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Lessons for Last Comers from Vietnam's Transition

James Riedel

What lessons can last comers, like North Korea and Myanmar, and the aid community that stands ready to assist them, learn from the experience of Vietnam? What motivated Vietnam to abandon Soviet-style central planning for a market economy (albeit one with a socialist orientation)? Did foreign technical assistance play an important role in designing and assisting in the implementation of the reforms that have propelled growth in Vietnam? Does Vietnam's experience support or contradict the increasingly fashionable view that institutional change is a prerequisite to successful economic reform? Can a country, such as North Korea, emulate the transition experience of Vietnam and expect similar success?

Keywords: Economic development, transition economies, industrialization strategy, international trade.

1. Introduction

Since the early 1990s, when it was as poor as the poorest of today's poor countries, Vietnam has been one of the faster growing countries in the world. During most of that period — at least since 1994 — all the major multilateral and bilateral aid organizations have been active in Vietnam, financing projects and building reform capacity. Vietnam's relative success and the importance that aid donors have given to "capacity building" make it a particularly relevant case study for those who hope to play a constructive role in assisting those countries that have not yet begun (or are just beginning) the transition to a market economy — last comers such as Myanmar and North Korea.

There is an ongoing debate about the role of aid in promoting growth and development, and, in particular, about the effectiveness of technical assistance. Related to that debate is an even broader debate about the primacy of institutions and politics versus economics and policy in determining development outcomes. Is the main constraint to economic reform the technical capacity or the political will to implement reforms? The key issues in those debates are considered here from the perspective of Vietnam's transition over the past twenty-five years — from a socialist centrally planned economy to a market economy, or as the Vietnamese authorities prefer to label it, a "market economy with a socialist orientation".

James Riedel is the William L. Clayton Professor of International Economics at the Johns Hopkins University School of Advanced International Studies (SAIS), 1740 Massachusetts Avenue NW, Washington, D.C. 20036, U.S.A.; email: jriedel@jhu.edu

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I begin with a brief overview of the achievements and setbacks in Vietnam's transition to a market economy (section 2). I then consider the role that aid has played in building Vietnam's capacity to design and implement the reforms that led to the fundamental reorientation of the economy (section 3). I also briefly consider how Vietnam's experience relates to the big debates about the role of aid and the fundamental constraints to growth and development (section 4). Finally, some tentative lessons for last comers from Vietnam's experience are offered (section 5).

2. Overview of Vietnam's Transition to a Market Economy

2.1 Socialist Transformation: 1976 to 1986[1]

The Communist government of Vietnam announced its intention to make a transition to a market economy at the Sixth Party Congress in December 1986. This marked a major change from the policy adopted a decade earlier at the Fourth Party Congress in December 1976, when it was decided to push for a complete economic unification of the north and south as rapidly as possible under the Soviet-style model of a socialist economy with state ownership of industry, collectivization of agriculture and handicraft sectors, a state monopoly on trade and a central plan for allocating inputs and outputs and fixing prices.

Economic unification of the two regions of the country proved difficult. Efforts to collectivize agriculture met stiff resistance from farmers in the south. As a result, agricultural output during the Second Five-Year Plan (1976–80) failed to keep up with population growth and never came anywhere near the targets set in the Plan (Bandara 1993, p. 6).

The nationalization of industry and commerce in the south was no more successful than the collectivization of agriculture. A 1978 decree prohibiting "bourgeois elements" from engaging in commerce led to the closing of more than 30,000 private businesses in the south (Bandara 1993, p. 24). Industry and commerce during the Second Five-Year Plan fared even worse than agriculture, growing at an annual rate of only 0.6 per cent (Doanh 1994, p. 3). Thus, just five years after political reunification, the socialist economy of Vietnam was on the brink of disaster, with real per capita income declining precipitously.

When the Third Five-Year Plan (1981–86) was adopted it was apparent that a new approach was needed. The Party retained the goal of complete socialist transformation of the economy, but adopted a more gradual approach and initiated two significant market-oriented reforms. One was a contract system in agriculture that set quotas for households rather than cooperatives, and allowed households to retain and trade whatever they produced in excess of their quota. The response to this reform was a significant increase in agricultural output.

The other market-oriented reform aimed to reinvigorate the industrial sector by initiating what became known as the "three-plan system". Plan One was the traditional plan under which enterprises were provided inputs and required to supply the state with set quantities of output. Plan Two allowed enterprises to produce beyond the amounts specified in Plan One, using revenues to buy additional inputs. Plan Three gave enterprises the right to engage in sideline activities more or less on a free market basis. The response to these new but limited freedoms was, again, an acceleration of industrial growth. After growing at 0.6 per cent from 1976–80, industrial output growth rose to about 7 per cent per annum over the following five years (World Bank 1993, p. 128).

While the piecemeal market-oriented reforms adopted in the early 1980s spurred output growth, they also had the unintended consequence of igniting runaway inflation. Allowing state enterprises to produce outside the plan and to engage in sideline activities (known as "fence breaking") led to a significant increase in enterprises' operational deficits, as firms shifted costs to planned production and revenues to sideline production. Under Vietnam's central planning system, the responsibility for financing state enterprise deficits fell to the central bank (State Bank of Vietnam, hereafter SBV) which printed money to cover the enterprises' losses.

