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*ASEAN and the Economic Crisis: Lessons for Vietnam*

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The views expressed in this report are mine, and do not necessarily reflect those of UNDP or the Government of Vietnam.

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# *ASEAN and the Economic Crisis: Lessons for Vietnam*

## INTRODUCTION

Southeast Asia is being buffeted by the economic storm that struck in 1997. While there have been many cross-country similarities in the effects of the crisis and in the policy responses to it, there also have been many differences. The experiences of and lessons from other regional countries can be useful to Vietnam.

Despite considerable economic reform since the beginning of *doi moi*, Vietnam remains a heavily state-oriented and very tightly controlled economy. One effect of these controls has been to insulate Vietnam from the global economy. This has postponed, but not prevented the crisis from striking Vietnam. It bought a small amount of time for Vietnam to develop a strategy to respond. It has also provided an opportunity to observe its effects in different countries and to learn from successes and failures elsewhere.

The time for delay is over. Vietnam is now feeling the effects of the crisis. Many danger signs are apparent — exports and investment, especially foreign direct investment (FDI), are falling; layoffs and unemployment are rising; economic growth is deteriorating. The situation will deteriorate further in coming months.

While the crisis clearly has global dimensions, domestic policy responses will be critical. Other countries in the region are responding to the crisis by undertaking important structural reforms. These will increase the efficiency and fairness of the operation of their economies. The social and economic rewards to the people in these countries will be great.

The biggest lesson for Vietnam is that the controls and regulations that provided some initial protection from the crisis will now present the most important and immediate economic policy challenges. A legacy of past controls and of continued heavy regulation of the economy is that Vietnam has one of the highest cost economies in the region. This will make it much more difficult for Vietnam than for any of its neighbors to adapt to and recover from the crisis.

Without a significant rejuvenation and re-invigoration of *doi moi*, Vietnam will suffocate and fall further behind the rest of the region. Economic gains of recent years will be dissipated, with serious implications for the people of Vietnam, and especially for the workers and the poor. Long run economic, social and political stability will become increasingly difficult to sustain.

This report draws on the experience of Vietnam's ASEAN neighbors to document the causes and effects of the crisis in these countries and to draw lessons for Vietnam.

The first part provides an overview of the crisis in neighboring countries, with emphasis on Indonesia and Thailand, where the crisis hit first and most severely. The second part discusses lessons and implications for Vietnam.

## OVERVIEW OF THE REGIONAL CRISIS

The report begins with an overview of the crisis, examining its origins and causes, its immediate effects, and the principal policy responses to it. While there is an attempt to provide a broad perspective on the crisis, the main focus is on issues related to trade and industry, and especially on factors related to international competitiveness. We concentrate primarily on Vietnam's ASEAN neighbors.

### Background

The ASEAN-5 countries enjoyed unprecedented high growth through the 1980s and most of the 1990s. This growth was characterized by some common features, including:

- high domestic savings and investment rates,
- increasingly open trade and industrial policies; steady movement away from (generally moderate) import substitution policies, through extensive deregulation, so that, with some important exceptions, industrial development was based increasingly on comparative advantage,
- high rates of growth of labor-intensive manufactured exports,
- relatively even-handed treatment of agriculture and (again with some important exceptions) other primary-based activities,
- prudent macroeconomic policies, especially with respect to fiscal and monetary “discipline” and the maintenance of appropriate foreign exchange rates,
- increasing openness, liberalization and development of capital markets, including stock and bond markets, and banking systems.

Most of these features of ASEAN growth are relatively well known and agreed upon. Nevertheless it is worth making some observations about points relevant to Vietnam in responding to the economic crisis and adapting its long term development strategy in light of the current situation.

#### *Savings and Investment*

While FDI played an important role in the rapid growth of the ASEAN countries in the 1980s and 1990s, the vast majority of investment was financed from domestic savings.

High savings were the result of a number of factors. Most critical was a stable, non-inflationary environment, a result of prudent macroeconomic policies. Relatively low marginal income tax rates and other features of the tax system also made an important contribution, as did the development of banking systems, stock markets and other financial institutions.

In several countries, savings were encouraged through “provident fund” schemes. These are compulsory savings programs in which contributions are shared among workers, employers

and the government. They have been especially effective in Singapore and Malaysia, and to a lesser extent in Thailand. A potential danger with these schemes, as shown especially in Malaysia recently, is that, in the absence of sufficient protection against government interference in the use of the funds, their value can be dissipated by investments in politically favored projects with low economic and financial returns. This can erode public confidence in the savings schemes, reducing their long term value as a source of retirement income, and encouraging people to find ways to reduce contributions and remove their savings from the funds.<sup>1</sup>

Investment in the successful ASEAN countries was guided largely by market forces, with some distortions, principal among which were

- trade policies, especially import restrictions which reduced foreign competition in the domestic market,
- investment licensing restrictions which limited investment in particular sectors according to the “capacity of producers to meet domestic demand”, and
- tax incentives, primarily in the form of partial or complete (and usually time-limited) exemption from income, sales and import taxes.

With a few exceptions, trade liberalization has gradually reduced the importance of the first of these distortions. Trade and industrial policies are discussed further in the next section.

Investment licensing restrictions limited domestic competition. Furthermore, and quite ironically, they often encouraged premature and excessive investment and hence resulted in the development of significant excess capacity.<sup>2</sup> For these reasons, investment licensing has also come to be recognized as an inappropriate policy tool. This is a very important lesson for Vietnam, which practices extensive investment licensing.

Income tax incentives were meant to encourage investment in “infant” and other “strategic” industries. The general consensus is that they provided windfall gains to large, established investors, many of whose projects would have been undertaken even in the absence of the incentives. Hence they resulted in large government revenue losses, did little to encourage

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<sup>1</sup> Vietnam’s social insurance funds suffer from similar problems. The funds are not invested with a view to maximizing returns, but rather are deposited in the State Bank at minimal interest rates.

<sup>2</sup> Under restrictive investment licensing regimes, in order to ensure permission to enter an industry, firms have to invest before it is “closed” to further investment. This creates an incentive to invest prematurely. It also encourages firms to invest more than is warranted by current levels and likely growth of demand. This is necessary to guard against future restrictions on capacity expansion. As in many other countries, these incentives were magnified in Indonesia and Thailand by high levels of import protection (or expectations thereof). Therefore, while investment licensing is meant to prevent, *inter alia*, “wasteful and excessive” investment, its unintended effect is often just the opposite. Vietnam faces excess capacity in a number of sectors and industries. In at least some of these, such as hotels and automobiles, similar regulatory explanations are probably relevant.

new investment, and were particularly ineffective at assisting small and new investors.<sup>3</sup> Indonesia abandoned the use of tax incentives in the mid-1980s, with no negative effects on foreign or domestic investment. Thailand's Board of Investment (BOI) has been strongly criticized for the effects of its generous incentive regimes; but vested interests in BOI and among the large investors benefitting from tax exemptions have blocked any significant reforms.

Vietnam's new value-added tax appears to be being used in the same way to provide *ad hoc* tax incentives for favored investors and producers. This will erode the effectiveness of the VAT in collecting state revenues and subject it to the same incentive problems that plague the sales and turnover taxes it is replacing. Liberal use of special end-use and end-user exemptions on import duties has the same effect.

### *Trade and Industrial Policies*

In the early to mid-1980s most of the ASEAN-5 countries had moderate to strong import-substitution-based trade policy regimes, comprising a wide range of import licensing and other non-tariff barriers and moderately high and escalating (by level of production) tariff structures.<sup>4</sup> Sales tax systems were also generally biased against imports. By the mid-1980s the cost-raising impact of these policies, and their damaging effects on industrial competitiveness, the current account and employment had become apparent. This spurred the launching of policy reforms to increase the openness of the economies to international trade.

By the late 1980s the majority of non-tariff import restrictions had been removed, and substantial progress had been made in reducing and simplifying tariff rate schedules. With the exception of Malaysia, all countries had also replaced their sales tax regimes with value-added taxes. Participation in the Uruguay Round, APEC and AFTA had assisted in the process of tariff reform. However, the real driving force in this regard was the desire to rationalize incentives facing producers and investors and to increase their competitiveness in world markets. This was all consistent with the attempt to adopt more outward oriented trade and industrial policy regimes.

Progress in rationalizing and increasing the neutrality of trade regimes was not always smooth. Investors who had been long protected in the production of consumer goods for the local market, for instance, did their best to maintain their protection. Even more problematic was the pressure from foreign and domestic investors in upstream industrial raw materials industries (especially steel, plastics and other petrochemicals). Indonesia and Thailand both succumbed to

## **1. Lessons from Trade and Industry Policy Reform in Indonesia**

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<sup>3</sup> See Boadway, Flatters and Wen (1996) for an analysis of the value of BOI tax incentives to small and medium investors in Thailand.

<sup>4</sup> Singapore, whose regional *entrepôt* role required a basically free trade regime, has always been an exception to this characterization.

Indonesia provides some good examples and lessons about trade policy reform.<sup>5</sup> In the early to mid-1980s, declining oil prices and oil exports led to serious concerns and questions about Indonesia's apparent lack of industrial competitiveness. Declining oil prices and export volumes were a grave threat to the balance of payments and to the government's fiscal position. New strategies were required.

On the basis of macroeconomic analysis and industrial case studies, it became apparent that the import policy regime was a major cause of Indonesia's "high-cost economy". Under the policy measures in place at the time, it was found that each job gained through investment in import substitution industries was counteracted by the loss of an average of four jobs in potential export industries that would have been able to develop in the absence of import substitution. Similarly, for each dollar of foreign exchange saved through import substitution, there was a loss of about four dollars of foreign exchange that could have been earned through exports.

The policy reforms covered a wide range of measures, the most important of which were:

- a complete reform of port and customs procedures, including the replacement of post-shipment inspection of imports by Customs officials, by a system of pre-shipment inspection (PSI) by a Swiss surveying company,
- replacement of a complex, cascading, multi-rate and anti-import and anti-export sales tax system was replaced by a simple, broad-based, single rate VAT,
- implementation of an effective system of duty-drawbacks and exemptions on imported raw materials used to produce exports, as a means of providing partial insulation of exporters from the high costs of the import-substitution regime,
- identification and the launching of a process for systematic removal of all forms of non-tariff barriers against imports,
- implementation of a process for tariff reform, in which both the number of rate categories and the average rate of tariff was reduced,
- the development of procedures for evaluating and dealing with requests for protection.

In the face of the emerging fiscal and balance of payments crisis, the government pushed through several of these reforms -- tax reform and the PSI system -- immediately.

The PSI system and reform of the ports was one of the most successful set of measures undertaken over the past decade and a half. Within months of these changes, average importing costs were reported to have fallen by more than 20%. Import tax revenues also went up. Exporters saw major improvements in their international competitiveness. The government also undertook a longer term legal and administrative reform of Customs, so that they would be prepared to resume their duties at some later date. This reform was slower and less successful. Since Customs took back control in 1997, there have been reports of increased importing costs and of other associated difficulties. However, the system is still much better than what existed in the early 1980s.

The VAT was a major success. The broad-based, single rate system replaced a complex sales tax which had been ineffective at raising revenues and which reduced the competitiveness of Indonesian producers. The VAT has made a much greater contribution to state revenues, and has eliminated most of the adverse incentives of the old system. A major and long-lasting triumph of the VAT was the ability of the

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<sup>5</sup> See Barichello and Flatters (1991) for more details on the background and history of the issues discussed here.



government, in the face of its serious fiscal crisis, to resist strong pressures from vested interests to riddle the system with exemptions and complex systems of multiple rates.

