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Vietnam: Economic Reforms and Commercial Relations with the United States

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Summary

Vietnam has made considerable progress in implementing economic reforms since 1986. The reforms have nudged Vietnam to a more market-oriented economy and have facilitated higher rates of economic growth, particularly during 1988-1996. Momentum for deepening the reforms, however, has stalled in recent years, and since 1997, there has been a significant decline in foreign investment, as well as a deterioration in the underlying performance of the economy. To address these problems, multilateral institutions and U.S. officials have urged Vietnam's leaders to initiate a second wave of economic reforms that will make its economy more market-oriented and efficient. Vietnam's leaders have moved cautiously in adopting additional economic reforms. Following President Clinton's recommendation of June 3, 1999, to renew Vietnam's Jackson-Vanik waiver for a year, joint resolutions (S.J.Res. 28 and H.J.Res. 58) were introduced to disapprove the renewal. On July 20, 1999, the Senate rejected a motion to discharge S.J.Res. 28 from committee by a vote 5-94, and the House on August 3 voted down H.J.Res 58 by a vote of 130-297. Although the United States and Vietnam on July 25, 1999 reached an "agreement in principle" on the terms of a bilateral trade agreement, Vietnam has postponed signing the agreement. The trade agreement is a necessary prerequisite for the restoration of full normal commercial ties between the two countries. This report will be updated periodically.

Background

Vietnam's reform program, known as *doi moi* or economic renovation, began in 1986 in response to deteriorating internal and external conditions. At home, the economy was in desperate straits, afflicted by hyper-inflation and food shortages. Abroad, the Soviet Union, its most loyal ally, was cutting back on its large foreign aid program.¹

¹For background, see CRS Report 96-489, "Vietnam's Transition to A Market Economy," by (name redacted), *Congressional Research Service*, May 30, 1996, 6 p.

In these circumstances, Vietnam's leaders adopted pragmatic, albeit partial reforms to regain economic growth. At the heart of the reforms adopted in the late 1980s were measures that eliminated price controls on most key goods, established land-use rights for farmers, clarified the legal status of private businesses, and tightened government spending. As part of the latter attempt, efforts were made to limit subsidies to state-owned-enterprises (SOEs) by providing greater autonomy in production, investment, and pricing decisions.

Vietnam's economy prospered in the decade following the initiation of the reforms. After years of stagnant production, shortages, and limited famine associated with orthodox Communist economic policies, economic activity increased by 3.9% annually from 1986-1990 and by 7.6% annually from 1991-1993 in real terms. The economy grew by 8.8% in 1994, by 9.5% in 1995, and by 9.3% in 1996 — rates of growth that enticed foreign investors to flock to Ho Chi Minh City and Hanoi in the early 1990s, amid much media speculation that Vietnam was poised to become the next Asian tiger.²

Growing Economic Problems

Beginning in 1997 and continuing in 1998 and 1999, Vietnam's economy has experienced a host of problems. Instead of leading to continuing predictions that Vietnam was about to become an Asian tiger, the problems have cast Vietnam more in the image of an Asian lamb.

Economic growth slowed to 8.2% in 1997 and dropped to 3.5% in 1998. Behind the deceleration of economic growth are cutbacks in foreign direct investment commitments and declines in exports, both of which have been exacerbated by the financial crisis in Asia.³

Vietnam's strong economic performance from 1988-1996 was substantially driven by foreign investment inflows. By the end of this period, foreign direct-invested projects accounted for about 9% of GDP (total output) per year, 20% of the country's export earnings, and \$300 million in annual tax revenues.⁴ However, beginning in 1997, the number of new foreign investment commitments slipped to about \$3 billion, compared to \$7.9 billion in 1996, \$5.7 billion in 1995, and \$3.6 billion in 1994.⁵ New commitments for 1999 are predicted to drop to about \$1.8 billion, the lowest level since 1991.⁶ Actual disbursements, according to the Asian Development Bank, may not even reach \$500 million in 1999.⁷

²World Bank Development Report, various editions..

³*Economist Intelligence Unit*, "Vietnam: Country Report," 4th Quarter 1997, p. 5.

⁴Freeman, Nick J. "Bust or Boom?", *The Vietnam Business Journal*, June 1998, p. 58.

⁵*International Monetary Fund*, Vietnam: Selected Issues and Statistical Annex," Staff Country Report No. 98/30, April 1998, [Annex] p. 35..

⁶*Economist Intelligence Unit Ltd.* Vietnam: Economic Policy, April 23, 1999.

⁷Keenan, Faith. "Comrades in Conflict," *Far Eastern Economic Review*, April 15, 1999.