As a consequence, inflation from 1980 to 1985 rose to an annual average of 165 per cent, soaring to 487 per cent in 1986, with deleterious social and economic consequences, including the mass exodus of "boat people" in the late 1980s.

2.2 Renovation: 1987 to 1994

Several hard realities faced the Communist Party at its Sixth Congress. The economy was on the brink of collapse. Prospects for external support from Vietnam's sole benefactor, the Soviet Union, were dwindling rapidly. Socialist transformation did not work. China, Vietnam's historical adversary and ideological soul mate, had in recent years achieved a measure of success by moving away from the Soviet economic model without yielding its monopoly over politics. The decision to transition to a market economy, even one with a socialist orientation, was obvious and entirely practical in political terms — it was a way to restore the legitimacy of the Party.

Under the slogan "*Doi Moi*" (renovation) the government launched several key reforms that laid the basis for the decade of growth and stability that followed (1995–2006). Reforms in agriculture reaffirmed the household as the basic production unit. The requirement that farmers sell a contracted amount of output to the state was lifted. Individual farm households were given land tenure rights, which were transferable under certain circumstances. For all intents and purposes, the dominant sector of the economy was effectively privatized.

No steps were taken to reduce state ownership of industry, but barriers to private commercial activity were removed in 1988, with the result that restaurants and shops opened almost as fast as they had closed during the purge of the private sector in 1978. Another major reform implemented under the *Doi Moi* programme was the elimination of the state monopoly on trade in 1988 and the elimination of import quotas, which were replaced with tariffs. In addition, a new law was introduced permitting foreign direct investment (FDI) and encouraging it with tax holidays, guarantees against expropriation and allowing for full repatriation of profits.

None of the above reforms had any significant or lasting effect, however, until measures were taken in 1989 to redress inflation, which from 1986 to 1989 averaged above 400 per cent per year. The stabilization programme Vietnam adopted in 1989 was pure International Monetary Fund (IMF) "big bang" orthodoxy, albeit without the IMF, which would not begin operations in Vietnam until 1994 when the U.S. embargo on Vietnam was lifted. The programme included raising interest rates, devaluing and unifying the exchange rate, legalizing gold trading and controlling the rate of growth of money and credit.

Inflation in Vietnam, as everywhere else, was a monetary phenomenon. The source of excess money growth was the central bank's financing of fiscal deficits that resulted from subventions required to cover the massive losses of state enterprises. The solution was to cut the fiscal deficit, which as Table 1 indicates the government did by a full 6 percentage points of GDP between 1989 and 1991. This was made possible by slashing subsidies to SOEs, cutting public sector investment, restraining wage increases for civil servants below the inflation rate and demobilizing a half million military personnel.

With a reduction in money growth from over 400 per cent in 1988 to about 4 per cent in 1992, the inflation rate fell precipitously from triple to single digits (8 per cent in 1993), making Vietnam's stabilization programme one of (if not the most) successful in the world. What is more, Vietnam achieved disinflation without sacrificing growth — indeed, the real GDP growth rate accelerated from 5 to 8 per cent per year during the stabilization period.

How was Vietnam able to avoid what many economists consider inevitable — a trade-off between growth and stability? The answer is that the people saw the government's stabilization programme as credible. And why would it not have been? The Party enjoyed a monopoly over politics; the real and financial sectors of the economy were almost entirely in the hands of the state; the economy was in crisis and by extension so too was the political system. The measures taken were draconian, but there was little reason

TABLE 1
Macroeconomic Indicators, 1988–93

	1988	1989	1990	1991	1992	1993
Fiscal deficit (% of GDP)	–7.2	–7.5	–5.8	–1.5	–1.7	–4.8
Money growth (%)	443.3	237.8	32.4	78.8	3.7	9.9
Exchange rate (VND/US$)	900	4,500	6,500	10,000	10,200	10,600
Inflation rate (%)	394.9	74.3	36.4	82.7	37.7	8.3
Real GDP growth (%)	5.2	5.0	5.1	5.8	8.7	8.0
Share in total liquidity of foreign currency deposits	9.3	24.7	32.4	41.1	30.3	23.0

SOURCE: Riedel and Comer (1998).

to expect that the government would abandon its stabilization programme before inflation was wrung out of the economy. As a result of its credibility, the stabilization programme was able to reverse expectations of high inflation and currency devaluation, thereby reducing, if not completely eliminating, the real cost of the disinflation (Thi Thu Tra Pham and Riedel, forthcoming).[2]

