www.mofe.go.kr

**Ministry of Finance and Economy, Republic of Korea**
Government Complex 2, Gwacheon, 427-725, Korea.
Tel: +82-2-2110-2581 http://www.mofe.go.kr

**KDI School of Public Policy and Management**
P.O. Box 184 Cheong-Nyang, Seoul 130-868, Korea
Tel. +82-2-3299-1252 http://www.kdischool.ac.kr

www.kdischool.ac.kr

9 788991 765016 93320
ISBN 89-91765-01-7

Major Policy Agenda and Policy Responses toward a Globalized Market Economy for Vietnam

December 2005

Knowledge Sharing Project

# Major Policy Agenda and Policy Responses toward a Globalized Market Economy for Vietnam

December 2005

MOFE Republic of Korea

Korea Development Institute

Government Publications
Registration Number

11-1190000-000116-01

Knowledge Sharing Project

# Major Policy Agenda and Policy Responses toward a Globalized Market Economy for Vietnam

December, 2005

Ministry of Finance and Economy, Republic of Korea

Korea Development Institute

**Major Policy Agenda and Policy Responses toward a Globalized Market Economy for Vietnam**


**Prepared for:**

The Government of Vietnam

**Prepared by:**

Korea Development Institute(KDI)

**Supported by:**

Ministry of Finance and Economy(MOFE), Republic of Korea

**Review committee:**

Nyum Jin, Chairman,
Professor, Sogang University and Former Deputy Prime Minister of MOFE
Jong-Chan Choi,
Professor, Hanyang University and Former Minister of Ministry of Construction and Transportation
Kyung-Hoon Lee, Professor, Seoul National University
Dong-Kyu Shin, President, Korea Eximbank
Seung Ho, Former Ambassador of Korea to Geneva

**Project Director:**

Jong-Chan Choi, Professor, Hanyang University and Former Minister of MOCT

**Project Manager:**

HeeYhon Song, Professor, Incheon University

**Authors:**

Chapter1: Shin-Il Kang, Professor, Hansung University
Chapter2: Jaemin Lee, Professor, Hanyang University
Chapter3: Chonghoon Rhee, Professor, Myongji University
Chapter4: Ehung Gi Baek, Professor, Sangmyung University
Chapter5: Seung-ho Sohn, Senior Deputy Director, Korea Eximbank
Chapter6: Eungho Ahn, Director, Korea Eximbank

**Editor:**

Sang-Woo Nam, Senior Research Fellow, Asian Development Bank

**Managed by:**

International Development Exchange Program(IDEP), KDI School
Ji-Hong Kim, Associate Dean, Center for Knowledge Cooperation
Gil-Sang Won, Director
Soo-Kyoung Jeong, Research Associate
Seung-Woo Jung, Research Associate



Government Publications Registration Number 11-1190000-000116-01
ISBN 89-91765-01-7-93320

# Preface

Since the "Doi Moi" process started in 1986, the Vietnam economy has achieved a fast economic growth of 6~7% per annum except during the period of the 'Asian Financial Crisis' in 1998. Meantime, inflation and exchange rates have been stabilized, and the ratio of current account deficit to GDP is sustained at around 4% since 2004. Unrequited transfer as a major credit source of current account is around 5% of GDP and it shows an increasing trend. Meanwhile direct investment as a major source of capital inflow is about 4% of GDP. Total external debt dropped to 36.4% in 2004, which was 329% in 1989. The international reserve of Vietnam retains imports of 2 months, but at least 3 months of imports is advisable. The fiscal deficit should be kept at a rate less than 5% and Vietnam currently maintains a rate around 4%. Moreover, through the Five-Year Socio-Economic Development Pan, the Vietnam government has been making special efforts to change their economy to a more market-oriented economy, developing new industries as growth power, improving the quality of labor force, joining WTO, and improving the welfare standard in Vietnam.