In the mid-1980s, the government began a comprehensive review of all non-tariff import protection measures that were in place. The review provided proof of the pervasiveness of the import licensing and quota systems, and of the high costs this was imposing on the competitiveness of Indonesian industry. These costs arose both from the protective effects of the NTBs and, of equal importance, from the non-transparent mechanisms through which they were administered. By the end of the 1980s, as a result of a comprehensive program undertaken under the direction of the key economic ministers, almost all of these measures had been removed.

Tariff reform under Indonesia's "gradualist" approach took longer and was more difficult than anticipated, as vested interests used their powers to impede it, primarily through delaying tariff reforms and lobbying for special tariff "surcharges." (These surcharges are similar to those being used in Vietnam to provide special protection for steel and petrochemicals. See Box 3 below.) Officials responsible for the initial strategy regretted the decision not to use a rules-based approach to tariff reform. Nevertheless, by the time of the Manila APEC meetings, Indonesia was able to provide an Individual Action Plan (IAP) which included a complete and final schedule for achieving a tariff schedule of 0 to 10% tariff rates.

The system of "export oriented protectionism" which is typified by the simultaneous use of import protection (mainly in the form of tariffs by the late 1980s) and various programs to insulate exporters from these measures has turned out to be a very incomplete substitute for comprehensive deregulation and liberalization. In particular, it has hindered the development of cost-reducing and employment-creating integrated systems of manufacture of exports and products of associated supporting industries.

The sustainability of the Indonesian reform program was compromised somewhat by its inability to be insulated sufficiently from the pressures of vested interests. In light of their strong connections, this might not be very surprising. The economic costs of policies dictated by these special interests were very high. The most important were those associated with a) grand schemes for "high tech" industries such as automobiles and aerospace, b) major resource processing industries (especially plywood), c) monopolies and other restrictions on the trade of small-scale resource products, and d) investments in upstream industrial raw materials, especially steel and petrochemicals. It was not until the onslaught of the economic crisis that the government was able to start dismantling these costly measures.

pressures to protect these industries, much to the detriment of downstream users of these basic raw materials.<sup>6</sup> One of the most important long run consequences has been an increase in costs facing local “supporting industries.” This has impeded what should have been a natural and self-sustaining process of industrial integration, and of increased industrial competitiveness in world markets.

As long as even moderate import substitution remained, it was necessary to offset some of its cost-raising effects on exporters through systems of duty drawbacks and exemptions, export rebates, and industrial and export-processing zones. This led to a system that could best be characterized as “export-led protectionism”.<sup>7</sup> While this was quite successful at promoting labor intensive export assembly industries, it was only a partial substitute for more complete trade liberalization, and did not promote integrated domestic manufacturing sectors or assist in the movements “up the ladder of comparative advantage”.

While trade and industrial policy liberalization was an ongoing process, strong networks of vested interests continued to secure privileges which impeded efforts to increase competitiveness of domestic industry. Conflicts among interest groups are a perennial and central problem of trade policy reform everywhere. One benefit of the crisis is that it has actually helped to tilt the balance in favor of reform, in at least some ASEAN countries.

Box 1 on Indonesia’s trade and industrial policy reforms illustrates in more detail some of the issues involved. While each ASEAN country is certainly unique, many of the issues that have arisen in Indonesia have had to be faced, often in a similar manner, by Vietnam’s other neighbors.

#### *Liberalization of Financial and Capital Markets*

All the ASEAN crisis economies were undergoing significant financial sector liberalization in the years prior to the crisis. This process of financial liberalization, which was still far from complete by 1996/97, was a principal cause of the financial crisis.

The affected ASEAN-5 countries had all developed stock markets in the decade prior to the crisis, and these had become a major vehicles for savings, capital market mobilization and speculation. In the years immediately preceding the crisis, the rapid growth in stock market values had become an important source of wealth accumulation. Serious problems of corporate governance and of compliance with and enforcement of accounting standards and other prudential regulations, that remained hidden during the period of rapid growth, became important issues when the crisis struck.

Banking sectors had been liberalized and grown very rapidly. The number of banks in Indonesia grew from 74 in 1988 to over 200 in 1997. Under the new regulations, many banks had been established with very small capital bases. State banks were routinely encouraged to

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<sup>6</sup> Vietnam engages in similar policies to protect upstream steel and petrochemicals industries. This is discussed further below. See especially Box 6 below.

<sup>7</sup> See Flatters and Harris (1995) for further discussion.

lend imprudentially to questionable state enterprises and to “priority projects” of various Ministries. Private banks had close relationships with particular business groups and routinely broke prudential rules in terms of amounts and conditions of loans to related companies. The banking environment in Indonesia also suffered from wild swings in credit policies imposed by Bank Indonesia (the central bank).<sup>8</sup>

While the number of banks in Thailand did not become nearly as large as in Indonesia, there had been a proliferation and rapid growth of finance companies, which differ from banks primarily in their inability to accept demand deposits.<sup>9</sup> The Thai financial institutions, and especially the finance companies, engaged in many of the same kinds of imprudent and illegal lending practices as the Indonesian banks.

The collapse of Bangkok Bank of Commerce (BBC) in 1996, the huge government bailouts that were provided, and the lack of prosecution or other retribution in response to clearly fraudulent actions by the banks’ principals were an ominous precursor of what was to happen in 1997 and is continuing to this day. Thailand had also developed an offshore banking facility (Bangkok International Banking Facility, or BIBF), designed to intermediate lending and savings to and from offshore. Unfortunately, it became more a mechanism for attracting short term foreign funds to be lent mainly to onshore borrowers.

While financial sector development is a key to economic development, it is now clear that the financial sector reform process in Indonesia and Thailand was seriously flawed. One of these flaws was that the reforms had been stalled and were far from complete when the crisis struck. More important were serious difficulties with financial sector supervision and monitoring of adherence to prudential and other banking rules. The problems arose from both lax regulations and inadequate implementation and enforcement. Rapid growth tended to hide banking errors and malfeasance, and made it difficult for bankers (and regulators) to develop proper banking skills in project appraisal and risk analysis. With rapid growth, almost all loans look good, there are very few defaults, and all bankers appear to be performing well. Rapid growth provides an effective cover for banking errors and financial malfeasance. Compounding the regulatory problems were shortages of skilled labor to carry out supervisory tasks. The booming financial sector led to a similar expansion of demand for workers with any kinds of financial market skills, and a corresponding growth of wages. This attracted skilled workers from all segments of the economy; and made it especially difficult for regulatory departments and agencies, constrained by civil service wage schedules, to attract and retain competent staff.

Radelet and Sachs (1998) provide a succinct summary of the role of the financial sector: “The partial reforms led to increasingly fragile financial systems, characterized by growing short

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<sup>8</sup> In mid-1997 Bank Indonesia required all state enterprises to withdraw their deposits from commercial banks and deposit them with the central bank. This caused a massive liquidity squeeze and a steep rise in interest rates, and made it impossible for any of the banks to meet statutory reserve requirements. This was done, strangely, just after Bank Indonesia had raised these compulsory reserve requirements. It is odd that, in spite of this obvious monetary tightness, the IMF’s initial response to the crisis in Indonesia included measures to combat monetary profligacy!

<sup>9</sup> They could issue certificates of deposit, however. Until the onslaught of the crisis, at least, these were viewed by savers as a very close substitute for demand deposits.

term private debt, rapidly expanding bank credit, and inadequate regulation and supervision of financial institutions.” (p.2) These interrelated financial sector problems contained the essential seeds of the crisis.

### **Immediate Origins and Causes of the Crisis<sup>10</sup>**

Among ASEAN countries, the economic crisis initially struck Thailand, Indonesia and Malaysia; the fallout for Laos was massive and almost immediate; it has now begun to “trickle down” to Vietnam. The Philippines and Singapore have been less affected. The crisis originated as a loss of confidence and corresponding collapse of an investment bubble, with important roots in both the real and financial sectors.

The most important single indicator of the crisis was a massive reversal in capital flows in the affected countries. According to the most recent estimates from the Institute of International Finance, net private investment to the countries most affected by the Asian crisis<sup>11</sup> fell from \$93.8 billion in 1996 to -\$6.0 billion in 1997, implying a net reduction of \$99.8 billion. Equity investment accounted for \$17.6 billion of this drop, and private credit for \$82.1 billion. This is a huge reversal of capital flows, and could not help but to have serious implications for the economies involved, despite the offsetting increase in official capital flows of \$33.5 billion.<sup>12</sup>

In popular discussions, the crisis is generally seen to have started in Thailand with the floating of the baht on July 2, 1997. Indonesia followed a month or so later. The immediate seeds of the crisis, however, were contained in several important sets of events that preceded these devaluations. We deal briefly with several of them.

#### *Investment Bubbles*

The crisis “announced itself” first in Thailand, which is quite appropriate since that country illustrates very well the financial problems that led up to it in Thailand and elsewhere. The years immediately preceding the crisis were characterized by an unprecedented boom in asset markets, most importantly the stock and property markets (especially, but not exclusively, in Bangkok). Real estate was an important form of collateral; increasing property prices inflated collateral values, permitting further loan-financed property purchases, which further increased collateral values, and so on. As long as growth remained high, this became a “virtuous” and self-reinforcing cycle.

As in the other ASEAN economies, Thailand’s boom included a significant increase in the rate of capital inflows. Over the early part of the 1990s, these inflows averaged 10% of GDP,

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<sup>10</sup> The following account of the causes and effects of the crisis is drawn from a number of sources, including the author’s own work in the affected countries. For more information, the reader is referred to Radelet and Sachs (1998) for an early regional overview, to Siamwalla (1997 and 1998) for the Thai experience, and to World Bank (1998) regarding Indonesia.

<sup>11</sup> These are Indonesia, Malaysia, Philippines, South Korea and Thailand.

<sup>12</sup> These numbers were reported in the *Asian Wall Street Journal*, September 30, 1998.

and rose to 13% in 1995. The majority was in the form of borrowing by banks and finance companies, aided in large part by the new offshore banking facility, BIBF.<sup>13</sup> Relative to GDP, bank credit grew by 50%, reaching 140% of GDP in 1996. Foreign liabilities of the banks and financial institutions reached over 28% of GDP by 1995 (Radelet and Sachs (1998)).

In addition to the partially self-reinforcing expectation of continued rapid growth, another reason for the rapid build-up of foreign currency denominated bank debt was the perception of low foreign exchange risk. Since the mid-1980s, the Thai baht had been fixed to a basket of currencies, in which most of the weight was given to the US dollar. The long adherence to this fixed rate policy, together with considerable market confidence in the Bank of Thailand's macroeconomic management capabilities, led to a general assumption that there was almost no foreign exchange risk involved in lending to Thailand, even if the returns to the projects in which loaned funds were invested were denominated in the local currency.<sup>14</sup>

However, returns to investments in property, stocks and other such assets depend ultimately on the net income they can be expected to provide. By 1996, it was widely apparent that the rapid expansion of office and residential property supply in Bangkok and other regions was leading to some alarming surpluses and growing vacancy rates.<sup>15</sup> This led to financial difficulties for a number of major property developers, and some of them began to have problems meeting foreign and domestic debt obligations. Unfortunately, Thailand's inadequate foreclosure and bankruptcy laws provided no incentive for debtors to come to terms with their creditors, and gave creditors no power to force the issue.

Rather than tackling these problems, the initial policy response was to search for quick fixes to prop up the teetering market and to provide immediate assistance to well-connected developers. This could not provide any long term solutions.