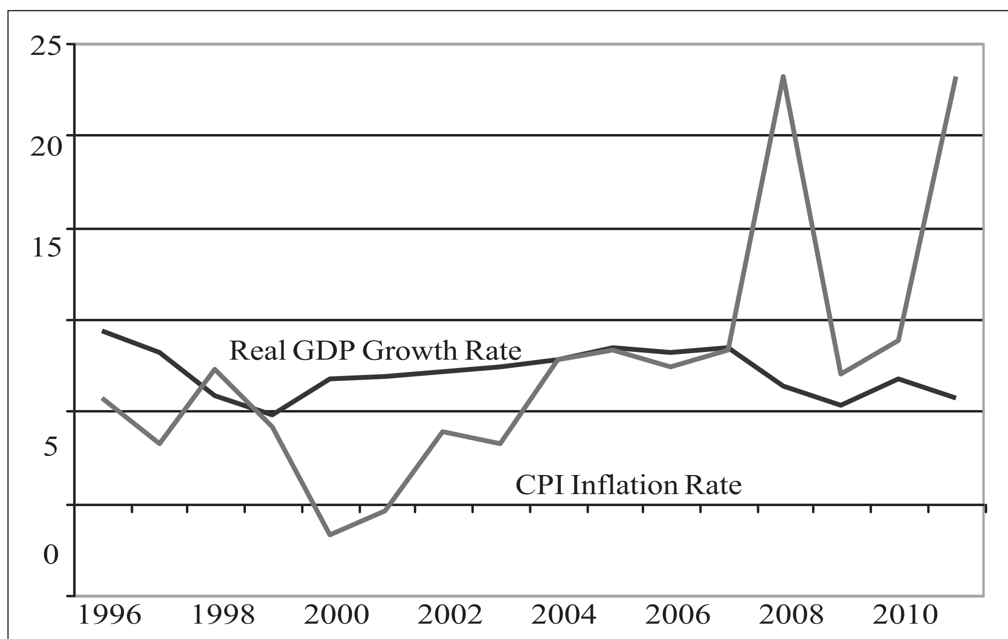
An indicator of the impact of the programme on inflation expectations is the share of foreign currency deposits in total liquidity (shown in the last row of Table 1). From 1988 to 1991, when inflation was in the double and triple digits, the share of foreign currency deposits in total liquidity increased more than fourfold, from 9.3 to 41.1 per cent. Then, from 1991 to 1993, during which time the inflation rate fell precipitously to single digits, depositors shifted back to the domestic currency and the share of foreign currency deposits fell by half, from 41.1 to 23 per cent.

2.3 A Decade of Growth and Stability: 1995 to 2006

The reforms undertaken between 1987 and 1994 laid the foundation for a decade (1995–2006) of relatively rapid growth (average annual real GDP growth of about 7.5 per cent) and low inflation (on average about 4 per cent). Since the main motivation for taking these reforms was to avoid an impending economic catastrophe that threatened the Party's prestige, and potentially its power, it is not surprising that once economic conditions improved in the early 1990s the momentum of the reform movement subsided. Nonetheless, a new constitution was adopted in 1992 that made private companies legal, and in 2000, a new enterprise law was adopted that aimed to level the playing field for private companies. In addition, over the next decade, Vietnam undertook an ambitious programme of legal reform, much of which is was required by Vietnam's obligations under the U.S.-Vietnam Bilateral Trade Agreement, which became effective at the beginning of 2002, and Vietnam's WTO accession treaty, which became effective in 2007.

Vietnam's record of growth and stability since 1995 is illustrated in Figure 1. From 1995 to 2006 real GDP growth averaged 7.5 per cent and inflation 4.4 per cent, a stunning turnaround from the earlier period. While this was indeed a remarkable achievement, deserving of the accolades the donor community continually lavishes on Vietnam, it should be noted that country's growth record over this period falls short of other countries in the region (e.g. Taiwan, Korea, China and Thailand) which posted double-digit growth during the take-off stage of export-oriented industrialization (Riedel and Thi Thu Tra Pham 2010).

FIGURE 1
Real GDP Growth and CPI Inflation: 1996–2011



SOURCE: IMF International Financial Statistics [online].

2.4 Macroeconomic Turmoil Since 2006

Since 2006, Vietnam has experienced high and volatile inflation and a declining growth rate. The onset of macroeconomic turmoil was associated with the euphoria that accompanied Vietnam's entry into the World Trade Organization (WTO). In 2007, both the public and private sectors went on a spending spree, with the current account of the balance of payment (which measures the difference between national income and expenditure) falling from a zero balance in 2006 to a deficit of 10 per cent of GDP in 2007. International financial markets also succumbed to WTO euphoria, flooding Vietnam with FDI and portfolio investments in amounts equivalent to 25 per cent of GDP.

In order to prevent a nominal appreciation of the currency and a resulting loss of international price competitiveness, the central bank (SBV) intervened in the foreign exchange market, buying up the excess supply of foreign exchange that was accumulating in the commercial banks and holding it as foreign reserves. The purchase of foreign reserves, equivalent to about 15 per cent of GDP in 2007, led to a massive increase in the money supply and a spike in the inflation rate to almost 30 per cent in early 2008. Rising inflation and the large increase in spending, in turn, drove up the trade deficit, which peaked at 30 per cent of GDP in April 2008. Rising inflation and the growing trade deficit eventually spooked foreign investors and, in May 2008, there was a run on the currency.

The government was remarkably successful in containing the 2008 currency crisis by reining in credit growth and cutting spending. But before the economy was stabilized, it was hit by the global recession at the end of 2008. Like most other countries, Vietnam responded to the global recession with an ambitious stimulus programme,

which included both an increase in government spending and an expansion of money and credit. Vietnam's stimulus programme succeeded in preventing an all-out collapse of growth (as Figure 1 indicates), but the stimulus measures were retained longer than was necessary to counter the global recession and as a result ignited a second bout of high inflation in 2010. It was not until February 2011 that the government finally decided to give priority to stability over growth, cutting government spending, raising interest rates and controlling the growth of credit. Those measures worked to bring inflation back down to single-digits in 2012, but at the cost of a significant slowdown in growth, which the country has as yet been unable to reverse. The past six years of volatility in the financial markets has put many companies, especially state-owned ones, in severe financial distress, which in turn has undermined the soundness of the banking system. It remains to be seen what the cost of macroeconomic mismanagement over the past six years will turn out to be (Thi Thu Tra Pham and Riedel, forthcoming).[3]

