupied a large part. They accounted for about one third of exports and two thirds of imports. Since late 1980s, as the Vietnamese economy shifted to an open economy, the share of the CMEA countries has fallen, while that of the Western countries has risen rapidly (see Chart 2-V-14). In particular, the trade relationship with Asian countries has been strengthening. They now account for 79.4 percent of total exports and 77.5 percent of imports.[15]

Looking at the structure of the commodities, Vietnam depends on imports for capital goods, intermediate goods and raw materials. This implies the acquisition of foreign currency as a precondition for investment. Increase of FDI will also enhance the import of capital goods. Regarding the export items, agricultural products and light industrial products occupy a good part. The increase in the export of rice and crude oil is remarkable.

The amount of trade, both imports and exports, has expanded rapidly since the economic opening in the late 1980s. With slightly faster increases in exports, the trade balance of Vietnam gradually improved (see Appendix 5,6,7).

(3) Informal Trade

As the liberalization of the economy progressed, contraband trade has been emerging. It is believed to have grown to equal official trade in recent years.[16]

It may be true that such informal trade brought about an increase in the supply of goods -- consumer goods in particular -- and thus contributed to the stabilization of the economy, easing the shock of the tightening policy and the cessation of assistance and subsidiary imports from the CMEA countries. However, it also has brought negative effects to the economy such as the omission of tariff revenues and the discouragement of domestic production.

2-6-3 Introduction of Foreign Direct Investment

The Law on Foreign Investment in Vietnam, which was proclaimed in 1988 and amended in 1990 and 1992, offers advantageous conditions to foreign enterprises in comparison with the corresponding laws in other countries. It allows enterprises with 100 percent foreign-invested capital,[17] gives guarantees to invested capital and allows remittance of profit. Foreign-affiliated companies are given preferential tax treatment according to the degree of priority of their projects, as seen in Table 2-V-9. Minimum wage is set at 35 dollars per month for Hanoi and Ho Chi Minh and 30 dollars for other areas.

Poor infrastructure is one of the factors which is arresting the development of FDI in Vietnam. To encourage FDI in such situation it is effective to establish industrial complexes or export processing zones (EPZs) and improve the infrastructure in those area selectively. In Vietnam, several industrial complexes and export processing zones are under construction, begining with the Saigon Export Processing Zone (SEPZONE) and Tan Thuan Export Processing Zone. To facilitate export-oriented FDI, the government is giving several types of preferential treatment to the export-oriented enterprises located in EPZs. Some examples are exemption of import tax for the import of facilities or raw materials, and a reduction in corporate tax.

Tables 2-V-10, 11, and 12 show the number and value of the FDI approved in Vietnam. Taiwan is the largest investor followed by Hong Kong, the former USSR and Japan. As for the sectoral share, manufacturing is the largest with 30.9 percent, followed by oil and natural gas with 24.3 percent and hotel and tourism with 19.6 percent.

By November 1993, 114 projects out of 793 were officially canceled.[18] It is considered that of all the approved projects, only one third are in actual operation. This low implementation rate may be attributed to poor preparation by both investors and recipients, uncertainty in actual administration and vague plans.

The resumption of ODA and the lift of the United State embargo largely contributed to remove uncertainty in investing in Vietnam. The rise in wage levels in the ASEAN countries is causing changes in the flow of FDI in Asia. In such a situation, Vietnam, which is located in a rapidly growing area and has abundant natural resources and a large domestic market, is now attracting a great deal of attention from investors as a new investment opportunity. If Vietnam succeeds in making good use of this opportunity, it will bring great benefit to the Vietnamese economy; not only direct but also indirect benefits such as technology transfer and spillover on domestic subcontractors.

2-6-4 Foreign Aid

The meeting of the assisting members held in Paris in 1993 decided to provide official assistance amounting to a total of 1.86 billion dollars to Vietnam within a year. The resumption of official assistance will also facilitate the inflow of private capital, since it will bring about the improvement of the poor infrastructure, which had been an obstruction to investment in Vietnam.

It is expected that official assistance of about two billion dollars per year -- one billion by international organizations like the IMF, World Bank and ADB, and another billion by bilateral assistance -- will be provided to Vietnam in the future. This figure is more than the expectation by the Vietnamese authorities expressed in the long-term plan toward the year 2000.[19]

It should be recognized that the inflow of a great deal of ODA may cause several anxieties. A surging and huge inflow of capital may cause a relapse into inflation. It also gives rise to corruption. There is also the risk of becoming a heavy debtor and relying too much on aid.