The evolution of the stock market was similar and indeed closely related to that of the property market. In what seemed like a permanent boom, stock market investors became accustomed to high rates of return. Until 1996 these expectations were self-perpetuating. When

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<sup>13</sup> Capital inflows to Malaysia over this period averaged 9% of GDP, peaking at 15% in 1992 and 1993. The majority was in the form of FDI. In Indonesia, the ratio was only about 4% of GDP, most of it in the form of borrowing by private corporations. (See Radelet and Sachs (1998), Table 1). One of the reasons for the greater proportion of corporate borrowing in Indonesia was government controls on overseas borrowing by banks. The ineffectiveness of the controls can be seen, in retrospect, by the ability of corporations to arrange to borrow directly from overseas banks, often with the assistance of domestic banks.

<sup>14</sup> While Indonesia had abandoned its fixed exchange rate regime in the mid-1980s, the managed float and associated exchange rate band produced an almost equal level of certainty about exchange rate movements as in Thailand.

<sup>15</sup> Significant surpluses had already begun to emerge in 1994.

the market began to collapse in response to realization that many companies could not generate earnings growth to justify stock values, many savers were quite shocked.<sup>16</sup>

While investor naivety and bubble phenomena provide much of the explanation for the rise and subsequent fall of the stock market, a number of stories have come to light that indicate significant corporate governance and malfeasance problems, as was the case in the banking system. These should have been covered by enforcement of normal accounting, reporting and other prudential regulations. These problems also contributed to the underlying instability of the financial system.<sup>17</sup>

The rapid build-up of short term foreign debts, together with incomplete and inadequately monitored and enforced financial sector reforms, made Thailand and the other affected economies especially vulnerable to a “confidence crisis” that could have been triggered by any of a number of possible shocks, including simply a slowdown in growth.

### *Banking Sector Problems*

By the end of 1996, the short term foreign liabilities of Thailand’s and Indonesia’s banking sectors exceeded the total foreign exchange reserves held by their respective governments. This created a situation which was especially prone to financial panic. If, for any reason, lenders began to fear for the creditworthiness of their loans, there could very quickly arise a “race to the exit.” Since there were not enough reserves for everyone to be able to convert their assets, there would be a rush to try to be near the front of the queue. The greater the rush, the greater the panic. This is the classic type of confidence attack to which these countries had become vulnerable.<sup>18</sup>

As mentioned above, by 1996 Thailand had built up a large short term foreign debt burden. This had been helped in part by the offshore banking facility, which turned out to be a route for foreign loans into the country, rather than a facility for intermediating among offshore borrowers and lenders (i.e. it ended up facilitating “in-in” rather than “in-out” financial transactions). The massive failure of the Bangkok Bank of Commerce in 1996, the lack of prudential controls that had permitted it to happen, and the negligence of investigators and other

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<sup>16</sup> An enduring image is the front page photograph that appeared in almost all Thai newspapers of a disappointed investor who engaged in a protest sit-in on the floor of the stock market and threatened to shoot himself unless the government acted to restore the value of his stock portfolio. While a bit extreme, the story reflects a general expectation among many savers that high stock market returns were “normal” and that their continuation was a responsibility of government policy-makers.

<sup>17</sup> Vietnam has much greater problems of financial reporting among both bank and non-bank enterprises. Major improvements in accounting and corporate governance practices will be an essential requirement for capital market development and efficient investment allocation in Vietnam.

<sup>18</sup> Once a panic begins, of course, it is not simply the foreign liabilities of the banks that are at risk. When an exchange rate comes under serious attack, as happened in Indonesia, Malaysia and Thailand, all holders of local currency denominated liquid assets will wish to convert them into more stable foreign currencies. This applies equally to both domestic and foreign holders of these assets.

government officials who failed to prosecute any of the responsible parties provided a chilling insight into some of the deep problems of the banking and regulatory system. The episode also saddled the government with enormous debts incurred in bailing out the bank's shareholders, depositors and other creditors. The cost of the government bailout was approximately \$7 billion at the prevailing exchange rates. This was an unfortunate preview of what was to unfold when the more general crisis struck in 1997.

The banking problems that were becoming apparent in late 1996 and in 1997 were due primarily to exposure to real property, car leases<sup>19</sup> and stocks. The next stage followed from increases in interest rates in 1997, as the government engaged in increasingly desperate measures to try to maintain the baht exchange rate. Other than tight monetary policies, the government tried a variety of other measures to defend the baht against increasingly strong "attacks" by foreign and domestic investors who recognized the fundamental overvaluation of the baht. In addition to direct use of foreign exchange reserves, the government attempted to reduce speculation by cutting off the offshore baht market and by engaging in large forward swap transactions. The forward transactions had the "benefit" of not showing up in official foreign exchange figures.<sup>20</sup>

Liquidity problems arising from falling confidence in the local currency, and from policy-induced higher interest rates aggravated banking problems. In Thailand, the government opened a large window of support through its Financial Institutions Development Fund (FIDF). Through this window, enormous amounts of liquidity support, in the form of FIDF loans, were provided to the banking sector. Meanwhile, the incidence of non-performing loans (NPLs) in banks and finance companies continued to increase. Unfortunately, due to both the lax NPL standards and very weak reporting and supervisory systems, the actual extent of these NPLs was unknown and might even have been, under the circumstances, unknowable, at least to the authorities. What was known to the authorities was the magnitude of the drain through the FIDF window.

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<sup>19</sup> During the pre-crisis boom period, many companies provided high priced automobiles as part of the compensation packages for principals and senior personnel. These were financed under highly leveraged leasing arrangements with finance companies. The economic slump led to defaults on these leases and large scale repossessions of Mercedes and other high priced automobiles. Many large parking lots filled up with such vehicles. The import of new cars practically stopped; in fact several thousand new Mercedes which had been stored in Customs to avoid paying import duties were re-exported.

<sup>20</sup> The practice at the time was not to report forward commitments as part of the government's foreign exchange liabilities. This non-transparency has now been rectified, with net forward commitments listed separately in BOT statements of its foreign exchange position. The forward commitments built up in the months prior to the crisis were not, in fact, a complete secret. The transactions were all carried out through a small number of banks and international currency dealers. Therefore, several major players in the market were aware of the government's strategy, although they did not know the exact total amount of the government's forward positions. The lack of complete disclosure undoubtedly increased Thailand country risk at the time.

### *Export Slowdown*

In early 1996 Thailand's export performance which had been seen as a major engine of her double-digit growth over the previous decade, began to deteriorate. From the second quarter of 1996 to the end of the first quarter in 1997, growth of total exports was negative. For the remainder of 1997 it was positive but low by historical standards. In the first quarter of 1998 growth once again became negative.

Manufactures, which now account for over 80 percent of total exports, have had a greater variance in growth rates than total exports recently. Manufactured exports declined through the final three quarters of 1996, and resumed positive growth in 1997, but at very low rates. In the first quarter of 1998 they became negative (-3.9%) once again. Even in the most successful quarter over this period, manufactured growth rates pale in comparison with 22 to 25 percent growth that had been the norm previously.

The slowdown in manufactured export growth that began in 1996 was spearheaded by absolute declines in a number of "traditional" exports, most notably textiles (and within this category especially garments), base metal products, furniture and parts, plastic products, and footwear. Electrical appliance, and electrical circuit apparatus (including integrated circuits) exports began to decline in the second or third quarter of 1996. On the other hand, a number of "sunrise" export sectors such as computers, computer parts and other machinery and mechanical apparatus; transformers generators and electric motors; motor vehicle parts; and chemical products continued to exhibit relatively strong growth.

By 1997, Thailand's manufactured export growth had leveled out to a much more uniform (and low) rate across sectors. This has continued through the first quarter of 1998. The only exceptions to this — the four "shining lights" — are plastic products, computer parts, integrated circuit parts, and vehicle parts. And growth of two of these — integrated circuit parts, and vehicle parts — has fallen in the last quarter or two.

The decline in the rate of growth of manufactured exports and in the absolute level of a number of Thailand's traditional labor-intensive exports significantly preceded the onslaught of the crisis in early to mid-1997. This has been interpreted in several different ways.

*The crisis was precipitated, in part, by declining competitiveness.* Different versions of the story point to

- rising real wages and labor costs in Thailand relative to countries like China, Indonesia and Vietnam,
- overvaluation of the baht arising from inappropriate policy response to large short term capital inflows,
- (related to the first point) the devaluation of the yuan in 1994, and
- the competitive edge given to Mexico in the North American market as a result of the North American Free Trade Agreement (NAFTA).



Past failures to invest adequately in human capital and infrastructure hindered Thailand's ability to move rapidly enough up the "ladder of comparative advantage" as her competitiveness in labor intensive goods declined. Significant outward foreign investment in countries like China, Vietnam, Laos by Thai producers of garments and other labor intensive exports are another sign of Thailand's declining competitiveness in these sectors.

*Changes in export patterns reflected an evolution in Thailand's comparative advantage.* The fact that a number of "sunrise" export sectors showed strong performance over the period suggested to some that there was no real manufactured export crisis. What was being observed, rather, was a desirable and orderly shift to less labor intensive exports, a natural occurrence as labor costs and skill levels rose. The more recent performance of the newly emerging export sectors, however, suggests that this transition is less smooth than might have been expected. The evolving comparative advantage interpretation is also belied by a closer examination of the skill requirements of the "higher tech" new export industries as well as by Thailand's relatively poor educational performance in recent decades.

Whatever the causes and effects of the initial manufactured export decline, recent data indicate that Thailand is now facing a second wave effect of the regional economic crisis. The spread of the crisis has led to declining demand growth throughout the region, and general excess capacity across a wide range of export industries. The prognosis is that an export-led recovery will not come quickly, and that such a recovery will now depend on a number factors, at least some of which lie beyond the control of Thai producers and policy makers.

Focusing only on manufactured export performance, it is again apparent that Indonesia's performance has been much stronger over the whole period. While Indonesian manufactured exports have slowed down relative to earlier years, growth has remained positive and strong. There were only two quarters since the beginning of 1996 in which manufactured export growth was less than double digit. In the two most recent quarters, Indonesian manufactured export growth exceeded 20 percent. However, there are some differences across manufacturing sub-sectors. Textile exports have remained quite strong over the entire period. Once again, this contrasts quite sharply with Thailand, in which there was large negative growth until the first quarter of 1997; after that, anemic but nevertheless positive growth resumed. The one similarity between Indonesia and Thailand is that growth was slower in 1996 than later.

Indonesian electronics and computer exports, on the other hand, have gone from very high growth in 1996 to quite high negative growth in the three most recent quarters. This contrasts quite sharply with Thailand's experience in computers and computer parts, and in integrated circuits and parts. These have been Thailand's "rising stars", and have shown very robust and rising growth over the period. The only electrical/electronic sector in Thailand which has had a similar experience to Indonesia's has been electrical appliances, in which Thai growth has been low, declining and often negative, but not as much so as in Indonesia. Indonesia's electronics exports have suffered both from both a slowdown in the growth of export-oriented investments in this sector in recent years and from a heavy concentration in household appliances whose international demand and prices have been falling, especially since the beginning of the crisis.

In general, however, Indonesia's export performance has been much stronger than Thailand's over the pre-crisis and crisis period. Prior to the crisis, Indonesia's floating exchange

rate regime, which ensured that the rupiah did not ever get substantially overvalued relative to the dollar, might be part of the explanation. There can be little question that Thailand's rigid and stubborn adherence to its peg with the dollar bears part of the blame for that country's relatively poor pre-crisis export performance.

The much greater depreciation of the rupiah than the baht since the onset of the crisis (82% versus 39% in nominal terms relative to the US dollar as of July 22) might also provide part of the explanation for Indonesia's continued export strength, especially compared with Thailand.

Very recently, however, some serious danger signals have appeared on the horizon for several of Indonesia's key manufactured exports. This will be discussed further below in connection with the effects of the crisis. See also Box 3 on Indonesia's recent textile and electronics export performance.