2.5 The Current Challenge to Sustainable Growth

A visitor to Vietnam cannot help but be impressed by the dynamism of the country, at least in the cities, where Honda motorbikes and Bentley automobiles compete for space on overcrowded streets; where high-rise buildings abound with many more under construction; where all the international brand names are on display and all the major multinationals and international banks advertise their presence. None of these existed in 1990 when I visited Vietnam for the first time (as an economist). Over the past twenty years, per capita income has increased at an average rate of about 6 per cent per year; industrial production has grown at an average annual rate of almost 10 per cent and the dollar value of exports has risen at annual rate of 20 per cent. The progress visible to the naked eye is validated by the statistical data.

Growing at almost 6 per cent per year, per capita income has tripled over the past twenty years, and yet it stands today at no more than about US$1,300 (at the nominal exchange rate). This level of per capita income puts Vietnam just barely on the north side of the line the World Bank draws between the income ranges of low- and middle-income countries. Having escaped low-income status, the authorities and most economic analysts in Vietnam seem almost to relish the prospect, much promoted by the World Bank, that the country is facing the "middle-income trap", where supposedly comparative advantage hits a dead end and prosperity is limited to the productivity of unskilled labour in labour-intensive manufacturing activities. To escape the middle-income trap Vietnam is encouraged to take whatever measures it must to move up value chain and produce more high-tech and innovation-intensive products. The export-oriented industrialization strategy, which worked elsewhere in the region and rests on the logic of a 200-year-old theory, is passé; competitiveness, dynamic industrial clusters and the knowledge economy are the order of the day — goodbye David Ricardo, hello Michael Porter!

A problem with all these new ideas that have become popular in Vietnam is that they run up against a hard reality that is easy to overlook and often uncomfortable for the authorities to acknowledge (Riedel and Thi Thu Tra Pham 2012).[4] That reality, described in Table 2, is that Vietnam is still a very poor, agrarian country. Agriculture may account for only 22 per cent of GDP, but it is home to 70 per cent of the population. This means that GDP per capita in rural areas is only about one-eighth of what it is in urban industrial areas. Although agriculture produces half the amount of GDP that industry does, it employs twice as many workers, which means that the average productivity of a worker in agriculture is one-fourth the productivity of a worker in industry.

The only way to raise the productivity of those who reside in the rural sector is to move a significant share of the agricultural labour force to industry. In order for this to happen, capital investments must be made to create the jobs in industry. How much value-added (GDP) and how many jobs a given amount of industrial investment

TABLE 2
GDP, Population, Employment, Per Capita Income and Productivity in Agriculture and Industry: 2010

	US$ Billions	*Per cent*
GDP	115	100
Agriculture	25	22
Industry	46	40
Services	43	38
	Millions	*Per cent*
Population	88	100
Rural	62	70
Urban	26	30
Employment	51	100
Agriculture	25	48
Industry	12	22
Service	15	30
	US$	*VND millions*
GDP per capita	1,309	29
Ag GDP/Rural pop	409	9
Non-ag GDP/Urban pop	3,456	76
GDP per worker	2,242	49
Agriculture	1,029	23
Industry	4,028	89
Services	2,857	63

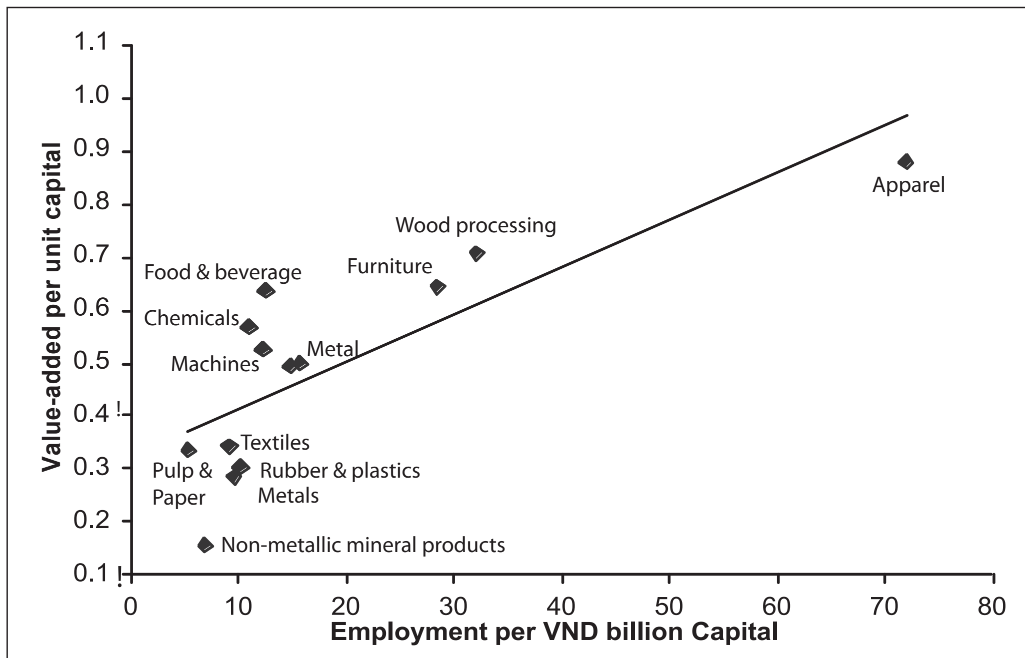
SOURCE: General Statistics Office (GSO) of Vietnam [online].

would create depends on which branches of industry the investment is made, since the income-generating and job-creating capacity of industrial investment varies widely across branches, as Figure 2 illustrates.