Despite the above achievements, drawbacks and problems exist in the socio-economic situation of Vietnam, which the Vietnam government should manage wisely and successfully. Therefore, the Korean government initiated knowledge sharing programs based on the Korean economic development experiences, in order to assist the Vietnam government to solve the current hot issues of the Vietnam economy. The programs are supposed to be carried out jointly among the agencies in both governments. They are the Ministry of Finance and Economy, Korea Development Institute of Korea, Ministry of Planning and Investment, and Development Strategy Institute of Vietnam. The experts from both countries have made joint efforts to identify the current major policy issues in Vietnam and have studied/researched together on those issues. The identified 6 major policy issues are ① Preparation for Joining the WTO, ② Effective Management and Privatization of SOE (Reform Plan of Public Enterprises), ③ Macro Economic Management (Improvement of Macro Economic Policy), ④ Manpower Development and Employment (Development of Human Resources), ⑤ (Attracting) Foreign Direct Investment, ⑥ (Establishment of) Export-Import Bank. For each policy issue, executive summary is presented in this report.

In short, it is desirable that the Vietnam knowledge sharing programs to be continued because the programs are considered to be very helpful for policy makers in the Vietnam government to understand the Korean development experiences. Moreover, the programs are considered as valuable opportunities for Korean experts to understand the current economic situations and the future prospects of Vietnam's economy. We have had impression that the major findings of the Vietnam knowledge sharing programs will be effectively utilized to formulate the economic policy directions and policy action programs in Vietnam.

KDI would like to express special thanks Jong-Chan Choi, the project director and HeeYhon Song, the project manager and all the research members. We also thank the researchers of Development Strategy Institute(DSI) and numerous Vietnamese government officials who willingly spared their time to discuss and share their expertise. Last but not least, Chairman Nyum Jin and all other members of review committee had contributed to this project by giving invaluable advice from their ripe experiences.

Jung Taik Hyun
President, KDI

# Contents

# List of Tables

# List of Figures

# Challenges for the Vietnamese Economy: Is the Korean Model Relevant?

*Sang-Woo Nam*
*ADB Institute*

Is the Korean development experience relevant at all for the Vietnamese economy? Some may claim that the external environment, particularly the world trade regime, differs enormously from that of 30-40 years ago, under which Korea pushed intensely with its export and heavy industry drives. To evaluate, differences in initial domestic conditions do exist. In transition from a centrally planned to a market economy, Vietnam carries the burden of introducing numerous new laws and institutions en masse within a short time period. Moreover the political system between the two countries also varies. The socialistic orientation of Vietnam's political system ultimately dictates that land ownership belongs to the state, and that the economy still be dominated by state-owned enterprises (SOEs). Yet in spite of these obvious and seemingly disparate differences, the Korean economic experience - its successes and failures - offers valuable lessons to Vietnam.

Like President Park Chung Hee during the 1960's and 1970's in Korea, leaders of Vietnam since the "Doi Moi" reform have seriously committed themselves to economic development, thus wrestling with the new role of the state in a market economy within their socio-political and external constraints. More specifically, the government of Vietnam (GOV) has become greatly concerned with the question of how to induce the business sector to strengthen its industrial and technological capabilities, thereby fostering the sure survival of Vietnamese enterprises against global competition, and leading a sustained economic growth. In Vietnam, the major players of the business sector are SOEs, a role fulfilled by largely family-based business groups in Korea. The GOV seems to be highly interested in nurturing enterprise groups as a way of enhancing efficiency. Accordingly, careful evaluation of Korean business groups can offer a lesson well learned in a key subject area: the merits, demerits, roles, and relationship between businesses and the government throughout the development process.

The financial and foreign exchange crisis of 1997 presented an unprecedented shock to the Korean economy. The way the Korean government dealt with large businesses and the banking sector in the past, coupled with inadvertence in coping with globalization - particularly the external opening of financial/capital markets, are the major causes to the crisis in Korea. Another lesson, however, could be that sound macroeconomic management is essential to better cushion against external or domestic shocks. Vietnam is likely to face similar challenges when it opens its capital account, most likely in a not too distant future, and stands to learn an important lesson from Korea's past failure. Along with capital, human resource is the key to economic development, since the skills, ideas, and work ethics of people are increasingly becoming essential sources of value creation and competitiveness. To note, the influence of the Confucian culture, both in Koreans and in Vietnamese people, is very high, as is reflected in the high value given education by people from both countries. Nevertheless, Vietnam seems to face a great challenge when attempting to nurture effective systems of human resource development to equip its workers with better skills and technologies. Given the relatively strong position of workers in SOEs, Vietnam may consider the traditional Japanese systems of human resource development, and encourage worker participation in corporate decision making in order to enhance their contribution to productivity increase.