### *Summary*

The roots and manifestations of the crisis differed considerably across countries. Nevertheless, there are also some basic similarities. The crisis expressed itself first and foremost as a massive reversal of capital flows. This was due to both underlying structural problems in the financial and real sectors, and the vulnerability that was created by excessive exposure to short term capital flows. However, the deeper reasons for the crisis of confidence were domestic policy failures, critical gaps in information available to market participants and to policy makers, and denial and delay in responding to danger signals when they first appeared. The reversal of capital flows had major effects on exchange rates and levels of investment, and led quickly to depression in local markets, with producers of non-tradeables and most import substitutes hit especially hard. As we shall see, these impacts, together with the effects of remedial policies had short run effects which aggravated underlying financial sector problems.

## **Effects of the Crisis and Policy Responses**

### *Thailand*

The crisis came to a head in Thailand, first, with the closing of 16 finance companies, and second, after *all* the country's foreign exchange reserves had been exhausted, with the decision to float the baht on July 2, 1997.<sup>21</sup>

Throughout the months prior to that it became increasingly apparent that Thailand was facing severe financial problems. Nevertheless, the government resisted adjustment of any kind, and simply tried to wish the problems away. As a result of months of denial and inaction, the problems were seriously aggravated, and the impact of the crisis was much deeper than would have been the case with earlier adjustment.

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<sup>21</sup> Thailand had \$39 billion of foreign exchange reserves in at the end of 1996. By the end of June 1997, the net available reserves were basically zero. On one single day in May, the Bank of Thailand sold \$1 billion as part of its futile attempt to maintain the value of the baht.

The initial policy responses were, in part, more in the nature of a salvage operation than an orderly program. This was largely due to the absence of most of the kind of information one would consider necessary. Key principles of the initial programs developed with the World Bank and the IMF included:

- “cleaning up” of the financial system by closing insolvent banks and finance companies<sup>22</sup> and forcing remaining financial institutions to recapitalize and adhere to much stricter prudential rules,
- offering government guarantees to all depositors and creditors of banks and finance companies, as a means of dealing with “systemic risk” in the financial sector,
- imposing strict monetary and fiscal “discipline,” manifested primarily in low monetary growth, and high interest rates, aimed at stabilizing the baht and avoiding excessive inflation, and
- structural reforms in the real economy (e.g. industrial and agricultural sector restructuring) and in bankruptcy and foreclosure laws.

It was generally expected that there would be a serious slowdown of economic growth for much of 1997, and a gradual turnaround in 1998.

The impact of the crisis has been much more severe and has persisted much longer than initially expected. In January 1998 the baht reached a low of 55 per dollar, (compared with 25 per dollar just before the crisis). The collapse of the baht, steep increases in interest rates, and the fall in asset values have had major wealth effects which have depressed local market demand for goods and services. This has led to sharp labor market contractions, manifested in rising unemployment, drastically curtailed hours of work for many of those who have retained their jobs, and significant cuts in nominal wages.

Growth in 1998 is projected to be about -7%, and is more likely to be -8 to -10%. Foreign exchange and interest rate conditions, together with the depressed markets facing local firms have severely aggravated non-performing loan problems of the banking system. More than half of the country’s banks and finance companies have now been forced to close. Remaining companies continue to face serious recapitalization problems.

By early August 1998, it had become apparent that the tight monetary and fiscal policy regime was in need of change. Thailand’s most recent Letter of Intent (LOI) with the IMF (August, 1998) includes room for significant loosening of both monetary and fiscal policies, together with significant new measures to aid and/or facilitate recapitalization of the banking system, and increased attention to “social measures” to deal with the impact of the crisis on the poor.

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<sup>22</sup> The government had very little reliable information on which to base decisions about the solvency of financial institutions, and was forced to rely on the only reliable information readily at hand, which was the amount of liabilities incurred with the FIDF.

Interest rates have eased considerably as the government has ceased borrowing in the repurchase market. The baht, which has been stable in the range of 40-42 baht per dollar since March or April, has actually appreciated slightly to 39-40 baht per dollar in recent weeks. The biggest question at the moment is whether the financial sector restructuring measures will be strong enough to encourage substantial structural changes. There is an underlying fear that the government has been “captured” by very strong vested interests in the banking sector who are unwilling to accept the necessary capital write-downs to make fresh investment and recapitalization possible. If so, this would further delay financial sector reform and increase the already enormous financial burdens on the government arising from FIDF loans and other financial commitments to the banking sector. Furthermore, bankruptcy and foreclosure laws continue to be delayed as a result of pressure from debtors wanting protection from domestic and foreign creditors.

The large size of the economic shock, and of the resulting changes in demand and relative prices had wide-ranging implications for different economic groups. Although many groups suffered large economic costs, others benefitted. Among the losers, some were hit much harder by others. A few observations about losers and actual or potential beneficiaries might be useful.

Among economic/industrial sectors, the most severely hit were those producing non-tradeables (especially construction and financial services), and import substitutes aimed at the local market (consumer electronics, motor vehicles, etc.). Those in export-oriented sectors, including rice farmers and other agriculture and food-processing sectors, as well as traditional and “sunrise” export industries have benefitted from increased competitiveness. Among these, the biggest winners will be those that take advantage of current conditions to establish a base in newly emerging Thai export sectors (motor vehicles and vehicle parts, for instance — an industry which Thailand liberalized more rapidly than her ASEAN neighbors, and in which, as a result, she is beginning to gain export competitiveness).<sup>23</sup>

### *Indonesia*

There are many similarities between the cases of Thailand and Indonesia; but there are also some major differences. The concentration of short term foreign debt obligations in the non-bank sector in Indonesia, for instance, has increased the number of affected debtors, and

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<sup>23</sup> Thailand has developed a comparative advantage in motorcycles and pick-up trucks, and is making similar progress in automobiles. Several major international producers are now investing in Thailand to make it a base for vehicle and components exports. Honda recently announced that it will make use of excess capacity in Thailand to produce the Honda Accord model for export to Australia and New Zealand. This experience is in sharp contrast to other ASEAN countries in which government incentives created industries which were aimed almost exclusively at the local market. These industries were all characterized by large excess capacity. The collapse of local demand as a result of the crisis has left them in even deeper difficulty. Vietnam, with 14 auto assembly factories serving a market of only a few thousand vehicles, is a classic example of this motor vehicle overcapacity syndrome.

hence caused much greater difficulties in achieving a coordinated corporate debt restructuring program.<sup>24</sup>

At the beginning of the crisis, Indonesia was generally perceived to be in much better condition to deal with it than Thailand. It did not attempt to delay foreign exchange rate adjustment; it called in the IMF much more quickly than had Thailand; its manufactured export performance had been stronger than Thailand's; it proceeded very quickly to deal with insolvent banks; it had a history of "structural reform" programs of its own, which it continued to implement, and even speed up when the crisis struck; and it had a widely recognized and respected group of technocrats in whom the President had entrusted major responsibility for economic policies.

As is now well known, Indonesia has suffered far more seriously than Thailand. Growth this year could easily be less than -15%. The exchange rate fell from roughly 2,500 rupiah per dollar in August 1997 to 15,000 a year later.<sup>25</sup> As a result of this depreciation and the high share of tradeable goods in basic consumption bundles, inflation, at rates of 50 to 90% per year, is eroding real incomes. By some estimates, the poverty rate could rise to more than 50% of the population this year, undoing several decades of economic progress.

This is not the occasion to present a detailed analysis of what went wrong in Indonesia. Instead, we will make only a few observations that might have some relevance for Vietnam.

The first thing to note is that, despite the desperation of the Indonesian economic situation, not everyone and not all lines of economic activity are suffering. Most notable in this regard is that, as a result of recent structural adjustment and deregulation policies, as well as the exchange rate changes, a large group of traditionally disadvantaged residents of Indonesia's outer islands are benefitting from an unprecedented export boom. (See Box 2 on Indonesia's small scale resource-based exports for more details.) Many other export industries, including sectors which until recently had demanded high levels of import protection to survive in the local market, are now among the world's most competitive producers and exporters. (See Box 3 on Indonesia's textile and electronics exports.)

In trying to determine what went wrong, it is necessary to look at policies and related events which aggravated the crisis of confidence in Indonesia. The initial features were similar to those in Thailand — banking system weaknesses due to the economy's exposure to short term foreign debt, aggravated, maybe more so than in Thailand, by incomplete and inadequately

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<sup>24</sup> This kind of corporate debt restructuring is commonly referred to as a corporate debt workout. Recall that the reliance on corporate debt resulted from efforts on the part of the government to control short term borrowing by banks. This is a good illustration of problems encountered in implementing foreign exchange controls, even those of the simplest kind. An offsetting benefit of the fact that foreign debts are in the hands of non-banks is that government and international agencies have felt no need to guarantee these debts to avoid systemic risk in the financial sector.

<sup>25</sup> At one point it reached 17,500 rupiah per dollar. It has recently been trading at around 10,500 to 11,000 rupiah per dollar.

## **2. Benefits of the Crisis for Small Scale Resource-Based Exports in Indonesia**

The depreciation of the rupiah has created many opportunities in resource-based, export-oriented activities. Deregulation of inter-island trade, abolition of marketing monopolies and other similar measures under the crisis response program developed with the IMF and World Bank have played a major role in realizing these opportunities. Small scale producers are the major beneficiaries.

Production of wooden furniture in the Semarang-Jepara region of South-Central Java is booming, creating employment and generating high incomes, not only for many workers and small-scale producers in this industry, but also for upstream logging and saw milling industries in the outer islands. Similarly, rattan furniture producers in nearby Cirebon are enjoying enormous export demand for their products. Indeed, rattan sellers in the outer island of Sulawesi are having some difficulties obtaining shipping to get their products to Cirebon and other markets because of a general export boom in this region. However, this is a relatively minor problem and is being overcome as capacity and shipping rates adjust. As with wooden furniture, the rattan furniture boom is creating jobs and raising incomes, not only in Java, but it is also in the rattan collecting and processing areas of Sulawesi and the other outer islands.

For the same reasons, many cash crops, produced largely in the outer islands, are enjoying unprecedented increases in export earnings. These products include cloves, pepper, coffee, rubber and coconut oil. Exports of less obvious products, including even lettuce from Java, are also beginning to be exported.

Since these resource-based products have little or no import content, the net domestic income generated per dollar of exports is much greater than for most manufactured exports. Thus, they have made a substantial contribution to the incomes of a wide variety of producers and of their local communities, especially in the outer islands.

In summary, the crisis and associated policy responses have created many new opportunities for small-scale resource-based exports. The benefits from these opportunities have been greatly enhanced by the abolition of inter-island shipping restrictions and of various marketing monopolies. As a result, considerable prosperity has been created in the traditionally isolated and underprivileged outer islands, as well as in many poorer communities in Java.

There is now general recognition of the importance of exchange rate policies for agriculture and resource-based local industries in Vietnam. The Indonesian example confirms this and illustrates as well the need to accompany this with measures to relieve small and medium businesses of the burdens of formal and informal regulatory constraints, especially at the local and provincial level.

implemented and monitored banking sector reforms. A few key factors are responsible for making problems much worse in Indonesia.