2-6-5 External Debt

Vietnam is in considerable debt, with outstanding external debt amounting to 8.1 billion dollars in 1990, which almost equals the Vietnamese GDP. Though the trade balance is improving, the overall balance has not climbed out of the red, and has been financed through the decrease in foreign currency reserves and the arrears on the debts. In 1990 arrears amounted to 1.7 billion dollars, which was one fifth of the total debt (see Table 2-V-13). The debt service ratio of Vietnam was 22.4 percent in 1992 (see Appendix 10).

3 Results Achieved, Remaining Problems

The Vietnamese economy is not only a transitional economy but also a developing economy. Thus reform in Vietnam has two aspects: developmental and transitional. In this section we will evaluate the reforms mainly from the development aspect; the evaluation of the transitional aspect will be covered in section 4.

3-1 Macroeconomy Stabilized

The most remarkable success of the reform has been the achievement of macroeconomic stabilization. Radical stabilization measures were massively implemented around 1989: as a result, the macroeconomy stabilized rapidly.

As a result of the tight monetary policy adopted in 1989, three-digit inflation drastically calmed down despite the price liberalization that took place in the same year. The inflation rate in 1993 seems to have quieted down to one digit (see Appendix 3).

The exchange rate has stabilized at the level around 10,000 dong/dollar since the unification of exchange rates in 1989.

The fiscal deficit is on a decreasing trend, reflecting the government's efforts to reduce expenditure and to establish a stable tax system.

The trade balance has improved with the rapid growth of exports.

The real GDP has grown at 7.1 percent on average during 1981-90 (see Appendix 1).

Thus the macroeconomic indicators of Vietnam show good performance. However, looking at from the microeconomic level, several problems remain.

3-2 Microeconomic Reform Stagnated

In contrast to the aggressive implementation of macroeconomic stabilization measures, microeconomic structral reform, in particular state enterprise reform, is lagging behind. Although the gradualness of the microeconomic reforms helped reduce the shock of the macroeconomic restrictive policies on the supply side and avoid a sharp decline in production on the one hand, it might on the other hand spoil the fruit of the macroeconomic reform in the end if it is unnecessarily prolonged. Microeconomic reform should proceed gradually but steadily.

Some progress can be observed in the agricultural sector and in trade and service sectors. In these sectors, a lot of small farming households and private economic actors are active, and they are aggressively responding to market opportunities.

However, in the industrial sector, although the transfer of management of state enterprises from the state to individual enterprises has progressed to some extent, there remains much to be done in this field. Ad hoc tax concession and subsidiary credit spoil the incentives of enterprises to improve efficiency. The monopolistic situation of the large state enterprises hampers proper market mechanisms, which secure efficent resource allocation. New entry of private enterprises to the market is also prevented.

The government should realize that the liberalization of prices and transactions and macroeconomic stability are not enough to secure the proper functioning of the market economy. To make the most of the reforms implemented so far, further microeconomic structural reform measures such as division of state enterprises, promotion of the private sector, abolition of remaining subsidiary measures, etc., are necessary.

3-3 Shortage of Capital

Shortage of capital creates a serious bottleneck in the development of the Vietnamese economy. Gross domestic investment has moved around 11 percent to GDP, a rather low figure compared with other developing countries; gross domestic savings cannot afford even such a small amount of investment (see Tables 2-V-4, 5). Not only the shortage of capital but also its inefficient use -- such as subsidiary credit to inefficient state enterprises -- is a serious problem.

On the other hand, the need for investment is dire. The weak infrastructure of Vietnam is one of the biggest obstacles for economic development, and massive investment in this field is badly needed. With the large gap in capital equipment between state and private enterprise, a large amount of capital needs to be invested for the private-sector development.

In the long-term plan toward the year 2000 compiled by the Vietnamese government, the capital required over the planned period, 1991-2000, is estimated at 40 billion US dollars. Half of it is expected to be accommodated domestically, with the other half coming from overseas. Two thirds of the overseas capital is expected to be provided as FDI, and remaining one third as ODA.

To alleviate the shortage of capital, measures as outlined below to mobilize both domestic and foreign capital have to be taken.