The fact is that apparel, footwear, furniture and wood processing, Vietnam's leading export-oriented industries, generate more than twice as much value-added and about five times more employment per unit of capital invested than do the import-competing sectors that are favoured by those who argue for industrial policies to push Vietnam up the value-chain into higher-tech, more sophisticated products.

The *Economist* magazine in 2012 reported a view that is commonly held in Vietnam that "[t]he formula of low-wage, low-cost manufacturing no longer works as it once did." (*The Economist* 2012). It is true that the flow of capital and labour into export-oriented, labour-intensive industry has diminished — but why? Could it be the result of the government's decision in 2006 to promote state-owned enterprise conglomerates that siphoned off a disproportionate share of bank credit to invest in unprofitable, rent-generating non-core businesses? Could it be the result of the government's imprudent macroeconomic policies that generated asset

FIGURE 2
Value-added and Employment per Unit Capital in Manufacturing



SOURCE: GSO [online].

price bubbles that attracted domestic and foreign investment away from manufacturing and into real estate and property development? Could it be a policy environment that favours risky, high-return short-term ventures over long-term industrial and agricultural investment?

The consequence of the government's misguided policies since 2006 is that the SOE and the real estate sectors currently find themselves under severe financial stress. The banks that financed their investments are holding a mountain of bad debt. The government has had to make "restructuring" the SOE and banking sectors its top policy priority. If the government's restructuring policy is successful it should relieve the government's fiscal burden and help to restore macroeconomic stability, but it will not achieve a restructuring of the economy. It will not reinvigorate private investment in manufacturing and it will not relieve the massive unemployment and low productivity that plagues the rural sector.

When I give lectures and seminars around the country about these realities, about the need to reinvigorate the export-oriented industrialization strategy, and why one should have faith in the venerable principle of comparative advantage, those in the audience (mainly government cadres and a few public economists) often roll their eyes and mutter "Not that same old story about comparative advantage again?". I have wondered why they do not buy the line. Is the logic wrong? Is the evidence from the success of other Asian countries that pursued the same strategy successfully not convincing? Or, could it be that the governing elite prefer things just as they are? The answer is offered below.

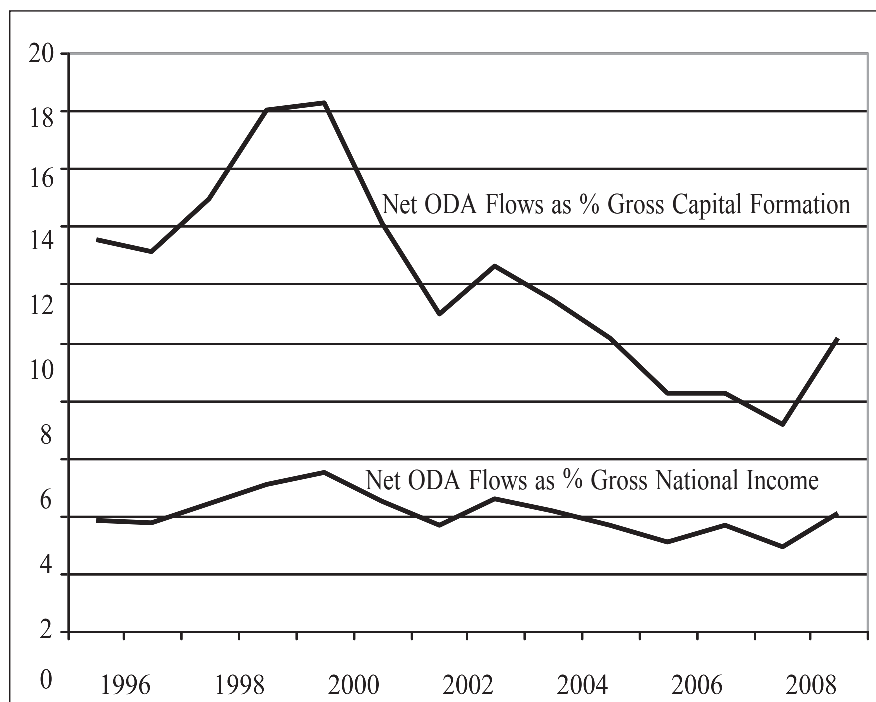
3. The Contribution of Capacity Building

The lifting of the U.S. embargo on Vietnam on 3 February 1994 marked the resumption of Overseas Development Assistance (ODA) flows to Vietnam. Since 1994, ODA flows from bilateral and multilateral donors have grown at about the same rate as the economy. As Figure 3 indicates, ODA disbursements have been a fairly steady 4 per cent of GDP. It is reported that Vietnam received ODA pledges of US$8 billion in 2011 — about US$3.3 billion from bilateral donors and US$4.6 billion from multilateral sources (*Vietnam News Agency* 2010). Since ODA disbursements usually amount for no more than about 50 per cent of the amounts pledged, the level for 2011 is, again, likely to be at about 4 per cent of GDP (or approximately US$4 billion).