The source of foreign investment has changed significantly since the onset of the Asian financial crisis. Just 17% of the early commitments in 1999 have come from Asia, compared to about 70% since 1988.⁸

Red tape, bureaucratic corruption, a constantly shifting legal structure, excessive licensing procedures, weaknesses in the banking system, and massive smuggling are longstanding problems that help explain the declining interest of foreign investors. This catalogue of problems is manifested by one business service poll which ranked the attractiveness of Vietnam's business environment 15th out of 16 Asian countries.⁹ With the cost of doing business dropping elsewhere in Asia, Vietnam's many investment hurdles evidently are now being weighed more heavily by foreign investors than its considerable locational and resource advantages.¹⁰

The downturn in foreign investment has also been exacerbated by Asia's financial crisis. Nearly three-fourths of Vietnam's foreign investment has come from Asia. With pressing restructuring problems at home, many cash-strapped Asian companies are being forced to shelve plans for new investments, or close down existing operations.¹¹

Asian's financial crisis is also having a negative effect on Vietnam's exports. As customers for more than 60% of Vietnam's exports, the slower growing Asian countries are buying less from Vietnam. And as competitors, many Asian countries are also able to undercut Vietnam's exports to third country markets with goods that are cheaper now as a result of their own large currency devaluations.¹²

The World Bank estimates that the combination of declining inflows of foreign investment and stagnation in export earnings is equivalent to about \$3 billion or 12% of Vietnam's GDP. This shock or cost to the economy has come on top a growth rate that, according to the Bank, had probably already peaked.¹³

Economic Reforms — Calls for A Second Wave

Citing many of these economic problems and challenges, the World Bank, the International Monetary Fund (IMF), and U.S. officials all publically urged Vietnam during 1997 to launch a *doi moi* two or second wave of economic reforms. To underline the seriousness of the problem, both the IMF and World Bank have denied Vietnam loans until it agrees to implement a strong and comprehensive package of economic reforms. Such

⁸*Economist Intelligence Unit*, "Vietnam: Economic Policy," April 23, 1999.

⁹*Economist Intelligence Unit*, "Vietnam: Country Forecast," 4th Quarter 1997, p. 3.

¹⁰Lamb, David. "Indochina Finds It's Not Immune to Asia Crisis," *Los Angeles Times*, February 15, 1998, Part D, p.1.

¹¹Levine, Joshua Jake. "Finding An Exit Strategy," *The Vietnam Business Journal*, June 1998, p. 20.

¹²Nathan, Melina. "Vietnam's Economic Programme Loses Its Momentum," *The Straits Times (Singapore)*, January 31, 1998, p. 28.

¹³*The Economist Intelligence Unit Ltd.*, Vietnam Country Report, April 23, 1999.

a package, according to the IMF, should minimally include SOE reforms, financial sector reforms, and trade liberalization.¹⁴

Despite progress in closing down some 6,000, mostly small and town-based SOEs since *doi moi* commenced, Vietnam still operates an estimated 5,800 state enterprises. These remaining SOEs dominate strategic sectors such as banking, cement, chemicals, telecommunications, and steel. Altogether, the SOE sector accounts for about 30% of GDP, 20% of total investment, 15% of nonagricultural employment, and about 50% of outstanding bank credit.¹⁵

As about 60% of these enterprises are considered to be unprofitable and many are highly indebted (on the average, SOE's have larger debt than equity), reform of the state sector is required for the modernization of the economy. To improve the efficiency of the SOEs, the government during 1995-1996 grouped nearly half of the state enterprises under 18 big holding companies known as General Corporations, in industries such as steel, rubber, electricity, coffee, food and chemicals. Patterned after the South Korean model of huge conglomerates or *chaebol*, the government hoped that the grouping would allow these corporations to compete more effectively internationally, while at the same time retaining control over their activities. Skeptics, however, maintain that their creation has served to reduce competition and undermined efforts to allow more scope for private sector activity.¹⁶

So far the government has resisted outright efforts at privatizing SOEs, but it established a program in mid-1992 to "equitize" (convert SOE's into joint stock companies). By March 1999, some 147 enterprises had been equitized. An accelerated process of equitization faces formidable opposition from the army, individual ministries, and regional authorities that now control them.

Closely related to challenges of SOE reform are problems in the banking sector. State-owned commercial banks (SCOB's) still dominate this sector, accounting for 80% of all loans and deposits. Their problems include a large accumulation of nonperforming loans, weak capital base, and low profitability. The banks also lack basic regulatory procedures, a situation conducive to lax and politically-influenced lending practices.

Progress in opening Vietnam up to foreign trade has been most rapid on the export side, with the reduction of export bans and quotas, and the gradual opening of trading activities to private business. Vietnam, however, continues to restrain imports by imposing high tariffs, quotas, bans, and non-tariff barriers. Since the onset of the Asian regional crisis, trade protection to promote "strategic" industries has increased. As in the case of

¹⁴Offerdal, Erik. "Seizing the Day: The IMF Makes the Case That Delaying Reforms Only Increases the Risk of Economic Instability," *The Vietnam Business Journal*, June 1998, p.54.

¹⁵*International Monetary Fund*, "Vietnam: Selected Issues," IMF Staff Country Report No. 99/55, July, 1999, p.42.

