reforms of the mid-1980s initiated the process of transforming the economy from central planning to market regulation.

The experience of countries in transition over the last decade seems to indicate that the policy *not* to follow is rapid trade liberalization and deregulation of internal markets. The first prompts a sudden increase in imports before export production can respond to relative price changes. The second provokes a wave of speculative activity, since making profit from the circulation of commodities requires little change in the relations of production; indeed, speculative activity is dramatically enhanced by the inability of the real economy to respond to price changes.

One policy option available to the Vietnamese government for the future would be to pursue the goals of internal and external balance within the framework of a managed exchange rate. Fiscal expansion, primarily in the form of state investment, would be used to keep the economy close to full capacity, with investment progressively expanding capacity over time. This fiscal policy would be consistent with the country's desperate need to improve infrastructure. At the same time, the exchange rate could be consciously managed to maintain export competitiveness and to counteract currency appreciation resulting from the anticipated boom in petroleum and natural gas exports and their associated direct investment inflows. If the experience of countries with natural resource booms teaches anything, it is that exchange rate determination should not be left to international currency markets. This combination of active fiscal policy, accommodating monetary policy and a managed exchange rate is one that some of Viet Nam's neighbours in East and South-East Asia have followed with great success. It also appears *de facto*, to be the course chosen by the Vietnamese authorities.

Notes

1. China experienced rapid growth in the 1980s and early 1990s during a process of economic reform. However, in terms of market liberalization the policy shift in China was considerably less comprehensive than in Viet Nam. For the purposes of this chapter, China does not fall into the category of a country in transition, but rather a country undergoing major, though selective, introduction of the market mechanism.
2. The Vietnamese transition has also been considerably smoother than that experienced by other low-income countries whose governments defined their economic policy in terms of central planning: Ethiopia, Angola, Mozambique, Guinea-Bissau, Laos and Cambodia. However, comparison is not appropriate, for in each case except Laos the transition was accompanied by major armed conflicts. Further, some of the countries pursued central planning more in form than in practice.
3. If there is no private market for bonds, thus the entire deficit is monetized, then the former implies the latter.
4. This distinction is made in Vylder and A. Fforde (1988) and discussed in Irvin (1994).
5. The system of interventions is briefly described in World Bank (1993, p. 130).
6. This is the title of World Bank working paper on Viet Nam by Leipziger (1992).

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programme of 1989, Viet Nam's GDP growth rate was quite high for a country in transition. At an average of 5.2 per cent per annum during 1985–9, national income increased significantly faster than population growth. This statistic is important because stabilization is considerably easier to achieve when growth performance is strong. Secondly, the stabilization period, 1989–93, did not result in a large reduction in the fiscal deficit compared to the previous four years. During 1989–91 the fiscal deficit was a higher proportion of GDP than during 1986–8, yet the rate of inflation fell dramatically: for 1986–8 inflation averaged over 350 per cent per annum; and for 1989–91 the average was less than 40 per cent.

The trade account provides a more convincing explanation of the successful stabilization than does the fiscal deficit. In Table 6.1 we see that during 1985–8 the trade deficit averaged almost 100 per cent of exports (imports were double exports), then for 1990–2 fell to an average of less than 3 per cent of exports (and less than 2 per cent of GDP). Table 6.2 shows that the trade deficit was virtually eliminated by the dramatic increases in exports of rice and petroleum, both of which were zero in 1985–6. The expansion of petroleum exports can he interpreted as good luck; however, the phenomenal

Table 6.2 Viet Nam's foreign trade, 1985–92 (exports and imports in US$ millions)

Year	Total exports (1)	Percent convert (2)	X–M (3)	Rice exports (4)	Oil exports (5)	(4) + (5)/(1)
1985	497	68	–406	0	0	0
1986	494	62	–627	0	0	0
1987	610	71	–574	0	30	7.0
1988	733	63	–679	0	79	17.0
1989	1 320	74	–350	316	200	52.8
1990	1 731	73	–41	272	390	52.7
1991	2 042	98	–63	225	581	40.0
1992	2 475	100	–60	300	756	48.9
1993	2 850	100	–205	363	844	42.4
1994	3 600	100	–900	429	866	36.0
1995 (to August)	3 086	100	–554	400	924	42.9

Notes:
1. X – M = trade deficit
2. Percent convert = percentage of exports in convertible currency

Source: World Bank (1993, pp. 239–40); Tran Van Hoe (1996, p. 15).

increase in rice exports, from zero in 1988 to over US$400 million in 1992, occurred as a result of government policy.[5]

On the basis of these tables, Viet Nam's success in transition can be explained as a process of export-led stabilization. Faced with an unsustainable balance of payments position in the mid-1980s, the government embarked upon a policy that had two aspects: institutional reform to make the economy responsive to standard macroeconomic instruments in the medium term, and emergency measures to increase exports to stabilize the economy in the short term. Expansion of petroleum exports would not have been sufficient, in itself, to achieve external balance; nor could rice exports alone have done this. But the combination of the two, along with capital inflows, stabilized the exchange rate by 1992. The capital flows themselves were in part the result of successful stabilization with growth. In the subsequent two years the *dong* appreciated considerably, dropping from a high of around 13 000 to the dollar to below 11 000. Whether or not this appreciation might represent an early symptom of the 'Dutch Disease' is beyond the scope of this chapter. The importance of exchange rate movements for stabilization was that they made the task of controlling inflation an easy one. Once the economy entered into an export-led stabilization process, it was possible for the authorities to maintain a relatively expansionary monetary and fiscal policy.