The low level savings in Vietnam reflects the people's distrust of financial institutions. The negative real interest rate also discouraged savings. It is quite important to attract "sleeping money" to bank deposits by establishing efficient and trustworthy banking institutions and raising real interest rates, since bank deposits bear the capital of several times of itself through credit creation. The establishment of efficient financial institutions also contributes to the improvement of the use of capital.

Considering the huge need for public investment to improve the infrastructure, it is also important to establish a sound tax system, and to increase tax revenue, as it works as a kind of forced capital formation.

Efforts also should be made to attract FDI and ODA. The importance of foreign capital is strengthened by the fact that the Vietnamese economy depends on imports for capital goods on imports and thus foreign currency capital is necessary for investment.

3-4 Social Issues

Social problems emerge as economies develop. These include unemployment, widening income gap, gaps in development among regions (see Table 2-V-14), environmental issues, corruption, etc. All are potential obstacles for economic development. The government has to take measures to prevent these problems and to prepare a social safety net. A gradual (but steady) implementation of microeconomic structural reform may help reduce the incidence of some of these social problems, but it might also produce different kinds of costs.[20]

3-5 Open Policy

Recent studies on economic development, including those by the World Bank,[21] stress the importance of the openness of the economy to the world. Though the concrete process remains unclear, there is a certain consensus that openness contributes to economic development, since it will facilitate technology transfers and since competition in the world market will bring about an improvement in efficiency. Empirical research in this field also found a correlation between economic growth and openness.[22]

In Vietnam, the importance of openness goes beyond these concerns. Vietnam is located among the most dynamically developing economies and can expect rich spillover effect from them. In addition, the introduction of foreign capital (FDI) would solve the two major bottlenecks of the Vietnamese economy; the shortage of capital and the state-enterprise monopoly.

The gap between state and private enterprises combined with the capital shortage in the private sector has been preventing the private sector from developing and has allowed state enterprises to enjoy their monopolistic situation. This has prevented the full blossoming of the market established in the reforms. The introduction of foreign capital in this situation means not only easing the capital shortage but also serving the supply-side structural reform since entry barriers to the private sector (the gap between state and private) would be lower if foreign capital and technology were available. The government will be able to concentrate its investment on infrastructure development, letting foreign capital invest in the private sector. Thus, the introduction of foreign capital provides a way for Vietnamese economy to kill several birds with one stone.

4 Evaluation of the Market Economy in Vietnam

4-1 Two Merits of Market Economy

Why is the transition to a market economy required in the planned economies? What are the merits of the market economy compared with the planned economy? The answer is that there are two kinds of mechanisms in a market economy.

The first is what is called the “market mechanism” in the neo-classical economic theory. Under several prerequisites, the market economy provides efficient resource allocation.

The second is what could be called the “incentive mechanism.” In a market economy the profit of each economic actor depends on its behavior. Thus, the market economy motivates people to act in an economically rational fashion. Furthermore, as Schumpeter pointed cut, in a market economy people have incentives not only to act in an economically rational way but also to innovate, since it brings “entrepreneur’s profit” to the innovator.

In other words, stagnation in the planned economies was caused firstly by the inefficiency of the resource allocation, and secondly by the lack of incentives.

Thus, the ultimate objectives of the reform should be to establish conditions which gives full scope to these two mechanisms of the market economy. However, these two mechanisms are difficult to synchronize, since the “market mechanism” requires “perfect competition,” or that innumerable small firms -- each of which does not have any power to influence to the prices (the “price takers”) -- act in the market based on economic rationality. Meanwhile the “incentive mechanism” causes dynamic and oligopolistic competition towards innovation, which is essentially different from the concept of “perfect competition”.

Accordingly, it is of strategic importance to strike a balance between these two merits. To foreshadow conclusion, in catch-up economies like Vietnam, greater importance should be given to the latter (the “incentive mechanism”), since for those economies innovation could be a good source of economic growth and those economies have several favorable conditions to make good use of the “incentive mechanism.”

In the following part, we will evaluate the market economy in Vietnam from the viewpoint of these two mechanisms of the market economy, further dividing the former mechanism into two; static market mechanism, or resource allocation among sectors, and dynamic market mechanism, or resource allocation among different points in time. The role of the government in a market economy is also discussed from the same viewpoint later.