¹⁶*International Monetary Fund*, Staff Country Report No. 98/30, p. 12.

banking reform, full trade liberalization reform appears to be intimately connected and dependent on a major reform of the state enterprise sector.¹⁷

Leadership Divisions Over Economic Reform

Although the Vietnamese Communist Party has relinquished some of its control over the economy as part of the *doi moi* process, it still exercises near absolute political power. Decisions are made collectively and behind closed doors. Opposition to the Communist Party rule, in the streets or in the press is not tolerated.¹⁸

At the same time, Vietnam is not the same highly regimented, centralized, and doctrinaire Communist state that it was a few decades ago. Its citizens may not have political freedom, but they appear to have considerable personal freedom. Provincial and local officials also have considerable power, and often act contrary to decrees issued from Hanoi. Top party leaders are most often described as pragmatists who are focused on two overriding objectives: bringing prosperity back to Vietnam and maintaining the party's monopoly on political power. The pace and scope of the economic reforms, however, are a matter of serious divide among Vietnam's ruling elite.

One group of "reformers" advocates more active policy reforms that support the development of a stronger private sector, the contraction of the largely inefficient state sector, and the country's continued integration into the regional and world economy. A second group of "conservatives" worries that an increase in the pace of economic reforms could undermine the country's "socialist" values, as well as the party's monopoly on power through an increase in societal demands for political reforms.

The leadership tensions are manifested in considerable policy ambiguity and caution. Concerning globalization, prime minister Phan Van Khai, for example, argued in a recent speech that Vietnam "cannot play by its own rules," but at the same time must carry out a reform program "that is proper for Vietnam." The leadership's continuing repressive attitude toward dissent and campaigns to "purify" party members also puts brakes on efforts to open up the economy more rapidly.

Currently, there are few indications that the leadership will agree anytime soon to initiate and implement a comprehensive second wave of reforms. Yet, a deteriorating domestic economy, growing unrest in some provinces, and a weak regional economy could prove a strong impetus for moving in this direction. Accordingly, Vietnam's leadership decisions on economic reform will continue to condition relations with the United States, including efforts to normalize commercial relations.¹⁹

¹⁷*International Monetary Fund*, Staff Country Report 99/55, p.4.

¹⁸Goodman, Allan E. "Vietnam in 1995: It Was A Very Good Year," *The Washington Quarterly*, Spring 1996, pp. 137-150.

¹⁹For a full discussion of bilateral relations, see CRS Issue Brief 98033, "Vietnam-U.S. Relations: Background, Recent Developments, and Issues for Congress," by Mark Manyin, *Congressional Research Service*, [Periodically Updated].

U.S.-Vietnamese Commercial Relations

Since President Clinton in 1994 ordered an end to the U.S. trade embargo on Vietnam, U.S.-Vietnamese commercial ties have grown. Two-way trade has increased almost four-fold, rising from \$224 million in 1994 (with the United States running a \$122 million surplus) to \$827 million in 1998 (with the United States running a \$279 million deficit). From just \$3.3 million in 1993, U.S. investment in Vietnam increased to \$1.2 billion by 1997, making the United States the 8th largest foreign investor in Vietnam.

Future increases in trade and investment flows could be affected by President Clinton's decision March 9, 1998 to grant Vietnam a waiver from the Jackson-Vanik amendment, which denies nonmarket economy countries that severely restrict free emigration certain benefits (e.g., most-favored-nation status in trade and access to U.S. government financial facilities). The waiver smoothed the way for the Overseas Private Investment Corporation and Export-Import Bank to begin providing support for U.S. investments and exports to Vietnam.²⁰

On June 3, 1999, President Clinton again issued an annual waiver of Jackson-Vanik restrictions on U.S. interactions with Vietnam. Joint resolutions disapproving the President's action were introduced in the Senate (S.J.Res. 28, June 7) and in the House (H.J.Res. 58, June 9). On July 20, 1999 the Senate rejected a motion to discharge S.J.Res. 28 from committee, effectively defeating the measure by a vote of 5-94. On August 3, 1999, the House voted down H.J.Res. 58 by a vote of 130-297.

In addition to providing Vietnam access to a variety of U.S. financial facilities, the annual waiver on Jackson-Vanik is one necessary step before Vietnam can receive most favored nation (MFN) trading status. MFN status would allow Vietnam to export its goods to the United States under much more favorable tariff rates. Many observers believe that until Vietnam gets access to the U.S. market on an MFN basis, it will remain severely handicapped in trying to attract large-scale foreign investment and in building a more sophisticated industrial base.

The other necessary condition for granting MFN status, as required by the Trade Act of 1974, is the conclusion of a bilateral trade agreement. The Office of the U.S. Trade Representative (USTR) announced on July 25, 1999 that an "agreement in principle" on the terms of a comprehensive bilateral trade agreement had been reached. Vietnam, however, has resisted signing the agreement to date, perhaps due to opposition from conservative elements in Vietnam's 18-member Politburo. According to one report, the Vietnamese army opposes the agreement due to concerns it will threaten its extensive commercial activities. Some USTR officials reportedly now hope that Vietnam will sign the agreement before the November 30, 1999 World Trade Organization Ministerial in Seattle.

²⁰Information provided by the U.S.-Vietnam Trade Council, Washington, D.C.

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