- It is argued by some (see Radelet and Sachs, 1998) that the immediate closure of a number of banks was inappropriate since it triggered a major crisis of public confidence in the banking system. According to this argument, further liquidity injections and overall looser monetary and fiscal policies would have been a preferred alternative. Blame is thrown at the IMF's instinct to fight balance of payments problems through austerity measures even when, as was patently obvious in Indonesia, the problem is not one of fiscal or monetary profligacy. While there certainly was excessive insistence on monetary stringency in Indonesia, there is more room for debate about the appropriateness of seeking speedy solutions to the problem of bank insolvencies.
- The attempt to push through structural reforms in trade, industrial and financial market policies backfired. This is not because the reforms were inappropriate. (See Box 2 on small scale resource-based exports, for instance, to see some of the beneficial impacts of the reforms.) The reason is that the government came to be seen as incapable of and/or uninterested in implementing the reforms. In the early days of the crisis-response program, strong vested interests made a public display of flaunting a number of the important reforms. Prior to that, through many years of experience, investors had learned to appreciate the government's long term deregulation program and its effects in increasing transparency, efficiency and fairness, despite the opposition of strong vested interests. The combination of the regional economic crisis, the apparent lack of commitment of the President to the long term reform program, and subsequent political and social unrest, caused investors (foreign and domestic) to make a fundamental re-evaluation of country risk in Indonesia.
- Falling investor confidence caused further depreciation of the currency. Strong interests who had a reputation for opposing necessary long term reforms were heavily represented in the new cabinet. This called into question the legitimacy of the political regime. The collapsing exchange rate imposed increasing burdens on consumers of basic commodities, aggravated the problems of political legitimacy and ultimately led to widespread, violent and destructive social unrest. This finally led to the fall of the government. Regardless of the legitimacy of the new government, about which there is considerable debate, the sequence of events had caused enormous and long-lasting damage to confidence in Indonesia.

These special factors compounded the crisis of confidence arising from the financial turmoil in the region. It will now take much longer for Indonesia to regain investor confidence. A simple indicator is the response of international buyers and investors in textiles and electronics, who are putting investment and buying plans in Indonesia on hold (or moving permanently offshore), despite the huge cost advantages of sourcing in Indonesia. (See Box 3 on Indonesia's textile and electronics exports.)

### 3. Indonesia's Textile and Electronics Exports: Costs of Social Instability

Indonesia's textile and electronics industries are in danger of succumbing to a crisis of confidence arising from social instability.

*Textiles:* The dollar value of Indonesia's textile and garment exports has been growing at an annual rate of over 12% since the third quarter of 1997. This is very impressive in the face of the economic crisis. This strong performance has been very broadly based across all parts of the textile industry.

Past investments, many of which were aimed largely at the domestic market, have now turned into very successful export activities. Fiber producers, who used to insist on the need for high levels of protection in the domestic market, are now highly competitive exporters and are able to export whatever quantities they produce. This export business is highly profitable. The same is true of yarn and fabric producers. One integrated fiber and yarn producer, for instance, which had only 400 spinning machines in 1985, now has three world scale polyester fiber units, each producing 200 tons per day, and 1100 modern spinning machines. A large part of the yarn they produce and almost all of their fiber is exported. The fiber units are now the lowest cost producers in the world. Another large integrated yarn and fabric producer is exporting 92% of its product, an increase from 60% in 1997. They are producing at full capacity, with total sales up 30% in US dollar terms and 50% in volume since a year ago. They also benefit from access to the lowest cost polyester fiber in the world, i.e. that produced in Indonesia. The local market is highly competitive. Indonesian polyester fiber is currently 12% cheaper than that in Thailand. Local rayon is also the cheapest in the world.

Garments are the most rapidly growing of the textile export sub-sectors. The high labor intensity of garment production makes this sector the most obvious and largest beneficiary of the rupiah depreciation. Especially after the depreciation, but even before, Indonesia has been seen as a highly competitive and reliable source for international garment buyers. While import and export procedures, and parts of the regulatory environment have not been perfect (Sri Lanka, for instance, is generally regarded to have been more successful than Indonesia), its large, relatively inexpensive and high quality labor force is Indonesia's greatest attraction. Indonesia has generally been regarded as having some combination of cost advantage and/or bureaucratic/regulatory reliability over countries like Thailand, Malaysia, China and Vietnam. As other East Asian countries have become more expensive and/or less reliable, Indonesia's attractiveness has increased, and at least some international buyers have long term plans to increase their presence here.

Unfortunately recent policy uncertainties, and the social unrest which culminated in the events of May 1998 had a major impact on the perceptions of international buyers. For complex clothing lines, on-time and coordinated delivery of all items is of paramount importance. Any doubts about the reliability of deliveries from a particular source can lead to speedy and massive relocation of orders. Recent political and social instability has caused considerable uncertainty among buyers about reliability of future deliveries from Indonesia. According to both producers and international buying agents, garment orders have been cut back substantially in recent months. One major buyer has been instructed to reduce his fall orders in Indonesia by over 60% from the same period last year. Producers report that some buyers have pulled out of Indonesia entirely. It will take some time to rebuild confidence of foreign buyers, let alone to convince investors to expand capacity in a sector in which Indonesia has a strong comparative advantage.

Upstream fiber, yarn and fabric producers do not face the same complex coordination problems. Since what they sell are essentially commodities, and they are sold in spot markets rather than on the basis of



advance orders, political risk is much lower. If producers have goods to deliver at the time orders are placed, buyers are happy to do business.

However, recent social instability has had another very serious impact on upstream producers. Prior to May, Indonesia's low costs made it an obvious location for expanded investment. However, the May events have caused a reassessment of future investment plans. One of the fiber and yarn producers referred to above, one of the largest and most profitable in Indonesia, recently announced its intention to purchase, upgrade and expand three polyester fiber plants in Thailand. In light of Indonesia's lower production costs, this would have been unthinkable prior to May.

*Electronics:* Indonesia's electronics exports have been declining in US dollar terms for several years. This is due primarily to two factors. *First*, there have been few new investments in recent years. For a variety of reasons, many of the major international producers have chosen to invest in other countries such as China, Philippines and Mexico. Even Malaysia, Thailand and Singapore, whose labor costs are much higher than Indonesia's, have gained investments in cases where Indonesia might have been an alternative. *Second*, due to depressed world demand and general excess capacity, dollar prices for the types of electronics goods exported from Indonesia have been declining — by about 20% on average over the past two years according to one industry expert.

Nevertheless, Indonesia remains, in principle, a very attractive location for electronics investments, especially in light of the recent currency realignments. As has been the case for several years now, a key factor is getting local export production to a scale at which Indonesia is attractive to investment in "supporting industries". At the moment, despite much lower labor costs, a typical electronics good costs 20% more to produce in Indonesia than in Malaysia. This is because of the heavy localization of supporting industries in Malaysia. If Indonesia were to achieve the same level of local content as Malaysia, costs would be 15-20% percent lower in Indonesia.

International producers recognize the cost advantages of moving production bases to Indonesia. China has been a major disappointment to those who invested heavily there in the mid 1990s. Investors are wary of Vietnam's uncertain and non-transparent regulatory environment. Malaysia is becoming less attractive due to labor shortages. Recognizing this, several investors have been developing major plans for investment in production and supporting industries in Indonesia. One company, which currently exports about \$300-400 million from Indonesia, has plans to increase this to over \$1 billion in the next few years.

Unfortunately, recent instabilities have put such investment plans on hold. As in garments, buyers are very nervous about delivery uncertainties. Local plant managers are having great difficulty convincing headquarters to shift some production from abroad to take advantage of excess capacity created by the collapse of Indonesian domestic demand. According to some firms, investment plans might remain in limbo until the end of 1999. Meanwhile, many sales orders and a number of potential new investments will be placed offshore.

## IMPLICATIONS AND LESSONS FOR VIETNAM

The implications and lessons for Vietnam can be grouped in two categories. The first relates to the mechanisms through which Vietnam is likely to be affected, and the second with recommended policy responses.

### How Will Vietnam be Affected?

The effects of the crisis have already spread widely around the world. Vietnam is being and will continue to be affected. Overall economic growth is falling, and is likely to be no more than 4% this year.<sup>26</sup> An increasing proportion of production is accounted for by goods which are simply being stockpiled. Unemployment is increasing very rapidly — the official unemployment rate in Hanoi is almost 9%, and underemployment is increasing in both urban and rural areas. Export growth is falling. For the first 9 months of this year exports have grown only 4.1%. This is a substantial drop compared with last year's growth of 14%. Traditional exports (rice, garments, footwear, etc.) have all fallen in most recent months. Foreign investment is also falling — FDI approvals in the first 8 months of 1998 are down to \$1.6 billion, compared with \$4.4 billion for all of 1997.<sup>27</sup> Previously-approved FDI projects have been canceled or halted. Actual foreign investment could fall to as little as \$500 million next year.

The picture given by macroeconomic data is confirmed by evidence at the microeconomic level. Textile exports to Asian destinations are falling.<sup>28</sup> A joint venture household electronics producer recently laid off 120 of its 800 workers due to declining demand in the local market and in Japan, its principal export market. Cement and steel factories are accumulating stockpiles of unsold goods (1,000,000 tons of cement and clinker, and 250,000 tons of steel); despite these enormous inventories, production reportedly continues, as if marketing of completed production is of no concern.

There are a number of mechanisms through which the crisis is affecting Vietnam and will continue to do so in the short term and in the long term. They can be divided into those which are based on external disturbances and those whose immediate causes are domestic.

#### *External Causes*

The first type of external transmission mechanism operates through standard income-expenditure linkages. In the short run, Vietnam will be adversely affected by shrinking world demand for its goods and reduced availability of investment funds. The most recent Institute for International Finance estimates suggest that net private international investment available to Asia-Pacific countries this year will be only \$19.4 billion, down from \$59.7 in 1997, and \$161.0

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<sup>26</sup> The forecast of 4% is the most recent provided by the IMF.

<sup>27</sup> Of the approvals this year, \$700 million is accounted for by a single hotel project in Dalat.

<sup>28</sup> Garment export orders from Japan are reported to have fallen by 50% in recent months. One company reports a fall of 70% this year.

billion in 1996. They forecast that only \$23.4 billion will be available in 1999.<sup>29</sup> Even if Vietnam manages to maintain its pre-crisis share of these funds, which will be very difficult without major structural reforms, this will leave a large hole in its external financing needs.

Since Vietnam has been especially dependent on Asian markets and Asian sources of investment funds, the effects might be particularly large.<sup>30</sup> Lack of MFN access to the American market, which at least until now has been the most resilient and dynamic part of the world economy, is especially costly for Vietnam at this time. In more general terms, Vietnam's non-membership in the WTO will continue to restrict her trade options to a much greater extent than most of her ASEAN neighbors, and hence make her a less attractive investment location.

At the same time as Vietnam's markets and sources of investment funds are shrinking, there is increasing competition from ASEAN neighbors who have already begun to make significant adjustments in response to the economic crisis. In the short run, the main effect is through the competitive advantage arising from these countries' recent devaluations.

A longer run, and much more important, competitive effect will arise from the far-reaching structural adjustments being undertaken in neighboring countries. Vietnam's neighbors had already undertaken major liberalization and deregulation programs over the past decade and a half. These programs have had a major beneficial impact on their industrial competitiveness. In all cases, however, significant regulatory and policy barriers remained, due in part to the power of vested interests to block further reforms. The crisis, together with associated political changes, have provided an opportunity to overcome the influence of many of these vested interests and to make new progress in structural and deregulatory reform. Countries that are successful in these reforms will have a major competitive advantage in the future over those that do not. This will pose a new and very important policy challenge to Vietnam, which had already been lagging significantly behind its neighbors in regulatory reform.

As a result of this legacy of past controls, Vietnam has one of the least transparent and highest cost economies in the region. This has steadily reduced its attractiveness to investors, and has seriously distorted investments which have been made by guiding them into capital intensive and uncompetitive upstream sectors, and/or "strategic" sectors already burdened by large excess capacity. As a result of the crisis, investors have become much more risk averse and less tolerant of high cost and non-transparent policy regimes. Without a serious renewal of economic reforms, Vietnam will fall much further behind its ASEAN neighbors.