4-1-1 Static Market Mechanism

To give full scope to the static “market mechanism,” or to achieve optimal resource allocation among sectors, several prerequisites are required. “Structural adjustment” from the World Bank can be regarded as the series of measures to establish such prerequisites. We can evaluate the function of static resource allocation of the Vietnamese market economy by assessing whether those prerequisites have been fulfilled.

(1) Competitive Microeconomy

Competitiveness of the economy is essential for the “market mechanism” to work. However, the concept of “(perfect) competition” in economic terms is rather unique; it is somewhat different from the ordinary concept of competition. It simply refers to a situation in which numberless small firms -- each of which does not have power over prices (“price takers”) -- are acting in the market trying to maximize their profits under the given price (“market price”). It does not include certain kinds of competition which are widely observable in a market economy, e.g. price competition, cost reduction, development of new products, R&D investment, etc. The concept of “perfect competition” must be distinguished from the “innovation competition” which is mentioned later.

In some sectors such as agriculture, service and trade, quite a number of small private farming households or traders are emerging as rational economic agents. It can be said that in those sectors a situation close to perfect competition has been established.

However, the situation of the industrial sector is far from perfect competition. Monopoly of state enterprises is commonplace, which brings about distortions in price structure, which imply inefficiency of resource allocation. The division of monopolistic state enterprises and the promotion of new private enterprises in such monopolistic markets are suggested.

(2) Stable Macroeconomy

Stable macroeconomy is one basis for rational economic transactions. In Vietnam, the macroeconomic situation has been largely improved. Inflation has settled to one digit, the exchange rate has stabilized, the fiscal balance and the trade balance is improving, and the GDP shows steady growth. The macroeconomic situation in Vietnam can be evaluated as favorable for the market mechanisms.

(3) Rationality of Economic Actors

In the theory of modern economics, economic actors -- both households and firms -- are assumed to act in an economically rational fashion; they maximize their individual utilities or profits subject to their budget constraints through market transactions under given market prices. As a consequence of such individual rationality, maximization of the total utility of the economy is achieved (the “invisible hand of God”).

The question is whether the economic actors in Vietnam are acting in an economically rational way. In other words, have the Vietnamese people adopted their way of thinking to a market economy ? Though a market economy itself contains a mechanism which motivates such rational activity of economic actors (the “incentive mechanism”), after the lengthy experience of a planned economy, people in Vietnam are not used to this kind of economic thinking.

However, in some sectors, economically rational actors have already emerged. In the agricultural sector, farming households have begun to act according to profit incentives. In the trade and service sectors, small private agents are quite active. In addition, on the demand side, households are acting according to economic rationality.

But in the industrial sector, the state enterprises -- the main actor in each market -- have not fully adapted their behavior to the market economy. The monopolistic situation prevents the state enterprises from acting as price takers. Ad hoc tax concessions and subsidiary credits prevent them from facing hard budget constraints. In addition, state enterprises are still expected, not only to maximize their profit as economic actors, but also to play a social role like a provider of social benefits to employees.

It is worth mentioning that the southern part of Vietnam has some advantage in this field, since it has less experience with a planned economy.

(4) Factor Mobility

To achieve efficient resource allocation, it is necessary that the factor market be established and production factors move smoothly in response to market prices. However, in Vietnam, both the labor and financial markets remain undeveloped; thus the mobility of labor and capital remains low.

(5) Perfect Information

Perfect information on the market, which includes information on prices, quality of goods, etc, is a basis for a person to behave rationally in an economic sense.

4-1-2 Dynamic Market Mechanism

(1) Perfect Forecast

In addition to perfect information, a stronger prerequisite, perfect forecast, is required for efficient dynamic resource allocation. For catch-up economies it is easier to have a somewhat clear perspective of future development because there are several reference cases to learn from. However it is still difficult for individual economic actors to get exact forecasts on economic development and to behave rationally, based on it.

(2) Capital Mobility

The role of the financial sector is quite important for the efficient allocation of resources among different points in time, since the efficient dynamic resource allocation is achieved in the financial market as an equilibrium between present and future consumption. It is necessary that capital flows smoothly according to the information from the market, i.e., according to interest rates (the relative price of present goods to future goods).

However, in Vietnam, it is difficult to conclude that the financial market is functioning well. Unskilled banking staff cannot accurately assess loan projects. There is constant pressure from the authorities to provide subsidiary credit to unprofitable state enterprises, while the private sector has difficult access to credit. In such a situation, interest rates do not reflect market conditions and there is no way for the financial market to realize its proper function.