Capacity building, or as the multilateral aid organizations prefer to call it, "capacity development", is only a part of ODA.[5] The usual assumption, for there are no hard data available to measure the amount of ODA that goes to capacity building, is that it constitutes about 25 per cent of total ODA flows.[6] Although capacity building is but a fraction of ODA, the aid community regards its importance as paramount. Country "capacity", which is understood as "the ability of people, organizations and societies as a whole to manage their affairs successfully", is considered the "the key to development performance and thus to efforts to accelerate economic growth, reduce poverty and achieve the MDGs (Millennium Development Goals)" (OECD 2006, p. 13).

How to build capacity, i.e., help countries to improve the ability of their people and organizations

FIGURE 3
ODA Flows as Percentage of Gross Capital Formation and Gross National Income



SOURCE: OECD Development Co-operation Directorate (DCD-DAC) [online].

to manage their affairs? Until recently, capacity building was viewed as a process of transferring knowledge from the north to south, but not any longer. Donors now insist, in principle, if not in practice, that "capacity development is primarily the responsibility of the partner countries, with donors playing a supportive role of mobilizing financial and analytical support" (OECD 2006, p. 15). Country ownership of capacity building is now recognized to be essential for success. However, there is a caveat — country ownership of capacity building is premised on a country having the capacity to exercise ownership. If a country does not have that capacity, then presumably donors must take the lead, which according to current conventional wisdom is unlikely to succeed.

The commitment to demand-driven capacity building, according to many aid critics, is mostly rhetoric. In practice, most technical assistance is supply, i.e., donor-driven ("Shanta Devarajan on Capacity Development" 2012). According to a scathing report of ActionAid International, "because technical assistance is donor-driven, it is both heavily over-supplied and over-priced" (ActionAid International 2005). ActionAid International estimates that only about one-quarter of the total amount of technical assistance that is provided to developing countries actually serves to build capacity; the other 75 per cent is what it terms "phantom aid". About one-third of total phantom aid is due to the tying of technical assistance, which according to an OECD study increases the costs of aid by between 15 and 40 per cent. Another one-third of technical assistance is wasted on mark-ups on exorbitant expatriate salary and non-salary costs. Finally, another one-third is lost on pure inefficiency and excessive administrative expenses. In the view of ActionAid International, technical assistance (i.e., capacity building) "sits like a fossilized relic within the aid system, at odds with the principles espoused over the last decade" (ActionAid International 2005, p. 48).

Has capacity building fared any better in Vietnam than it generally has in the rest of the developing world? Unfortunately, information about the amounts of ODA expended on capacity building and the outcomes of that spending is no better in Vietnam than it is anywhere else.[7] All I can offer is my opinion (based on more than twenty years as an occasional capacity builder in Vietnam), which agrees with the now conventional view that capacity building is effective only when it is demand-driven. In my experience in Vietnam, capacity building projects that have been initiated by donors mainly serve the interests of donors and do little to build capacity to design and implement reforms.

4. Big Debates about Development

The question of how to initiate and sustain economic growth in developing countries has been debated since the term "developing countries" was invented and it shows no sign of abating. Indeed, the recent publication of several highly acclaimed and popular books by leading academics in the development field, each offering very different answers to the big question, has rekindled the debate. It is useful to consider how Vietnam's transition to a market economy relates to the central themes of these books.

I begin with Jeffrey Sachs's best-selling book, *The End of Poverty* (2005), which aimed to persuade governments and the general public in rich countries to increase the level of aid they give to poor countries on grounds that it is not only the right thing to do, but also in their own national interest. Fifty-two years ago, W.W. Rostow's *Stages of Economic Growth: A Non-Communist Manifest* (1960) made a similar appeal, arguing along the same lines. Both Rostow and Sachs argued that developing countries were caught in a poverty trap from which they could not escape without a significant increase in foreign aid and both suggested that it was in the national interest of the rich countries to increase aid, in Rostow's case to thwart the spread of communism to the third world and in Sachs' case to eliminate the conditions that breed global terrorists in poor countries.

In the decades that followed the publication of *Stages of Economic Growth* there was no significant increase in levels of aid flows to developing countries, nonetheless about two-

thirds of the world population was lifted out of extreme poverty and got a foot on the ladder of development, as Sachs himself points out in *The End of Poverty*.[8] How was that possible if they were stuck in a poverty trap? The answer can only be that they were not trapped in poverty in the first place, but instead, were victims of their own bad policies, which somehow they managed to change in favour of better ones.

It would be hard to think of a single country in which foreign aid was the decisive factor in the take-off to sustained growth. Certainly Vietnam would not qualify, since it engineered a sweeping reform and reorientation of the economy in the late 1980s without the presence of any multilateral and very little bilateral aid. Indeed, as I have argued, it is more likely that it was the absence of foreign assistance that was the decisive factor — had the World Bank and IMF been on hand to bail Vietnam out of the severe crisis it faced in the late 1980s, arguably the Communist Party would not have been as willing to abandon collectivization and central planning in favour of a market-oriented economy. This decision was not reached as a result of any kind of ideological conversion, but instead was one that dire economic and political circumstances forced the Party to make in order to protect its hold on power.