This paper discusses and elaborates upon the above issues, mainly highlighting the Korean experience and offering some suggestions for coping with the challenges facing the Vietnamese economy today. The topics covered will broadly define the main characteristics of the Vietnamese socialist market economy, with a hope of illuminating potential risks expected ahead.

## *Engineering a Take-Off and Laying Foundation for Sustained Growth*

History is witness to the fact that a country's fate can be radically changed by a leader with vision, as is Korea's economic take-off in the 1960's. Accordingly, it could be argued that countries with poor economies are blessed if a strong leader with vision and strong commitment to economic development rises to the fore, uncorrupt or un-captured by vested interests. Such leadership is likely to provide political stability and command strong and efficient support from the country's bureaucracy. Whether the country is a true democratic government or not may be a secondary issue, especially if concern is focused purely on economic performance. Along this line, immature democracies easily suffer from partisan electoral politics and an inefficient allocation of what meager resources are available, due to various short-term demands and rent-seeking by interest groups. Thus, what seems to be most critical is rule of law and institutional checks and balances for sound governance, ironically often provided by non-democratic regimes, as well as by democratic governments. Strong, honest and dedicated leaders often make up for the inadequacy of laws and institutions (Pei, 1999 and Bardan, 1999).

A market economy necessitates a sound legal system and institutions that ensure the efficient operation of the economy. Vietnam has made remarkable efforts to put this system and institutions in place since the adoption of the Doi Moi reform. However, the task is far from complete. Many laws and institutions are still to be introduced, and the ones that have already been introduced need refinement and effectiveness. In fact, some laws seem to be poorly observed or enforced (Fforde, 2004), which is not surprising given that these laws and institutions are mostly implanted in their original form directly from a very different soil to that of Vietnam- that is, from matured market economies. Fortunately, Vietnam has relatively strong institutions of checks and balances at both the central and the local government levels, preventing any gross abuse of power and ensuring a degree of good governance.

How does the socialist orientation of Vietnam affect the construction of a market economy? Ultimately private ownership of land is denied in Vietnam. Even though long-term land use rights are honored and can be bequeathed or transferred, it is nonetheless a far cry from ultimate ownership. A more important aspect of Vietnamese socialism may be the role of SOEs. In spite of the acceleration of SOE reform in recent years, approximately a mere 8% of SOE assets have been transferred to private hands thus far (Vu, 2005). While many small or unprofitable SOEs have been consolidated, sold, liquidated or leased, the GOV is rather reluctant to lose control over larger and more profitable SOEs. Although many SOEs are likely to be equitized (partially privatized) to mobilize capital and utilize other private input, the GOV desires to retain its control over these enterprises, in part by placing them as subsidiaries under a SOE holding company (HC).[1] The efficiency of how these SOEs are managed and survive under increasing global competition will be the litmus test for the future of Vietnamese socialism.

The Korean top leadership that came to power through a military coup d'etat in the early 1960's was a group strongly committed to economic development. In order for his regime to gain legitimacy, the leader of this group, President Park, needed to keep his public promise of "delivering the Korean people from poverty." Albeit his near two decades of rule was an authoritarian regime, it provided a fair degree of political stability and a consistent policy environment, requisites for long term investment and sustained growth. Largely free from political and business interests, President Park was reasonably successful in keeping senior bureaucrats and politicians corruption free. Vietnamese political leadership, on the other hand, does not depend on a single leader, but rather on the idea of shared power between the Communist Party and the state, as well as multi-layer state organizations. This balanced relationship seems to ensure political stability and a stable policy environment (Painter, 2003). The disadvantage of the system is that the decision making process is usually slow and at times lacks transparency. In order to enhance the efficiency of the GOV, Vietnam should streamline its policy coordination and its decision making processes.