4-1-3 Incentive Mechanism

In addition to the merit of efficient resource allocation, the market economy has another important merit: it motivates people economically (the "incentive mechanism"). The market economy gives people profit incentives and encourages economically rational behavior in people. Some argue that the "incentive mechanism" is a more substantial merit of the market economy than the "market mechanism".[23]

In the world of the typical neo-classical school, where there is no innovation at all, people are motivated toward "normal profit." In other words, they are motivated to maximize their profit/utility under fixed production/utility functions and under the market prices. As explained previously, with such economically motivated people ("homo-economics") and "perfect competition," the "market mechaism" guarantees efficient resource allocation.

However the story does not stop there. If you introduce "innovation," or the changes of production/utility functions, into the world, the meaning of "competition" totally changes (the world of Schumpeter). In this world, people are motivated to compete with each other towards innovation and acquire "entrepreneur's profit." The "entrepreneur's profit" is a kind of excess profit (not "normal profit"), which can be acquired by only a few entrepreneurs who achieved innovation earlier than the others. It is generated in a dynamic process in which the economy is not on equilibrium (which the neo-classical theory presumes) but on the process of the movement from one equilibrium to another. Thus, Schumpeter style competition has the character of dynamic and oligopolistic competition among a few innovators and followers. This Schumpeter style competition is essentially different from neo-classical "perfect competition" by its nature. We will call this kind of competition "innovation competition" in the following pages. We cannot expect the efficiency of resource allocation through innovation competition but can expect other kinds of merits such as improvement in productivity, development of new products, etc.

For catching-up economies, the implication of innovation competition is quite large since these economies have great potentiality for innovation, which will be one main source of economic growth. For such economies, innovation competition will provide more abundant fruits than perfect competition.

In Vietnam, however, it is difficult to find innovation competition. A huge monopolistic state enterprise keeps control over the market in most fields; consequently there is little incentive for innovation. It is strongly suggested that Vietnam foster competition among enterprises: it should at least strive for oligopolistic competition, if not perfect competition, to promote innovation.

With the poor private capital in Vietnam, one effective way to promote such competition may be the introduction of foreign capital. It will not only bring competition into the market but also facilitate innovation through technology transfers, and thus will accelerate economic growth.

4-2 Role of the Government in a Market Economy

In a market economy, economic decisions are basically made on a market basis: the economic order rises through market transactions. But this does not necessarily mean that there is no role for government to play. In a market economy a government is required to fill the following complementary roles to the market;

(i) to establish and maintain conditions which guarantee the two mechanisms of the market;

(ii) to substitute for the market when the market does not function well because of under-development or market failures.

In most developing countries, the market is still undeveloped. Thus, the government has to consider the balance between the above two roles. On the one hand, with the market undeveloped, the government has to substitute for it and play some role in resource allocation. However, if it goes too far, it will prevent the proper development of the market. The government therefore has to be engaged in the somewhat contradictory business of encouraging the development of the market while substituting for it.

In the following sections, we will highlight the role of government in Vietnam according to the headings corresponding to the previous section.

4-2-1 Static Market Mechanism

(1) Undeveloped Market

Looking at the environment around the market in Vietnam, as discussed previously, it is far from certain that Vietnam has established good conditions for the market to thrive. The Vietnamese government has to try to improve these conditions and encourage the development of the market (i.e., establishment of a competitive microeconomy through structural adjustment, macroeconomic stabilization, education so that people can adapt themselves to the market smoothly, facilitating factor mobility by removing restrictions or informal pressures on it, etc.), while playing a substitutional role for such undeveloped market.

(2) Public Goods

Providing public goods is one role of the government which is theoretically justifiable. If it is left to the market, the supply of public goods falls less than the desired volume.

However, in Vietnam, with its hard fiscal conditions, the government cannot afford enough public investment. This leads to the poor infrastructure situation of Vietnam.

(3) Externality, Economies of Scale, etc.

Besides the case of public goods, there are several kinds of market failures including externality, economies of scale, etc. With such market failures the equilibrium acquired in the market does not guarantee efficient resource allocation. In such a case, the government has to take some measures to correct the market failure. Theoretically speaking, price measures like subsidies or taxes are preferable to quantitative measures, since the latter discourages competition.