The second type of external transmission mechanism operates primarily through expectations and investor and buyer confidence, rather than through income-expenditure linkages. The economic crisis in the region and in the world has manifested itself in a collapse in confidence. Once confidence is lost, it is difficult to restore. Not only have investors lost a great deal of confidence in Asia, but their expectations and demands have suddenly increased. Problems that used to be tolerated in times of rapid growth are no longer felt to be tolerable.

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<sup>29</sup> See report in Asian Wall Street Journal, September 30, 1998.

<sup>30</sup> Nearly 70% of Vietnam's FDI comes from East and Southeast Asian countries., and more than 70% of trade is with these countries.

This applies especially to complex, uncertain and non-transparent policy environments. As a result, policy reforms are necessary now, not simply to reduce costs and improve efficiency, but also as a signal to restore confidence in a country's markets and among potential investors.

### *Domestic Causes*

The discussion so far might be interpreted as implying that the main causes of the crisis in Vietnam are external. This is certainly not the case. As already indicated, many of the "external problems" have roots in domestic policy failures.

Furthermore, the domestic economy is riddled with unsustainable contradictions and imbalances. The banking system has a high proportion of non-performing loans (currently estimated to be 20% of all loans). Heavy industry produces large amounts of goods which cannot be sold, while scarce investment resources continue to be wasted in these capital intensive and economically unviable enterprises. The domestic savings rate of 17% is very low, especially in light of the slowdown in foreign resource inflows..

Vietnam has managed to cover up these difficulties for some time already. High growth has provided a temporary respite. The same was true for some time in Thailand and Indonesia. But growth in Vietnam is now slowing down. A steady inflow of foreign funds can also help delay reform. But private inflows to Vietnam are rapidly diminishing. As was seen in Indonesia and Thailand, postponing adjustment will diminish confidence and further diminish the rate of capital inflow. Official flows are still increasing, but it is uncertain whether this will continue. To use funds provided on either a commercial or a non-commercial basis to try to paper over serious structural problems would not be beneficial.

Vietnam's system of capital and currency controls makes it unlikely that the problems will manifest themselves in a massive and sudden short term capital outflow. The controls might also make it possible to deal with some of the problems, for a short period of time, through money-financed government subsidies and expenditures. This is a short term and short-sighted measure which would soon manifest itself in rapid inflation. This would not be economically or socially desirable.

### **Policy Options**

The crisis faces Vietnam with a fundamental choice — whether to continue with its market-based reforms or to return to a state-directed and controlled economy. This is not really a choice at all. Reducing costs and increasing competitiveness of economic activities in this country requires a vigorous continuation of the process of economic reform. Without a renewal of reform, Vietnam will suffocate under the rising costs of its regulatory system. This was true even before the crisis. The crisis makes the task much more urgent.

Whether, to what extent, and at what speed this is possible are political questions. But the economic costs of failing to adjust to current economic circumstances — external and domestic — and of failing to continue with fundamental reform in Vietnam's regulatory environment will be high. One of the most important lessons of the crisis in other countries is that the costs of delay are great. Furthermore, the costs of postponing adjustment will be much greater for a country, like Vietnam, that is further behind to start with.

Carrying out necessary reforms will require overcoming strong vested interests. That increases the difficulty of the task, but it does not make it any less necessary or any less beneficial. Another lesson from past events in Vietnam as well as in many other countries is that crises often weaken the power of vested interests, and, in that sense, can be viewed as a blessing in disguise.

Relatively low rates of domestic savings, together with increasing scarcity of and competition for foreign resources, makes it critical for Vietnam to *improve the mechanisms and institutions which allocate investment resources*. This is a fundamental issue. Investment needs to be made less dependent on government budgets, bank lending and especially state-directed bank lending.<sup>31</sup> Continued reform of incentives provided by trade and industrial policies need to be viewed in this context. Other major issues here include increased transparency of government policies and of their implementation. Dealing effectively with capital market development, incentive reform, and more general governance issues will not only ensure a more rational and productive use of investment resources, but also create an environment that will encourage growth of domestic savings and make Vietnam more attractive to foreign investors. These are essential for improving Vietnam's long run competitiveness

There are many good reasons for increasing transparency, improving information flows, and reducing corruption. One of the most important, in current circumstances, is its role in rebuilding confidence and reducing perceived country risk in Vietnam. As has been mentioned earlier, the economic crisis is largely a crisis of confidence. One result is that investors have become much less tolerant than before of weaknesses in governance — at the national, provincial, local or corporate level. According to the most recent corruption perceptions index published by Transparency International, Vietnam is ranked 74<sup>th</sup> out of 85 — below all other ASEAN countries surveyed except Indonesia (which ranked 80<sup>th</sup>).<sup>32</sup>

## **Specific Recommendations**

### *Tax Reform*

Tax reform is necessary both to increase the efficiency of state revenue collections, and to remove adverse incentives created by the tax system. There is also a pressing need for increased transparency.

At the beginning of 1999 Vietnam will replace its turnover tax with a value-added tax (VAT). Introduction of a VAT was an especially useful part of Indonesia's reform program in the mid 1980s, and it should also be for Vietnam. (See Box 1.) Unfortunately, the VAT that

<b>4. Taxes and Labor Costs in Vietnam</b>
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<sup>31</sup> Recasting the issue of "state enterprise reform" as one of "capital market development" might be especially appropriate in this regard.

<sup>32</sup> Obtained from Transparency International Web Site, September 23, 1998.

Vietnam's greatest resource is its people. The most direct impediment to realizing the potential of this resource is excessive taxes on employment.

Vietnam's income tax rates are among the highest and most progressive in the world. The system comprises a basic income tax, an additional 30% surcharge above a certain income level, and health and social insurance levies on both employers and employees. The marginal income tax rate (including surcharge) is low at low levels of income, but increases very rapidly, and reaches a very high maximum rate of 72% of gross salary. Health and social insurance contributions magnify this. Adding these charges makes marginal rates higher at all levels of income, but especially at low incomes. The maximum, over 81%, occurs at incomes over 800,000VND per month.<sup>33</sup>

The following are some of the implications of this marginal tax rate structure.

- It increases the cost of hiring labor in Vietnam. To hire a worker willing to work for 173,000 VND per month, an employer must pay 215,000 VND. At higher income levels, the differential gets much larger. To hire a worker willing to work for 1,840,000 VND per month costs the employer 7,281,000 VND.
- High marginal tax rates encourage non-compliance and collusion between tax payers and tax collectors. Many tax payers stay out of the tax net or pay far less than their legal obligations; and negotiations enrich both tax officials and tax payers at the expense of the state budget.
- Systemic non-compliance and tax negotiations create uncertainty and penalize companies and tax payers who 'play by the rules'.

The tax structure does not impose excessive burdens on low-skill, minimum wage workers at the moment. This will change as wage levels rise. Even at current wage levels, however, the system imposes very high costs on workers or firms that upgrade skills through training and further education. With marginal tax rates of 81%, a firm must pay 2,632,000 VND in additional employment costs to a worker whose training has raised his productivity (in monthly terms) by 500,000VND. This is a very heavy penalty on human capital enhancement.

A purpose of a progressive tax system is to achieve social equity. However, excessively progressive rates impose high costs on human skill development, contradicting a principal human development goal of the government. They also encourage non-compliance and corruption. And they penalize firms that want to make use of and reward Vietnam's most abundant and important resource, its people.

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<sup>33</sup> This second set of marginal rates is calculated relative to total employer cost rather than gross salary.

Vietnam currently plans to put in place is deficient in many important respects, even in comparison with those in other ASEAN countries.

The most critical problems are the narrowness of its coverage, largely as a result of generous use of exemptions, and the multiplicity of rates. In addition, the government has indicated a propensity to use an *ad hoc* approach to dealing with requests by tax payers for special treatment. This includes a variety of hidden forms of import protection. Any of these features alone would be a serious weakness. Together, they threaten failure of the reform.

The system will produce arbitrary differentials in incentives across activities and tax payers; it will lack transparency; it will be difficult, if not impossible to administer; and it will foster a continuation of non-compliance, negotiated tax payments and administrative corruption. Major improvements in the VAT are required in order for it to become a useful part of the government's long term reform program.

Vietnam's income tax is also out of tune with the kinds of reforms that are necessary to improve Vietnam's competitiveness. High and steeply increasing marginal rates penalize savings, discourage compliance, and, more importantly, and tax the use and improvement of Vietnam's most important resource, its labor force. (See Box 4 on taxes and labor costs.)

#### *AFTA, APEC and WTO*

Vietnam's national interest will be best served by meeting AFTA, APEC or the WTO requirements as quickly as possible. Liberalization of the trade regime must be a principal element of any Vietnamese strategy to deal with economic crisis and to increase the competitiveness of domestic producers.<sup>34</sup> In addition, membership in WTO and access to MFN treatment in the US market are especially important in the face of the crisis.

#### *Non-Tariff Trade Measures*

Non-tariff import and export restrictions are inefficient, usually unfair, and almost always non-transparent in their administration. This is certainly true in Vietnam. An early and very important part of the trade policy reform process in other ASEAN countries was to identify and eliminate non-tariff measures. Vietnam is required to do so under its AFTA commitments; it will need to do so to gain entry to the WTO.

There has been some important progress recently. Decision 55 of the Prime Minister (March 3, 1998) and Decree 57 of the Government (July 31, 1998) have removed a number of restrictive export and import licensing restrictions. Many firms are hoping that this will significantly simplify and lower the cost of importing and exporting. As is often the case with major deregulatory reforms, however, the success of these measures will depend very much on details of implementation. Importers have observed that, although Decree 57 was to take effect on September 1, implementing circulars have not been completed or made generally available to importers and exporters. Importers' recent experience with Customs suggests that it will be some time before tangible benefits are felt.

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<sup>34</sup> See Flatters (1997) for further elaboration.

A major difficulty with both of these Decisions is that they tie import procedures to business licensing regulations — firms are permitted to export or import goods *associated with the business activities for which they are registered*. As is well known, the Vietnamese business registration system is far from transparent. It is certainly not defined in a way that corresponds to standard import and export requirements. To tie an importing or exporting law to this business registration system is to invite arbitrariness in its implementation.

A simple solution to this problem is to allow *any* domestically registered company or business to import or export *any* good. In addition to drastically simplifying the procedures, it would allow the development of specialized trading companies who would be free to move into any importing or exporting activity for which there was a market need. This could be accomplished by having the Ministry of Trade create a simple “General Import License”. Any company or individual would be able to obtain such a license by simple registration at the Ministry of Trade. The licenses would be permanent. They would not be restricted in any way with respect to the goods to which they applied. Holders of general import licenses would be permitted to import any commodities which are not regulated by specific, legislatively defined restrictions.

Decision 55 and Decree 57 do not begin to address non-tariff restrictions in many other forms. For instance, they do not alter the power of government departments to impose import or export quotas. And they do not eliminate in any way the complex set of formal and informal rules and procedures related to use and disposition of foreign exchange for trade purposes.

While there has been recent progress, there remains much to be done in eliminating non-tariff import and export measures. This needs to be taken on as an urgent part of the government’s policy reform program.

### *Customs Reform*

The experience of other ASEAN countries shows that inefficient and/or corrupt customs systems can be a major cause of a “high cost economy”. Improvements in customs operations reduce importing costs and increase international competitiveness. Industry interviews found customs to be one of the most pervasive sources of cost-increasing government policy administration. Vietnam is not unique in this regard among other countries at a similar level of development; but this need not be the case.

There are many ways to increase the efficiency of customs. The first is to simplify and increase the transparency of all import rules, taxes and procedures. (See Box 5 on smuggling.) This would include reducing the number of import tariff rate categories, eliminating high rates, dispensing with tariff distinctions based on end uses or end users of imported goods, ensuring that all import rules related to the import and export of specific goods specify the HS codes of the goods, and eliminating complex rules and rate structures based on degree of assembly of imports. Non-tariff import measures would be largely eliminated.