Efficiency in policy coordination seems to be particularly critical for economic growth. In Korea, the 1960's saw the adoption of export-oriented industrialization as the development strategy, together with efforts to support this strategy through institution building and policy reforms. An Economic Planning Board (EPB) was created as a super-ministry in charge of planning, budgeting, and coordination among the economic ministries. A Five-year economic development plan was prepared and used as a central framework for ensuring policy consistency and inter-ministerial coordination, as well as for mobilizing adequate support for

1) During the 2000-2004 period, about 3,400 SOEs were reformed, of which almost two-thirds (2,242 SOEs) represented equitization and the remainder included mergers and consolidation, transfer to ministries, sales, and dissolution. For SOEs equitized in 2003 and 2004, state equity share was still kept at 55% and 50%, respectively (Vu, 2005).

the realization of planned targets through various incentives. In Vietnam, the Ministry of Planning and Investment (MPI) undertakes a similar function. However, its coordination role seems to be rather weak, often resulting in inconsistencies among policies and delays in decision making. In Korea, the Minister of the EPB, coincidentally the only person given the title of Deputy Prime Minister, chaired the Economic Ministers' Meeting, where inter-ministerial coordination and relevant final decisions were made rather swiftly. With the growing and diversifying demand of the people, and with the progress of globalization, major policy decisions will increasingly involve more ministries and agencies, making the coordination function within the GOV all the more important.

Opting for the strategy of export-oriented industrialization was a rational choice for Korea during its period of development. Although seemingly obvious at this point, it was not as evident during that period. In fact, popular development thought during that time favored import substitution rather than exports, and many developing economies, particularly in Latin America, chose this path, investing largely in import substitution industries. A country with a poor endowment of natural resources cannot proceed with industrialization without the import of raw materials, and intermediate and capital goods. The necessary foreign exchange for development can be obtained through a combination of foreign aid, foreign loans, foreign direct investment (FDI), and the economy's exports. Korea chose to rely mainly on exports and foreign loans. Without much industrial capacity, the export industry commenced with some primary commodities and labor-intensive products.

Vietnam is somewhat better "natural resource endowed" than Korea. Nonetheless, Vietnam has taken export promotion as an important element of its development efforts, as shown by its sincere efforts to join the World Trade Organization (WTO) in recent years. This strategy should be the appropriate one, since ample evidence exists that countries with an outward orientation perform better than countries that don't (Dollar, 2001 and Baldwin, 2003).[2)] Vietnam currently relies more on FDI than Korea did during its early stage of development, a sensible choice given the need for Vietnam to rapidly obtain technology from near scratch. In the case of Korea, policymakers' fear of domestic industry domination by foreign industrial giants caused an overly restrictive FDI policy. Although some believe that this approach assisted Korean enterprises in developing their own technological capabilities in the long run, this is not necessarily the case for Vietnam. Vietnam might be tempted to develop heavy industries at an early time. However, the Korean experience evidences that heavy industries development should be pursued in consideration of technological capability, the skill level of workers, and

2) Outward orientation means exposure to global competition inducing stronger efforts for efficiency and expansion of markets beyond national boundaries to realize economies of scale and the benefits of specialization on the basis of a country s comparative advantage. Outward-oriented countries tend to be less subject to foreign exchange constraints enabling them to achieve more stable capital formation and growth. Outward orientation is also likely to lead to better discipline in macroeconomic management since misalignments of key policy variables such as overvalued exchange rate will give a rather immediate warning signal through the external sector.

capital requirements. Labor-intensive manufacturing industries help create more jobs and achieve a better shared growth.

### *Engaging the Business Sector for Development*

The role of the Korean government in economic development deviated substantially from the typical role played by the governments of matured market economies - providing physical infrastructure and establishing laws and institutions necessary for the efficient functioning of the market. While markets are still imperfect due possibly to the lack of effective laws and institutions, in the past the Korean government directly intervened in the decision making of the private sector, most prevalently in the process of the heavy and chemical industry development drive during the 1970's (and in the 1960's on a selective basis). President Park or senior government officials often directly negotiated with, or coordinated among, the chairmen of a few large business groups, the typical method of decision making on the allocation of the national projects, specific performance target for each project, and associated government support and incentives during those times. In essence, the government and large business groups were development partners.