The kind of reforms that Vietnam undertook in the late 1980s is a contradiction to the central thesis of the widely-acclaimed book by Daron Acemoglu and James Robinson, *Why Nations Fail: The Origins of Power, Prosperity, and Poverty* (2012). Citing evidence drawn from comprehensive historical cases studies, they argue that political and economic institutions determine whether nations succeed or fail. When institutions are inclusive (i.e., allow political power and economic opportunities to be shared broadly) nations succeed; when they are extractive (i.e., protect the political and economic power of the elite) they fail. Institutions define and limit the scope of economic policy. Since the design and development of institutions typically dates back centuries, they are not easily or quickly changed. It follows, therefore, that since institutions cannot be easily changed neither can policy. Economists who run around the world telling poor countries how to change policy for the better are deluding themselves—without institutional and political change there can be no sustainable change in economic performance, so Acemoglu and Robinson argue.

So, how was Vietnam able to achieve a major economic turnaround without political change?[9] Acemoglu and Robinson do not discuss Vietnam, but they do take up the case of China, which a decade earlier than Vietnam engineered major policy reforms and a fundamental reorientation of its economy without changing its extractive political institutions. The authors acknowledge that, as in the case of Vietnam, so too in China the decision to move away from extractive toward more inclusive economic institutions was not the result of any kind of ideological conversion, but instead was driven by practical political considerations. This is how they explain it:

> [T]his did not happen because the Chinese Communist Party finally understood that the collective ownership of agricultural land and industry created terrible incentives. Instead, Deng Xiaoping and his allies, who were no less self-interested than their rivals but who had different interests and political objectives, defeated their powerful opponents in the Communist Party and masterminded a political revolution of sorts, radically changing the leadership and direction of the party. Their economic reforms, which created market incentives in agriculture and then subsequently in industry, followed from this political revolution. (p. 68)

Certainly that is not how it worked in Vietnam. There was no political revolution in Vietnam of any sort, nor do I believe there was in China. In 1978, when Deng took power, China was in a crisis much like Vietnam was a decade later. The Great Proletarian Cultural Revolution left the economy devastated and Party in disrepute. Deng's fight with his opponents in the Party was not about how to maximize economic growth, but about how to restore the Party's prestige and maintain its hold on power. Giving the people some limited economic rights was a concession

made to preserve China's extractive political institutions (Qian and Wu 2002). Acemoglu and Robinson do not give enough consideration to the role of crisis as a catalyst of change. The saying of Samuel Johnson that "the prospect of being hanged focuses the mind wonderfully" seems also to apply to the political elite of extractive political regimes.

Acemoglu and Robinson predict that the rate of economic growth in China will inevitably decline. Of course it will if for no other reason than the inextricable forces of diminishing returns to capital investment and the diminishing impact of technology catch-up as a country moves closer to the technology frontier. But their argument is that China's highly authoritarian, extractive political institutions will inevitably lead China into a growth trap somewhere in the middle-income range.

It is easy to intuit the logic behind their prediction.[10] Suppose we take as a premise that the level of income of a nation (Y) is a positive but diminishing function of the inclusiveness of its economic institutions as measured by the quality of its overall policy framework (P):[11]

$$Y = Y(P, \ldots), \qquad Y'_P > 0, \qquad Y''_P < 0$$

Further, we take as a premise that the objective of the ruling elite in a country with extractive political institutions is to enrich itself by extracting as much rent as possible from the economy. The amount of rent that can be extracted (R) is also depends on the quality of policy, but via two effects that work in opposite directions. One is the scale effect, which is a positive function of the quality of policy — the higher P the higher Y and the larger the scale of rent-seeking. The other is the scope effect, which is a negative function of P — the more inclusive are the country's economic institutions (the higher P) the less scope there is for the ruling elite to capture rents through licensing and other restrictions it imposes on economic activity.

$$R = R(Y(P,\ldots), P,\ldots), \qquad R'_Y > 0, \qquad R'_P < 0$$

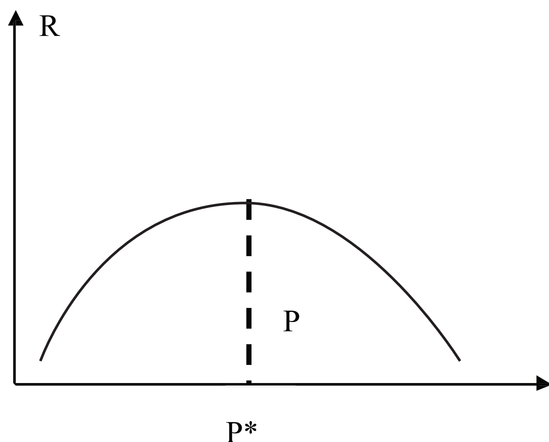
It follows, therefore, that the effect of policy liberalization (i.e., making economic institutions more inclusive) on the amount of rent the elite can extract is ambiguous.

$$\frac{dR}{dP} = R'_Y \cdot Y'_P + R'_P$$

The first term in the numerator (the scale effect) is positive, but the second term (the scope effect) is negative.[12] Since it is assumed that the income effect of policy reform is subject to diminishing returns ($Y'_P < 0$), it follows that the scale effect dominates in the early phase of reform and the scope effect in the latter phase. If the ruling elite choose the level economic inclusiveness (P) that maximizes rents (P*), it will halt the reform process well before the economy is fully liberalized, trapping the economy somewhere in the middle-income range. See Figure 4.