However, in the case of Vietnam, it does not seem that the government is taking into account such market failures when determining economic policies.

4-2-2 Dynamic Market Mechanism

(1) Undeveloped Market

As discussed previously, it is difficult to say that the situation in Vietnam secures efficient resource allocation among different points in time. The capital market is undeveloped and it is difficult for individual economic actors to have a clear perspective on future development.

In such a situation, it would be beneficial if the government could provide information on the future perspective of the economy and the direction of future development policies in the form of indicative economic plans or in other forms, since the government should have has better access to information about future development from the reference cases (in Vietnamese case it could be Thailand, Malaysia, Korea, Japan, etc.).

Since the factor markets in Vietnam are still undeveloped, the government should play some role in resource allocation. In this the government should enhance the flow of production factors into the sectors which will lead economic development. This relates to the argument of infant industry.

(2) Infant Industry

Industries which do not have international competitive power at present but will in the future through dynamic scale merit are called “infant industries.” In other words, infant industries are the industries which do not have “static comparative advantage” but have “dynamic comparative advantage.”

If the factor market is perfect and there are no market failures in those industries, infant industries can develop without government intervention through the market mechanism of dynamic resource allocation. However, we cannot expect perfect factor markets in most developing economies. In addition, infant industries are often accompanied by market failures like externality. In such cases government intervention is required to promote those infant industries. In particular, infant industries with external economic effects, such as spillover effects to related industries, should be promoted as target industries.

As for the measures of promotion, theoretically speaking, production promotion measures like production subsidies or preferential loans are preferable to protection measures like import restrictions or import tariff since the former bring less distortion to the market. Production subsidies or subsidiary credits are justifiable if they are provided under a definite strategy to elevate the target industries.

However, in Vietnam, subsidies or credits are given to unprofitable state enterprises without such a strategy: they are handed out just to help their financial condition.

The Vietnamese government should have a strategy concerning future industrial structure. Labor intensive industries should become targeted, considering the dynamic comparative advantage of the Vietnamese economy.[24] In particular, export-oriented labor-intensive industries should be greatly promoted since they produce spillover effects to the rest of the economy such as technology transfers, access to foreign markets, derivative demand to subcontractors, etc. Subsidies and other promotion measures should be taken in the context of such a strategy.

4-2-3 Incentive Mechanism

As explained previously, “innovation competition” has a different character from the neo-classical perfect competition. To make the best use of the merits of such innovation competition, a certain role is expected of the government from the following points.

(i) Since innovation competition, by nature, has the character of oligopolistic competition, there is no guarantee that the equilibrium acquired through the competition will be optimal.

(ii) Innovation is a kind of public goods.

(iii) Innovation competition is accompanied by various risks, e.g. uncertainty concerning future technology or future demand, the risk about whether innovation can be achieved faster than rivals, etc.

Accordingly, a government is required to play the following roles.

(a) To provide information about the perspective of future demand and technology, and the direction of its economic development policies. This will help to remove uncertainty and/or risks accompanying innovation competition. It will also contribute to increasing the rationality of competition since it provides a common basis of economic decision to each enterprise. Designation of the target industries and indicative economic plans will be two main policy measures in this field.

(b) To facilitate innovation. Since innovation will be public goods once it is achieved, the government has the mandate to promote innovation through government led R&D, technology imports, preferential treatment, etc.

(c) To control innovation competition to an appropriate level. Since innovation competition is dynamic and oligopolistic, we cannot expect that it will converge to the optimal level. The economy might suffer from over-competition or under-competition. As for control measures, price measures (subsidies or taxes) are preferable to quantitative controls since the latter will spoil the incentives of the economic actors.

In the catch-up process, there are several conditions which strengthen the effectiveness of these government roles: the government can get a somewhat clear and correct perspective of the future economic development from the experience of the developed economies; thus the government can identify the target industries relatively easily; import of technology from developed countries is available, etc. The so-called “industrial policy” adopted in Japan and other East Asian countries could be justified in this context although it still includes unnecessary government interventions.[25] The experience of these economies are providing a good model of the government roles in the catch-up process for Vietnam.

5 Conclusion

What characterizes reform in Vietnam is the fact that the Vietnamese economy is not only a transitional economy but also a developing economy. Thus the reform has two aspects of transition from a planned economy to a market economy and economic development. We have discussed the development aspect of the reform in section 3 and the transitional aspect in section 4. However, these two aspects are intertwined. To conclude this chapter, we will try to synthesize these two aspects.