To offer an analogy, the government and large business groups were similar to parts of a single enterprise with multi-units? perhaps informally called Korea, Inc. or a quasi-internal organization (QIO). The government represented the headquarters, while each participating business group represented a business unit; from another perspective, the government was a pure holding company, while each business group was a subsidiary. The subsequent question, then, is "was the QIO efficient?" Building major heavy industries usually involves undertaking several complementary (often vertically related) projects. Therefore, the effective coordination of the timing, sequence and scale of the individual projects is the key to the success of entire task. When only a limited number of potential participants get involved in the projects, it ironically can be more efficient than leaving the decisions to the market. Nevertheless, the risk of government failure always exists. Even if the market might be inefficient, there is however no guarantee that the government will do a better job. In Korea, operation of the QIO was relatively successful. This success may be attributable to several factors (Nam, 2001b).

First, the government, often the President himself, was an effective monitor of tasks, something that can be expected under a strong political leadership fully committed to economic development. In fact, the President himself paid keen attention to the projects, voicing his interest and encouragement at each stage of achievement. Under this situation, the possibility of opportunistic behavior by participating enterprises or their diversion of funds provided by the banks for the project was minimized. In the rare case that such behavior was exposed, the enterprise or group paid a heavy penalty - being excluded from the QIO. However, effective monitoring might not have been possible without a strong bureaucracy - one that is both capable and corruption free. The Confucian value of respecting civil servants, along with the merit-based system of hiring and step by step promotion, created in Korea a strong government bureaucracy. Elite bureaucrats have generally been unsusceptible to corruption, in part from their fear of losing their pride and their life-time tenure, and/or the chance of moving to an honorable position outside of civil service. These fears and desires, along with a strong belief in the Confucian values of altruism and social service, created in Korea an apt bureaucracy.

Second, strong incentives were given to the participating enterprises, without which enterprises would not have actively participated in the projects, regardless of however strategic the projects might be for the country. Since heavy and chemical projects were capital-intensive and risky with a long gestation period, enterprises showed some initial reluctance. In order to induce them to undertake the projects, the Korean government was willing to be an implicit risk partner. The government provided various tax incentives, urged banks to provide loans at subsidized interest rates, facilitated introduction of foreign capital, even providing repayment guarantees, and provided protection from imports.

Third, there was a sensible performance criterion in the operation of the QIO. Without the right criteria, the whole purpose of the task - coordination and monitoring - would be defeated. In Korea, the most important criterion was export performance - viewed as the ultimate litmus test of efficiency and competitiveness. The criterion - though possibly imperfect - was also clear and easy to administer without much confusion or discretion. Although the projects were geared initially towards import substitution, participants knew that their survival required success in the international markets. Even though no elaborate performance-reward system was in place, the plan was nonetheless successful, resulting from several factors: through such schemes as subsidized export credit, using export performance as an important consideration in the government's allocation of other development projects, and the self motivation by enterprises for corporate growth through success in the export market.

Finally, operation of the QIO might have not been as successful were there many participants. With a large number of participants, the burden of the government to coordinate among the participants, to work out fair incentive packages across different projects and enterprises, and to monitor the performance of participating enterprises multiplies. In the case of Korea, the number of candidate enterprises was few, at least during the initial phase of its industrialization.

However, the healthy maintenance of the QIO might be shorter than expected. Above all else, the initial role of the government (headquarters) becomes relatively weaker as enterprises accumulate experience, knowledge and information. The result might be that enterprises gain greater wisdom in selecting promising investment projects. Moreover, subsequent to initial success in industrialization, the political leadership can be faced with other competing agenda, possibly resulting in lessened commitment to economic development. This can also impact the role of the government/bureaucracy as effective and impartial monitors. Furthermore, operation of the QIO will become increasingly ineffective since the government is likely to find it increasingly burdensome to keep providing strong incentives to the participants. The health of the banking sector and the government budget might be jeopardized; otherwise, market and external pressures for deregulation, fair competition, and subsidy reduction might make it difficult to keep the incentives. Finally, the number of candidate participants in the QIO will increase as the economy develops. As a result, the government will find it increasingly unjustifiable to keep the QIO as the original “exclusive organization” on the one hand, and increasingly costly to manage if membership expands on the other.