This simple model suggests that the ruling elite operating within extractive political institutions do have an incentive to pursue economic reform up to a point. But why, one might ask, do they rarely initiate reform without having to be forced to do so by a major economic crisis that threatens their hold on power? My hypothesis would be that they do not recognize just how rapidly a very low-income country can take-off when even modest reforms, mostly in the form of government just

FIGURE 4
The Middle-Income Trap



getting out of the way, are introduced. I doubt anyone in China in 1978 or in Vietnam in 1988 could have anticipated the tremendous response to the initial reforms that were taken. I know for a fact that in late 1990, I could not imagine the magnitude of change would ensue in Vietnam over the next two decades. Another hypothesis would be that a crisis is necessary to overcome the inertia that uncertainty about the outcome of change instills in those who are the main beneficiaries of the status quo.

Finally, it is worthwhile drawing attention to one other equally widely acclaimed book that offers "a radical rethinking of the way to fight global poverty", *Poor Economics* (2011), by Abhijit Banerjee and Esther Duflo, both professors at the Massachusetts Institute of Technology (MIT). This book largely dismisses the relevance of the big debates, including Sachs versus Easterly (2001) on whether there is or is not a poverty trap and Acemoglu and Robinson versus "most economists", who they claim ignorantly adhere to the "ignorance hypothesis" that countries are poor because their rulers lack knowledge about how to engineer prosperity.

Banerjee and Duflo argue that the reason poverty alleviation projects often fail, whether funded domestically or through ODA, is because those who design and implement them do not understand or are indifferent to how poor people make economic decisions. If one unravels that mystery, for example by means of randomized controlled experiments, then it becomes possible, Banerjee and Duflo argue, to improve poverty alleviation programmes in ways that can have big effects on the lives of the poor. Moreover, they argue and present convincing evidence that suggests that there is scope for improving the functioning of institutions at the margin, even in countries with broad extractive economic and political institutions. As they conclude: "The focus on broad INSTITUTIONS (capital letters indicating macro as opposed to micro institutions) as a necessary and sufficient condition for anything good to happen is somewhat misplaced" (p. 264). That conclusion is sufficiently nuanced as to be unexceptionable. If, however, "anything good" is replaced by "anything major", like the lifting of about 800 million people out of extreme poverty in China and another 60 million in Vietnam, then clearly the focus on broad institutions is certainly not at all misplaced.

5. Lessons for Last Comers (e.g. North Korea)

The first lesson, I would suggest, is that unless North Korea makes the political decision to transform its economy from a dysfunctional Soviet-style socialist economy to a market economy, even one with a "socialist orientation", there are no lessons, period. North Korea does not have to look to Vietnam's experience to learn that the Soviet-style socialist economy does not work.

If it should make such a decision, then Vietnam's experience suggests that quite a lot of economic change can occur from even modest reforms, most in the form of government just getting out of the way and letting people pursue their ambitions. Getting out of the way and following prudent monetary and fiscal policies do not require a great deal of technical expertise. Much can be accomplished without any external technical assistance or capacity building. Indeed, large inflows of ODA, by providing an alternative source of rents, could undermine the political will to transform economic institutions.

If North Korea should make the big decision to change its economic institutions then one can expect that the international donor community will rush in as it has most recently in Myanmar. Loans and technical assistance will follow. Perhaps the country could succeed in spite of all the money and experts that will flood the country, but, who knows?

As a latecomer, starting at the very bottom, North Korea should be able to achieve a period of quite remarkable economic growth even if it retains its extractive political institutions. Sustaining rapid growth beyond the initial phase will, however, require the country to move towards inclusive political institutions, but it cannot look to Vietnam for lessons about that because Vietnam has yet to make that move itself.

NOTES

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1. This section draws heavily on James Riedel and Bruce Comer, "Transition to a Market Economy in Viet Nam", in *Economies in Transition: Comparing Asia and Eastern Europe*, edited by Woo Wing Thye, Stephen Parker and Jeffrey D. Sachs (Cambridge, Massachusetts: MIT Press, 1998).
2. See Pham and Riedel (2013).
3. See Thi Thu Tra Pham and James Riedel, 2012, "Expectations and the Cost of Disinflation in Vietnam", *Journal of Asian Pacific Economy* (forthcoming).
4. Riedel and Pham 2012.
5. A report by the OECD (2006) argues that "capacity development is used advisedly in preference to the traditional capacity building." The "building" metaphor, it is suggested, involves a "step-by-step erection of a new structure, based on a preconceived design", rather than a process that is adaptive and sensitive to the condition of the recipient country (or something like that). This distinction is a bit too fine for my taste, so I will stick with the old term, capacity building.
6. According to a review of ODA by the Vietnamese Ministry of Planning and Investment, an approximate share of 25 per cent applies as well in Vietnam.
7. See McCarty (2005).
8. Sachs (2005) notes that in 1960, upwards of five-sixths of the world's population lived in extreme poverty. Today the share is about one-sixth, or approximately 1.5 billion people, mainly in South Asia and Africa.
9. While political reform was absent in Vietnam, it has been suggested that the memory of the upheavals of collectivization motivated the central government to take a more equitable approach to decollectivization with positive consequences for poverty and growth (Ravillion and Van de Walle 2008).
10. Inspiration for this model was drawn from Daron Acemoglu and James A. Robinson (2006).
11. A single prime indicates the first derivative of the function and a double prime the second.
12. The denominator is unambiguously positive.

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