As discussed in section 4, the transition to a market economy has two merits: the "market mechanism" and the "incentive mechanism". To give full scope to the market mechanism, "structural adjustment" is effective; to give full scope to the incentive mechanism, "industrial policy" is effective. For developing economies, the incentive mechanism is more important, since it will accelerate economic growth through innovation.

Since the Vietnamese economy has aspects of a developing economy, greater importance should be given to the incentive mechanism. Thus, the Vietnamese government should adopt industrial policy.

Industrial policy consists of the following three pillars:

(i) to provide information about the future perspectives of the economy (through designation of target industries and indicative economic plans);

(ii) to facilitate innovation;

(iii) to control innovation competition.

In addition, if the market is undeveloped, the government itself may have to take some roles in resource allocation to enhance the flow of production factors into the target industries (e. g. subsidies, credits, etc).

In adopting industrial policy in Vietnam, the Vietnamese government should designate labor-intensive industries as target industries, considering its dynamic comparative advantage. In particular, export-oriented labor-intensive industry should be highly promoted since a great spillover effect to the rest of the economy can be expected, considering the dynamism of the neighboring Asian economies.

However, in promoting export-oriented industries, two essential problems exist:

(i) lack of competition in the economy (monopoly of state enterprises);

(ii) shortage of capital.

The introduction of foreign capital would provide a solution which kills these two birds with one stone.

The Vietnamese government therefore should increase the openness of the economy to promote the inflow of foreign capital into the export-oriented, labor-intensive industries.

(*Mihira*)

FOOTNOTES

1/ IDCJ [1993, p. 21].
2/ IDCJ [1993, p. 22].
3/ World Bank [1992, pp. 62-63].
4/ IDCJ [1993, p. 23].
5/ There are several figures about inflation rate in Vietnam. This figure is from ADB [1991].
6/ IMF [1990, p.4].
7/ IMF [1990, pp. 4-5].
8/ IDCJ [1993, p. 24]. The Bank for Investment and Development provides low-interest loans to state enterprises. The determination of the receivers of these loans is considered to be under stong influence by the government, and repayment ability is barely taken into consideration. The lending rate often falls below the deposit rates and the back spread between them is, in principal, to be compensated for by the central bank. In reality, compensation is rarely made.
9/ ADB [1993, p. 216].
10/ JETRO, *Tsushokoho*, [August 5, 1993].
11/ Sekiguchi and Tran [1992, p. 49].
12/ Permanent licenses were given to the firms who exported over five million dollars worth of goods; annual licenses were given to those with the exports of over two million dollars.
13/ IMF [1990, p. 24].
14/ Firms producing export goods are exempted from the turnover tax. If those firms invest their profit again in the production of export goods, they will receive the corporate tax reduction.
Firms producing import substitution goods will enjoy the reduction of turnover and corporate taxes at the beginning of production.
Firms who receive contract of processing from foreign companies will be exempted from the import tax for the equipment and raw materials necessary for processing. They are also exempted from the turnover tax.
15/ JETRO, *Tsushokoho*, [February 23, 1993].
16/ ADB [1993, p.228].
17/ In the Law on Foreign Investment in Vietnam, four kinds of investments are allowed; contractual business cooperation, joint ventures, enterprises with 100 percent foreign invested capital, and construction-business-transfer contract (BOT).
18/ *Nihon Keizai Shinbun*, [October 21, 1993].
19/ In the plan, about six billion dollars is expected to be provided through ODA in the ten-year period from 1991 to 2000.
20/ There is the risk of unnecessary prolongation of the reforms, which is easily caused by political resistance, and it may fatally damage the achievements of the reforms. Ad hoc determination of the prolongation of reform also gives rise to corruption. The government has to determine the speed of the structural reform taking into account the costs and benefits of the gradual approach.
21/ e.g. World Bank [1993].

22/ e.g. Fukuda and Toya [1993] , World Bank [1991] , etc.
23/ e.g. Murakami [1992, volume II, p. 88].
24/ Vietnam has static comparative advantage in the first industry e.g. rice production, crude oil production, etc. However, developing economies should not stick to static comparative advantage but promote industries with dynamic comparative advantage. See Murakami [1992, chapter 8].
25/ Murakami [1992, chapter 8].

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