In retrospect, the QIO in Korea - development partnership with big businesses might have outlived its desired span of life, degenerating and leading to moral hazards on the part of big businesses and the banking sector. Consequently, many unprofitable investment projects were undertaken and many enterprises either failed or were in extreme financial distress, triggering the financial and foreign exchange crisis in late 1997.

What lessons can Vietnam learn from the Korean experience regarding the relationship between the government and the business sector? In the case of Vietnam, apart from very small family businesses and foreign direct investment, the business sector is mainly comprised of SOEs. That is, the state virtually owns the business sector, and the government and enterprises in tandem form an internal organization. Since there are a large number of SOEs in Vietnam, the government has already grouped them into many enterprise groups called General Corporations (GCs) beginning in the mid-1990’s.[3] Several concerns regarding the efficiency of the internal organization arise.

The first is whether the headquarters the Prime Minister’s office, each ministry, or the local government has the capacity to lead their SOEs by suggesting their strategies and their investment directions. Another is whether the decentralized headquarters can effectively block political or line ministry interferences in the day-to-day operation of SOEs. Also questionable is whether strong incentives exist to monitor the performance of SOEs. If the officials of the headquarters are vulnerable to capture by the member SOEs, headquarter monitoring will not be effective, making it difficult to impose hard budget constraints on SOEs, and possibly permitting managers to abuse their positions in pursuit of their private benefits.

As a way of mitigating these problems, the GOV is currently in the process of transforming the GCs into HCs. While GCs are largely administrative groupings for the purpose of more effective control over SOEs, each HC is being constructed with a strong parent company in mind (often formed by the merger of some SOEs), and for its subsidiary SOEs to be controlled by the parent company through a capital relation. The extent to which this HC structure will

3) There are18 bigger GCs (with 487 subsidiaries as of the end of 2003) in strategic sectors governed by the Prime Minister s Office. They represented 53.1% of all SOE capital, 43.7% of total employees and 51.9% of total revenue of the SOE sector in Vietnam. Also, there were 79 smaller GCs (with 989 subsidiaries), mostly under line ministries except for some under the local People s Committees, representing 15.1% of state capital, 33.3% of total employees, and 11.9% of total revenue of the SOE sector (Pham, 2004). Many of these GCs had the Prime Minister s approval for pilot conversion into HCs. Also decided was pilot establishment of 4 Economic Groups, where a HC can be its subsidiary, in 4 areas including electricity, gas and petroleum, telecommunication, and cement.

help with the tasks of the headquarters strategic direction and monitoring will very much depend on the capacity of the agency responsible for managing state capital, the composition and function of the management board (board of directors) of the parent company, and the selection of top management.[4] Yet another concern is whether the internal organization would be judged by the right performance criteria. Many Vietnamese SOEs will sell their goods and services only in the domestic markets, which are likely to possess a monopolistic or oligopolistic structure. In this case, accounting profits would not necessarily serve as reliable performance indicator, thereby complicating the monitoring task.

## *Will the Enterprise Groups and Holding Companies be Efficient?*

Enterprise groups possess some benefits, particularly in the early stage of development when markets and institutions are not well developed. First, coordination of business activities, especially among vertically related firms, is relatively easy within a group, and some synergy effect can also be expected. Second, the grouping allows member enterprises to enjoy economies of scope by sharing some scarce resources and making joint business efforts. Examples include entrepreneurial talent (of the headquarter CEO), and physical facilities underutilized by one single enterprise. Third, in general, imperfections in the financial/capital market cause the failure of funding a number of promising investment projects. However, such investment may be better funded if a group-wide internal capital market is operated, tapping the financial resources of member firms. Lastly, business risk will be reduced due to (unrelated) diversification of activities. High-risk activity such as a major technology development might be better undertaken with the sharing of the risk among the member companies (Nam, 2001a).