Conclusion

The standard stabilization package, implemented with little success in the transitional economies of Europe, calls for demand reduction through restrictive monetary and fiscal policy. This was not the policy implemented in Viet Nam. On the contrary, economic management in Viet Nam placed growth as the first priority. By maintaining, then increasing, the growth rate through export expansion, the government was able to stabilize the exchange rate and bring inflation under control. The circumstances of each country in transition are different, so it is dangerous to attempt to draw general lessons from the experience of one country. However, the success of Viet Nam can he placed in a wider context. First, considerable accumulated evidence from IMF programmes over several decades indicates that balance of payments adjustment and the reduction of inflation are more easily achieved in a growing economy than through restriction of demand (Pastor, 1987). Secondly, it seems obvious that institutional reforms aimed at creating markets and linking nominal to real variables should precede stabilization measures. The process of transition is not one of 'awakening markets',[6] but rather of constructing the institutional mechanisms by which producers can respond to policy measures. In this context it is a misinterpretation to refer to the pre-1989 reforms in Viet Nam as a 'half-hearted attempt' (Leipziger, 1992, p. 1); on the contrary, the

exchange rate. In Viet Nam before the 1990s this was not the case. Prior to enterprise liberalization and deregulation of foreign transactions, investment and export decisions derived from central planning. As a result, the goods market (IS) and BP (external flows) curves were virtually vertical and the money market (LM) curve virtually horizontal. A sustainable balance of payments position was maintained through administrative action to control imports and direct enterprises to export. The economic reforms of *Doi Moi* can he interpreted as permitting enterprise initiative to respond to relative price movements. In order to develop a new macroeconomic policy consistent with the *Doi Moi* reforms, the problem of the Vietnamese government was not to 'get prices right', but, as pointed out by de Vylder and Fforde (1988), to 'make prices matter'.[4] The necessary condition for implementing policies for external and internal balance using market instruments was the prior reform of the production and allocation system.

Only by the mid-1990s were these reforms sufficiently advanced to allow for a meaningful stabilization policy based upon the principles of government intervention in a market economy. Perhaps by 1992 or 1993 the government could begin to apply the lessons of standard macroeconomic theory to its policy-making and consider the policy options associated with fixed and flexible exchange rates. During 1992–4 a *de facto* fixed exchange rate policy was followed, with the *dong* fluctuating in a narrow band around 11 000 to the dollar. This exchange rate stabilization and associated reduction in inflation represented the consequence of a prior stabilization exercise that had little to do with the orthodox monetary and fiscal measures favoured by the World Bank and International Monetary Fund (Irvin, 1994, p. 24). Had stabilization in Viet Nam followed such a prescription, the likely consequence would have been the extreme economic and social costs suffered by the transitional economies in central and eastern Europe and the former Soviet Union. Fiscal and monetary policy require an institutional context in order to affect the real variables in the economy. In the absence of this context, their implementation results in converting a difficult process of transition to a market economy into a disaster. The disaster arises, as in Russia, when prices are liberalized but organization of production at the factory and farm level is not price-responsive. The lack of price response results from the absence of markets for the elements of production, especially land and labour. The next section offers an interpretation of how disaster was avoided in Viet Nam.

Stabilization and adjustment in Viet Nam, 1989–94

In its 1993 report on Viet Nam, the World Bank commented that 'Viet Nam has shown strong growth throughout its adjustment program', and 'Viet Nam's recent economic success is attributable to an ambitious adjustment and reform program which it has undertaken without significant support from outside' (World Bank 1993, pp. iii, i). While both these statements are true, what distinguished the case of Viet Nam was the central role played by the state in managing the transition, rather than leaving adjustment to the dictates of the market.

The World Bank interpretation of the Vietnamese stabilization success is that price stability is based upon the analytical framework that presupposes the existence of developed factor and product markets, as described in the previous section. In the World Bank view, success in Viet Nam was achieved through implementation of tight monetary and fiscal policy, especially the reduction of bank financing of the government deficit. This view is repeated by Irvin: 'a problem [that is, inflation] – it is argued – rectified mainly by the adoption of an IMF-style stabilisation package in 1989' (Irvin, 1994, pp. 5–6). A review of macroeconomic indicators suggests a different interpretation of what happened in Viet Nam during 1989–93. Table 6.1 shows various indicators of external and internal balance, the fiscal deficit, the trade deficit, inflation and GDP growth. It should he noted that even prior to the stabilization