<b>5. Stop Subsidizing Smugglers</b>
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A common complaint of Vietnamese producers is their inability to compete against smuggled imports. Producers of garments, bicycles and electronic goods, for instance, are protected by import tariffs ranging from 35 to 60%, as well as by import bans, quotas and other non-tariff import restrictions. These measures appear not to be working. Further increases in tariffs, and new bans are consequently being requested. They are sometimes granted, but they do not work.

Last year the government implemented a system of customs stamps to certify that goods were legally imported. Bicycle producers report that sales of domestic bicycles temporarily increased, but the market soon returned to normal. Prices of smuggled bicycles have increased by no more than the rate of depreciation of the VND over the past year. Electronics producers provide the same kinds of reports — the stamping system caught only a small portion of the imported goods, and has had no significant effect on the local market.

These stories indicate that high levels of import protection do not have the intended effect. Why? The reason is that, by creating large cross-border price differentials, their main effect is to *subsidize* smuggling. Incidental effects are to reduce government revenues and supplement the incomes of a few government officials who collude with smugglers.

Vietnam has long and porous borders. The only way to stop smuggling is to reduce the incentive to engage in this business. The most effective way to stop subsidizing smugglers is to reduce import duties and eliminate other import restrictions. An import tariff of 10% would remove the incentive to smuggle bicycles and most electronics goods. It would probably generate more government revenue than a tariff of 40% or 60%. If accompanied by reductions in tariffs and other import restrictions on industrial raw materials, it would provide more net protection to producers of bicycles and electronics goods than they receive at present.

Unnecessary and/or counter-productive procedures, such as inspection of all export shipments, should be eliminated.<sup>35</sup> Commonly used valuation systems based on actual market and invoice values should be adopted, as Vietnam is committed to doing under AFTA and will also be required to do under the WTO. More generally, there needs to be a shift from physical control and 100% inspection to increased use of document-based procedures and proven methods of risk analysis. This is similar to the systems employed in administering value-added taxes.

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<sup>35</sup> Under current procedures, Customs is apparently required, or at least has the authority, to inspect all export shipments. For example, to export a container of ordinary clay tiles requires a full customs inspection. The official charge for this inspection is 60,000 VND. There is an additional unofficial charge of 300,000 VND, 5 times the amount received by the government budget. These amounts do not include the time and other costs to the exporter of arranging and waiting for the inspection. This system serves no purpose and is a significant tax on exports.

### *Industrial Zones*

Development of industrial and export processing zones is one of Vietnam's biggest growth industries. Vietnam already has 57 licensed industrial zones. As in many other rapidly growing sectors in Vietnam, there is considerable excess capacity. No more than 20% of the capacity of currently completed zones is filled. Despite this, there are grand plans for future expansion. The latest proposals include developing a number of "mega-zones" in principal industrial development areas of the country, and expanding their mandate to include schools, hospitals and other social infrastructure.

The need for government involvement in the promotion and development of industrial zones arises from the failure of other government policies. Such failures include excessive or inefficiently administered income and sales taxes, high taxes and restrictive procedures for imports and exports, inadequate provision or high costs of infrastructure and basic public services, and inflexible and inefficient land laws. In short, they are necessary only because of burdensome and non-transparent regulatory and tax systems and/or other problems in provision of government services.

Experience in many other developing countries suggests that industrial zone authorities are at least as likely as other agencies to fall prey to the same pervasive bad governance practices. At best, industrial zones can provide some small assistance in overcoming the costs of other more basic problems. Export processing zones, for instance, become part of a regime of "export oriented protectionism" which, as is illustrated by Indonesia and Thailand, is a relatively short-sighted industrial development strategy. More commonly, industrial zones become high cost locations, and offer few, if any, offsetting benefits in service provision. The costs of industrial zones are generally very high, and almost always greatly exceed any benefits they provide. Enormous excess capacity suggests that this is the case in Vietnam.

Regardless of whether zones can be efficiently run and make a positive net contribution to the economy, they are, at best, a very weak "second best" solution. The most effective long run policy is to deal directly with the failures of the tax and regulatory regimes and other social systems that make industrial zones necessary. The government of Vietnam should concentrate on solving these problems and not waste further efforts or resources on expansion of industrial zones.

### *Textile Export Quotas*

Many of Vietnam's textile exports to Europe are subject to EU import quotas. To comply with these requirements Vietnam must administer a system of export quotas. The same will be true if and when Vietnam gets access to MFN treatment in the US.

To get the maximum domestic value from import allocations in foreign markets, the export quotas should go to their highest value uses. The best way to ensure this is through some kind of market or quasi-market allocation.

Vietnam's system of quota allocation is not transparent, flexible or efficient. Quotas are not officially allowed to be traded or sold. They are initially allocated in a fashion which seems to strongly favor state firms at the national and provincial level. In fact, quotas are traded

unofficially. However, since the system is not open, it does not operate very efficiently. The result is that quota is often left unused; and the quota that is used does not go to the highest valued uses. The system discourages entry of efficient new firms, especially private firms.

The government has recently announced an experiment under which some of the EU textile quota will be auctioned. This is a major improvement. It should be followed up by the development of an open and legal system for trading of textile quotas. This will be resisted by inefficient state firms and quota administrators who benefit from the current system. But it will contribute to the growth, in quantity and value, of one of Vietnam's most important and most labor-intensive manufacturing export sectors.

### *Infant Industry Protection*

At the current level of Vietnam's industrialization, it is not unusual to hear pleas from ministries, SOEs, joint ventures, and foreign investors for the government to provide special import protection to new manufacturing industries, especially producers of "essential" goods. These might be industrial raw materials, "strategic products" such as motor vehicles, or even basic consumer goods such as medicines. In addition to the essential nature of such goods, it is often claimed that these industries developed in other countries only because of infant industry protection of the sort being sought in Vietnam.

It is true that other countries have sometimes provided such protection. This is not a reason for Vietnam to make the same mistake. Infant industry protection is often not necessary. When it is necessary, it is usually not appropriate. The cost of protection of steel, petrochemicals and pharmaceuticals is borne in the form of higher costs for downstream, labor intensive industries and/or poor consumers. (See Box 6 on supplying essential goods.)

Vietnam should strongly resist pleas for infant industry protection.

### *Entry and Exit of Firms*

Entry of firms into new or existing industries is constrained by a complex system of formal and informal constraints. The brunt of these measures is borne by small and medium enterprises, and by the private sector. Business licensing policies of a number of national level ministries as well as provincial and local governments are possibly the most important and pervasive burden in this regard. But a wide range of other policies, such as export and import licenses and quotas, bank lending policies, and limitations on access to foreign exchange also act as barriers to entry.

There is growing concern in Vietnam about the plight of small and medium enterprises, in both the urban and rural sectors. Such enterprises can be major vehicles of economic and social progress. There is, in fact, a general need to remove burdens which artificially impede the development of the private sector, small, medium or large; domestic or foreign. Discriminatory administration of any kind of government policy, from tax collection to quota allocations, access to land, and the implementation of import procedures can have this effect.

## 6. Supplying “Essential Goods” (And Killing the Beneficiaries)

Many goods are widely viewed as “essential”. Steel and petrochemical products, such as plastic raw materials, are essential for industrial production. Basic medicines, such as antibiotics, are essential for public health. Confusion sometimes arises between the need to make such goods available at the lowest possible cost and making them available from local sources of supply. There need not be a contradiction between these two goals; but there often is. Ignoring the distinction can be costly.

Indonesian and Thai users of industrial raw materials (i.e. producers of almost all manufactured goods) have borne very high costs due to protection of domestic upstream plastics and steel industries. Since the onslaught of the crisis there has been considerable pressure from downstream industries to reduce this protection, in order to increase the competitiveness of the downstream producers. Indonesia has already announced substantial reductions in protection of plastic raw materials.

Vietnam’s main users of steel and plastic raw materials are labor intensive industries; many are small and medium firms, and most produce essential goods for the poor (e.g. sandals, buckets, bicycles).

The investors in Vietnam’s first upstream PVC producer (a large multinational company in a joint venture with a large state-owned enterprise (SOE)) have put intense pressure on the government to protect them in the local market. Due to the effects this would have on downstream industry and on poor consumers, the government has resisted. However, it has granted an import tariff of 3% and has recently been given a further import surcharge of 5%. They are still pressing for more protection.

Vietnam’s domestic steel industry is protected by a wide range of quotas, licenses, bans and other NTBs. The rules are constantly changing. Downstream producers of bicycles and basic metal furniture have to deal with the confusion and cost-raising effects of these measures on a daily basis, making it very difficult to compete and provide low cost products in the local market.

Plastics and steel illustrate how local provision of essential industrial raw materials, when done under the umbrella of import protection, hurts rather than helps the downstream users of these products.

Amoxicillin and ampicillin are basic antibiotics. In the mid 1980s, a multinational pharmaceutical company persuaded the government of Indonesia to provide it with import protection in order to produce the ingredients for these essential medicines domestically. The government imposed an import ban; the ban was later replaced by a tariff and import surcharge totaling 50%. Not surprisingly the result was a large increase in the domestic price of this essential medicine — a cruel penalty to impose on the sick. As a result, the protection was gradually reduced, until the total tariff burden reached 10% in 1998. Despite the import protection provided by this tariff and even more so by the recent depreciation of the rupiah, the producer made a formal complaint to the government that antibiotics were being imported into Indonesia at “dumping prices”. Granting the company’s request for further protection would be major blow to consumers who were already suffering from the impacts of the depreciation and the crisis.

A Korean joint venture is producing amoxicillin and ampicillin in Vietnam. It has been granted protection in the form of an import duty of 7%. It is pleading for an increase in this tariff. As was the case in Indonesia, local production of essential medicines hurts rather than benefits local users. Local supply of essential goods can kill the intended beneficiaries.

The government should continue and expand existing programs to identify, examine and remove all unnecessary formal and informal barriers to development of the private sector. New

incentive systems, subsidies or other special privileges are not required. In all likelihood they would only add to the complexity and weight of an already intractable regulatory system. A serious effort to remove the multitude of existing barriers will suffice.

The recent experience of Vietnam's ASEAN neighbors suggests that, just as important as removing barriers to entry of new businesses are programs and policies which facilitate exit and transfer of assets from existing to new owners and managers. Bankruptcy and foreclosure laws are intended to accomplish this through an appropriate balancing of the interests of creditors and debtors, bearing in mind the need to avoid waste by tying up potentially productive assets in unproductive uses. Banking systems and financial markets cannot operate properly in the absence of such laws.

Development of appropriate policies to facilitate both entry and exit of private and state enterprises should be another government priority to increase the competitiveness of the Vietnamese economy.

### *Capital Controls*

The use of capital controls has become a hot topic as a result of the crisis. There are several important issues.

The first issue, a long term one, relates to short term flows as a source of financial and economic instability. The large build up of short term foreign debt liabilities in Thailand and Indonesia was an important trigger for the crisis. The fact that these liabilities came to exceed the countries' foreign exchange reserves, together with weaknesses in financial systems and asset bubbles in a number of major sectors created an unstable situation that was especially vulnerable to a collapse of confidence and resulting financial panic.

It is important to observe, however, that when the panic did strike, it was not just the short term debt liabilities that were at risk. All holders of domestic currency denominated liquid assets had a strong incentive to convert them to foreign currencies; many did so. And equally importantly, long term foreign lenders and investors held back future investments. Policy-makers in the affected countries devoted considerable effort to encouraging foreign lenders to roll over short term loans. This was relatively successful.<sup>36</sup> Despite this success in stemming the outflow of short term foreign credit, there still was a massive change in net capital inflows. The net reduction in private capital inflows to the five most affected economies was approximately \$100 billion between 1996 and 1997.