Vietnamese HCs seem to be dominated by operationally related enterprises, particularly by vertically related enterprises. As such, the most important aspect of the groups is likely to be coordination and feedback among member firms, including, among others, decisions related to the scale, timing, product mix, and quality improvement among such activities as procurement/production of raw materials and intermediate goods, production of final goods and services, and marketing activities. Moreover some room exists for economies of scope through the sharing of resources as well as the utilization of the group-wide internal capital market.

4) Members of the board of a SOE are appointed annually by the person who has approved the regulatory document concerning the enterprise depending on the performance of the enterprise (being dismissed, for instance, when the enterprise records deficits or fails to achieve profit target for two consecutive years). The members are limited to Vietnamese and those holding a bachelor s degree with business competence. Stipulated functions of the board are largely in line with those of Anglo-American board of directors (Hoang, 2004). The State Capital Investment Corporation (SCIC) is to be established as of January 1, 2006 to take over and manage state capital in SOEs, and to make decisions concerning allocation of investment funds.

Vertically related HCs, however, pose some potential problems. By virtue of the vertically related characteristics of the group, numerous internal business transactions among the member enterprises will take place. Raw materials and intermediate goods might be purchased from member firms, even though better suppliers exist outside of the group. Inefficient firms in financial distress might be subsidized and bailed out by other members. The consequence is weakening competitiveness for the group as a whole. Furthermore, exclusive internal transactions will ultimately lead to a monopolistic or oligopolistic market structure, since new entries will be discouraged, thus negatively impacting the development of private entrepreneurship. Facing little competition, HCs might lose their diligence to enhance efficiency while lobbying for delay in market opening. Vietnam needs to be extra cautious in this regard in fostering HCs. This problem, in fact, is one that Korea has faced in the past.

From an organizational point of view, HCs mainly composed of (vertically) related businesses, as is the case for Vietnamese HCs, also presents a problem. A HC structure may not work very well in the case of (vertically) related enterprises. The key advantage of a HC comes from the division of functions between the headquarters and the management of the subsidiary enterprises. The headquarters specializes on strategic planning, resource allocation, coordination and monitoring, while the top managers of the subsidiaries are authorized to make operating decisions on the basis of relevant local information. Since the managers are given the authority to make and implement operational decisions, they are accountable for their performance, which induces their greatest endeavors for good business performance. However, in the case of HCs with operationally related enterprises (particularly, vertically related ones), the coordination function of the headquarters is likely to interfere with the operational decision making of the management of the subsidiaries. As a result, making the top management of the subsidiaries fully accountable for their managerial performance might prove difficult, weakening one of the key strengths of the HC structure (Hill and Hoskisson, 1987).[5)]

In any case, an essential element of operating an enterprise group is the role of the headquarters. Its tasks include charting group-wide strategies, preparing investment and financing plans, coordinating among member firms for the best interest of the group, and monitoring the performance of subsidiaries. To perform these functions, Korean business groups in the past utilized a Planning and Coordination Office directly supporting the Chairman of the group. Staffed with the most talented people, the Office served as the control tower of the group. However, this Office became the target of public criticism after the financial crisis, in part because it was often found to be preoccupied mainly with maximizing founding family interests rather than that of all shareholders or broader stakeholders. The Office was also used by the Chairman to intervene in the management of member firms, regardless of whether he/she

5) In the early development stage of Korea s business groups, they tended to pursue operationally unrelated diversification as they made new entries into whatever industries offered good business opportunities. At a later stage, however, they focused more on operationally related diversification by expanding their businesses around key enterprises in different industries. Related diversification creates opportunities for internal transactions, which can be abused for the maximization of interests of the controlling owners.

possessed an official position in the firm, such as membership in the board of directors or some other form that promoted accountability for his/her managerial role.

On the other hand, family-owned and managed enterprises have their strengths, particularly in developing countries where institutions lack protection for outside investors. These include strong dedication and commitment of the family members, smooth communication among the members, and minimal disparity of interests between the management and shareholders. As the enterprises grow, the families usually relinquish management to professional managers. As controlling owners, however, they still possess strong interest in closely monitoring the management unlike firms with diffused ownership, where small shareholders suffer from a free-rider problem (no interest in monitoring). This is believed to be an important source of superior corporate performance for firms with large shareholders (Shleifer and Vishny, 1997).