Table 6.1 Indicators of external and internal balance, Viet Nam, 1985–92

Year	(T – G)/GDP	(X – M)/X	Inflation	GDP growth
1985	–12.0	–82.7	132	5.7
1986	–4.7	–126.7	487	3.4
1987	–4.1	–94.1	317	3.9
1988	–7.7	–92.6	311	5.1
1989	–11.4	–26.5	76	8.0
1990	–8.0	–2.4	29	5.1
1991	–2.5	–3.1	8	6.0
1992	–3.8	–2.4	17	8.6
1993	n.a.	–7.2	5	8.1
1994	n.a.	–25.0	14	8.8
1995	n.a.	–18.0	n.a.	7.9
Annual averages				
1985–89	–8.0	–84.5	265	5.2
1990–(last)	–4.7	–9.7	15	7.4

Notes:
1. (T – G)/GDP is ratio of the budget deficit to GDP; (X – M)/X is ratio of the trade deficit to exports.
2. 1995 trade statistics are to end of August. GDP growth rate is provisional estimate.

Sources: Tran Hoang Kim (1992); World Bank (1993); Nguyen (1996).

6 Open economy adjustment and transition in Viet Nam

John Weeks

Introduction

In the 1980s the government of the Socialist Republic of Viet Nam embarked upon a policy of transition from central planning to managed market regulation (*Doi Moi*). Of the many countries that entered into this process, the Vietnamese transition proved the least costly in terms of inflation, loss of potential output and, therefore, deterioration in living standards.[1] Indeed, after a short period of severe internal and external imbalance, the economy not only stabilized but displayed a remarkable growth performance. As yet there has been no thorough analysis of how and why the Vietnamese transition proved so successful compared to the extreme instabilities and severe output losses suffered in central and eastern Europe and Russia.[2] This chapter is a step towards developing that analysis.

No attempt is made to review the major institutional changes that facilitated the transition in Viet Nam, except in so far as their treatment is necessary to understand macroeconomic policy. The first section reviews the basic principles of neoclassical and Keynesian open-economy adjustment for internal and external balance, based on the standard IS–LM model. By use of this model alternative policy options are compared. The second section applies these general principles to Viet Nam. The final section presents a tentative interpretation of the macroeconomic options for the future in Viet Nam.

Principles of open economy adjustment

The principles of short-run, open economy adjustment can be summarized in a general equilibrium model with separate but linked markets for labour, output, money and external transactions. Standard terminology defines internal balance as price stability and the socially desired level of resource use (achievement of full potential output), and external balance as a sustainable set of foreign exchange flows. In the simplest case, internal balance is full employment, and external balance is no change in a country's foreign reserve holdings. In this model, which implicitly assumes one homogeneous output (Weeks, 1989, ch. 1), the only prices are the money wage, the nominal interest rate and the nominal exchange rate. With the capital stock and the labour force fixed in the short run, the clearing of all markets (general

equilibrium with full resource utilization) is achieved through relative price changes. In comparisons of equilibrium positions there is no difference between the nominal and real interest rate or exchange rate. However, money wages and the price level vary across equilibrium states, so the relevant variable is the real wage. In general equilibrium the impact of relative prices is as follows: (a) the labour market clears through adjustment of the real wage; (b) the market for output equilibrates in response to changes in the interest rate and exchange rate; (c) the money market achieves its balance through movement in the interest rate; and (d) external transactions respond to the interest rate and exchange rate. However, because the adjustments involve interaction of markets, it is not valid to analyse a market in isolation (partial equilibrium).

Full utilization of resources is a special case, in which the problem of achieving internal balance is trivialized by assuming it always prevails. In the general case of less than full utilization, adjustment occurs in part as a result of changes in output. In the special case of full utilization general equilibrium the model is price-constrained; that is, the values of the real flow variables in the system are determined by relative prices. In the more general case of under-utilization, the model is demand- or quantity-constrained, with flow variables determined by aggregate demand. The full employment case can be called the pure neoclassical outcome, while the demand-constrained case is associated with Keynesian analysis. If the economy is demand-constrained and external capital flows are sensitive to the domestic exchange rate, then one reaches the standard conclusion that fiscal policy is more effective than monetary policy in achieving internal and external balance if there is a fixed exchange rate, and monetary policy more effective if there is a flexible exchange rate. With a fixed exchange rate a fiscal deficit financed by money creation ('monetizing' the deficit) results in excess demand, which is either eliminated by imports or, if these are restricted, by inflation. If the exchange rate is flexible, the imports generated by excess demand result in the depreciation of the exchange rate; this, in a neoclassical world, provokes a relative price shift in favour of tradables, which eliminates the external imbalance. If the fiscal deficit, thus monetary emission, persists, government 'dissaving' creates its mirror image in a fall in private investment: so-called crowding-out (government expenditure minus revenues must equal private saving minus private investment). It is from this basic Keynesian/neoclassical framework that the generalization is derived that 'stabilization' of the economy (achieving internal and external balance) must be achieved through orthodox ('sound') macroeconomic policies: fiscal deficit reduction and restrictive monetary policy.[3]

The theory summarized above applies to a market economy in which the investment and export decisions are sensitive to the interest rate and the