Are capital controls an effective and useful tool to deal with this instability problem? Chile has done this with some success. One lesson from Chile is the importance of trying to operate on the inflows and not outflows. Furthermore, it is necessary, not to try prevent all capital inflows, but rather to try to find a way to put "speed bumps" in the way of short term

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<sup>36</sup> A major reason, of course, is that after the large exchange rate depreciations, many borrowers were incapable of paying off their loans anyway. Calling them would have led to significant capital losses by the lenders, and, in the face of weak and ineffective bankruptcy and foreclosure laws, very high transactions costs in reaching a final settlement.

flows, while at the same time trying not to destroy confidence of lenders and investors and discourage long term investment in the country. This is a very difficult, if not impossible balance to achieve. Even Chile has found that a longer term consequence of its controls has been to discourage and lose the benefits of long term capital flows.

Capital controls are a costly means of postponing more fundamental and direct approaches to financial sector management. Of course, no developing country can, through its own policies, eliminate “herd instincts” and other long term problems in the behavior of foreign lenders and investors. Globalization and increased capital mobility impose much greater burdens than before on domestic institutions for risk management.<sup>37</sup> The result is that it is now much more important than ever before for developing countries to ensure integrity, transparency and proper regulation and monitoring of their own financial systems. This is certainly one of the important lessons from Indonesia and Thailand.

In Vietnam, not even central government ministries have accurate information about the financial health of major state owned enterprises and groups of enterprises. It is very difficult for banks (domestic or foreign) or other investors to behave rationally in such an environment. Solving these problems is essential to ensuring long term financial stability. Before Vietnam can even think about taking full advantage of domestic savings, let alone foreign capital, it is necessary to clean up the regulation of its own corporate governance and financial market supervisory systems.

Unlike Indonesia and Thailand, Vietnam is not in danger of suffering from massive inflows or outflows of short term capital triggered by underlying structural and financial problems. Instead, Vietnam will slowly suffocate under the costs of a financial and regulatory system that discourages savings and misallocates scarce investment resources. Capital controls are a means of hiding from and delaying badly needed domestic responses to these problems. Before loosening capital controls too quickly, however, serious and major financial and capital market reforms are urgently required.

The second issue in current debates about capital controls is that capital mobility appears to have diminished the fiscal and monetary independence of domestic authorities. In order to stop their currencies from collapsing further, Indonesia and Thailand maintained very tight monetary policies. Any loosening of these policies and consequent reductions in interest rates would cause further capital outflows and currency depreciations. The affected countries seem to have been stuck between two equally unappealing alternatives — further exchange rate collapse, leading to escalating costs of basic goods and of foreign denominated debts, and high interest rates which would stunt growth, and aggravate non-performing loan problems in the financial system.

Paul Krugman recently (and reluctantly) advocated the use of controls as a means of breaking this link between monetary policies and the exchange rate.<sup>38</sup> The Government of Malaysia chose very soon thereafter to adopt such policies. The main elements of the program

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<sup>37</sup> See Rudi Dornbusch (1998).

<sup>38</sup> See Krugman (1998a).

were an appreciation and fixing of the exchange rate, and imposition of a wide range of controls on sales of foreign exchange and on outflows of capital.

Vietnam's pervasive system of foreign exchange controls means that this is certainly not an issue here.

It is significant that Krugman wrote an "open letter" to Malaysia's Prime Minister about the potential dangers of following this strategy.<sup>39</sup> He warned Malaysia not to use the newly-created insulation from world markets to delay necessary structural, banking and other reforms. He also stressed that *long term* use of controls imposes high costs on the economy, and these costs increase the longer the controls are in place. This is a lesson that is obvious, although maybe not sufficiently recognized, in Vietnam.

As is well-known in Vietnam, major practical problems arise in implementation of capital controls.<sup>40</sup> To avoid circumvention of regulations usually requires a vast network of controls and restrictions which unintentionally but inevitably interfere with the efficient operation of many important parts of the real economy. For instance, to prevent under- and over- invoicing of imports and exports it is necessary to impose foreign exchange controls on ordinary import and export trade, and to engage in costly and burdensome direct monitoring and controls of exports. These are major barriers to trade. Vietnam has considerable direct experience in this regard. The unintended indirect costs of capital flows are very large.

In the early, "denial stages" of Thailand's response to its financial crisis, the government tried to insulate its financial markets through capital controls which cut off access to offshore markets for the baht. As we have seen, this did not succeed; it only delayed and aggravated the underlying problems, and significantly increased the ultimate costs of dealing with the crisis.

An early measure of Thailand's new government in the second half of 1997 was to eliminate the capital controls imposed by the previous government. This elimination of capital controls turned out to be an effective means of beginning to restore investor confidence in the new policy regime.

After implementing a wide range of other structural adjustment policies, Thailand has recently engaged in a significant loosening of its monetary policies. This has led to significant reductions in interest rates, with no adverse impacts on the foreign exchange value of the baht. In most recent days, in fact, the baht has appreciated by 3 to 5% against the dollar. Thailand has shown that prudent structural reforms and open policy management are an alternative to the Malaysian approach.

The main lesson for Vietnam from recent debates about capital controls is that such controls are very costly, and that their costs increase with the length of time they are in place.

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<sup>39</sup> See Paul Krugman (1998b).

<sup>40</sup> Recall, for instance, how Indonesia's controls on international borrowing by banks were circumvented through direct borrowing by corporations (often with the assistance of the banks).

Their main value is in providing some immediate “breathing space” to avoid foreign market “discipline” arising from bad domestic policies. The breathing space provided by Vietnam’s controls is rapidly running out. Without reforms, Vietnam will slowly suffocate, not due to any outside forces, but because of the weight of its own regulatory environment.

## SUMMARY AND CONCLUSION

Vietnam’s ASEAN neighbors have already borne most of the brunt of the economic storm that hit them last year. The storm was triggered by a confidence-based collapse of capital inflows, whose immediate cause was an excessive build up of short foreign liabilities in the preceding years. However, the deeper reasons for the crisis of confidence were domestic policy failures, critical gaps in information available to market participants and to policy makers, and denial and delay in responding to danger signals when they first appeared.

Indonesia, Malaysia, and Thailand have already made many policy adjustments to deal with the crisis and to prepare for their long term recovery. Some have been more successful than others. But they all started from a better position than Vietnam, and will emerge from the crisis with a far superior policy framework than they had beforehand.

One effect of Vietnam’s legacy of economic controls and regulation has been to postpone, but certainly not prevent the crisis from striking here. The time for delay is over. The controls and regulations that provided some initial protection from the crisis have also made Vietnam one of the highest cost economies in the region. This will make it much more difficult for Vietnam than for any of its neighbors to adapt to and recover from the crisis.

Without a significant rejuvenation and re-invigoration of *doi moi*, Vietnam will suffocate and fall further behind the rest of the region. Economic gains of recent years will be dissipated, with serious implications for the people of Vietnam, and especially for the workers and the poor. Long run economic, social and political stability will become increasingly difficult to sustain.

Rejuvenating *doi moi* does not mean removing the state from the economy. It does require, however, massive reforms in the way in which the state is involved. The legacy of previous controls is a regime that is excessively complex and non-transparent. Many existing rules are inconsistent with each other and with achieving the government’s social and economic goals. Many are unnecessary. At the same time, basic information and necessary regulation are often missing.

A fundamental weakness lies in inefficiencies in the mobilization of savings and in the allocation of investment. These deficiencies arise from absence of information, underdevelopment of capital market institutions, and grave weaknesses in financial and corporate governance.

The report provides policy recommendations in a number of specific areas.

- *Tax Reform:* Replacement of the turnover tax with a value-added tax (VAT) in 1999 is an excellent reform, in principle. However the proposed law, together with the government’s cavalier and *ad hoc* way of granting special privileges “on request” will destroy most of the benefits of the reform. The income tax law, especially the confiscatory marginal rate structure, is also in urgent need of reform and simplification.



- *AFTA, APEC and WTO:* Vietnam should strive to meet AFTA, APEC and WTO requirements as quickly as possible, on a unilateral, MFN basis. Liberalization of the trade regime must be a central to Vietnam's strategy to deal with economic crisis and to increase the competitiveness of domestic producers.
- *Non-Tariff Trade Measures:* All non-tariff import and export measures need to be identified and, except for those necessary for health, safety or national security reasons, eliminated. Recent measures announced under Decision 55 and Decree 57 are important first steps. However to achieve even their limited goals requires more rigorous and transparent implementation. They also need to be broadened by permitting all licensed general importers and exporters to import or export any goods whose trade is not explicitly regulated under some other decrees or regulations.
- *Customs Reform:* Inefficiency and corruption in import and export procedures is a major cause of Vietnam's "high cost economy". The best way to begin increasing the efficiency and transparency of customs is to simplify and increase the transparency of all import rules, taxes and procedures. General trade policy reform is highly complementary with the legal and administrative reforms that are required in customs.
- *Industrial Zones:* Vietnam's industrial zones have enormous excess capacity, and yet they are still expanding. At best, such zones are a very poor "second best" solution to deeper underlying regulatory problems in the economy. Vietnam should focus directly on the failures of the tax and regulatory regimes and other social systems that make industrial zones necessary. It should not waste further effort or resources on expansion of industrial zones.
- *Textile Export Quotas:* Vietnam's textile export quotas are non-transparent, inflexible and inefficient. Initial quota allocations strongly favor established state firms. This discourages entry of efficient new firms, especially private ones. Unofficial systems for trading quota are not open, and do not operate efficiently. As a result, quota is often under utilized, and does not go the highest valued uses. In order to promote the growth of one of Vietnam's most important labor-intensive manufacturing exports, the government must develop an open and legal system for trading textile quotas.
- *Infant Industry Protection:* Vietnam's ministries, SOEs, joint ventures, and foreign investors often request special import protection for new manufacturing industries, especially "infant industry" producers of "essential" goods. Infant industry protection is often not necessary. When it is necessary, it is usually not appropriate — the economic costs far outweigh any benefits. The cost of protecting steel, petrochemicals and pharmaceuticals are large and are borne by downstream, labor intensive industries and/or poor consumers. Vietnam should strongly resist pleas for infant industry protection.
- *Entry and Exit of Firms:* Vietnam's policy regime imposes numerous formal and informal barriers to the entry of new firms, especially small and medium ones. These barriers need to be identified and removed. Similarly, as the recent experience of Vietnam's ASEAN neighbors shows, inadequate bankruptcy and foreclosure laws, as well as general government reluctance to facilitate change, impede industrial adjustment

and waste scarce human and physical capital. Vietnam needs to improve the regulatory environment to facilitate both entry and exit of firms.

- *Capital Controls:* The main lesson for Vietnam from recent debates about capital controls is that such controls are very costly, and that the costs increase with the length of time they are in place. Their main value is in providing some immediate “breathing space” to avoid foreign market “discipline” arising from bad domestic policies. The breathing space provided by Vietnam’s controls is rapidly running out. Without reforms, Vietnam will slowly suffocate, not due to any outside forces, but because of the weight of its own regulatory environment.

Accomplishing the necessary reforms will require a policy environment that is open and which accommodates and encourages change. The recent experience of Vietnam’s ASEAN neighbors shows the economic dangers of becoming beholden to entrenched vested interests. The special characteristics of the Vietnamese system, with the emphasis on the “central role of state-owned enterprises” and the strong links among these enterprises, central ministries and major political interests are a potent barrier to change. This need not be the case, but the potential is very great. Developing procedures and institutions that promote change might be the biggest challenge facing Vietnam in dealing with the economic crisis. Hopefully the crisis can become an opportunity to meet this challenge, and to fulfill the promise of *doi moi*.

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