The negative side of family-based business groups is their pursuance of family interests. If a firm or business group is 100% owned by a family, little problems exist when the family pursues their interests. On the other hand, this becomes a serious problem when a business group is partially owned by the family. Typically through cross-shareholding among member firms, the family can control all firms in a group, even if the family's equity shares in some of the firms may be very small. The family can maximize their wealth through various types of internal transactions among member firms, such that the benefits of the transactions are concentrated on the firms mainly owned by the family. The internal transactions may include advance payments, loan, guarantees, and transfer of goods and services, real estates, manpower, securities, etc. free of charge or on preferential conditions. This behavior not only hurts the interests of outside shareholders but also the health of member business enterprises.

In their pursuit of family interests, the Korean business groups showed some additionally typical behavioral patterns (other than extensive internal transactions). First, they were extremely reluctant to give up management control, and the chairmanship of the groups was inherited to a family member almost without exception. Second, in order to maintain management control with limited family wealth, they relied mainly on borrowing and capital subscription by other member firms for business expansion making their capital structure weak. Lastly, they kept diversifying their businesses, increasing the number of member firms to several dozens for the largest groups. More firms meant a higher chance of gaining family interests through more internal transactions. The consequences of pursuing family interests in an unfair manner were the misallocation of resources, fragile balance sheets, and the concentration of economic power; ultimately this triggered the financial crisis (Nam, 2001a).[6)]

6) Among the 35 cases of chairmanship succession for Korean business groups until 1996, all but 1 were succession to a family member. The debt-equity ratio for the 30 largest groups in 1996 amounted to 387%. Average number of subsidiary companies in 1997 was 52.4 for the five largest groups, and 27.3 for the 30 largest groups. Internal (within the group) transactions for the largest five groups in 1997 amounted to over 30% of their total sales on average. Finally, the rate of ordinary profit to total capital remained at 1.3% during 1994-97 for the top 30 groups (-0.6% for the 11th-30th groups) compared with 1.7% for all industries and 1.9% for all companies listed at the Korea Stock Exchange (Nam, 2001a).

What are the lessons for Vietnam? Family enterprises should be fostered since they represent a very dynamic and valuable source of economic growth. However, when they grow large enough to share their ownership with other investors, and to possess numerous affiliated firms under a business group, they need to be disciplined through regulations and sound corporate governance mechanisms. Vietnam, however, may not see the emergence of strong family-based enterprises for some time. Rather, the impending task is to ensure the efficiency of SOEs, especially the parent companies of HCs. How can the best-qualified top management be selected and motivated to put forth their best efforts? Who will provide them with a strategic direction for HCs, while not interfering with their operational decision making?

We may already know the answers. There should be clear separation between the state's ownership function, and its market regulation and other functions. The representation of state capital as the owner, moreover, should be made in a consistent and serious manner. Selection of the top management and other members of the management board should be strictly based on their expertise. The board should have a sufficient number of outsiders, and high standards of transparency and disclosure should be observed (OECD, 2005). These suggestions are easier said than done. Vietnam may also learn from the Korean system of evaluating the performance of public enterprises together with the incentive schemes, as well as from the Korean rule of banning government officials from joining the management of public enterprises, or the practice of recruiting the top managers through open bidding. Still, Vietnam may better try to develop its own corporate governance system, for instance, by enhancing the role of employees. As a way of checking the potential abuse of employee power, creditor banks may be encouraged to play some kind of role this coming after their own restructuring and corporate governance reform.

## *How can Vietnam Avoid a Financial Crisis?*

There are many factors responsible for the Asian financial crisis of 1997. Some blame the irrational behavior of the international financial market, especially its herding behavior generating a boom and burst cycle in the recipient developing countries. Others focus more on macroeconomic mismanagement: large current account deficits financed by short-term foreign capital and the consequent expansion of domestic credit resulting in real estate boom and unwise investment (Schmukler, 2001 and Willett, 2002). In the Korean context, the crisis was largely the result of fragile balance sheets of large enterprises and the banking sector combined with poor management of foreign exchange assets and liabilities in the wake of capital market liberalization.

Near the end of 1970's, the Korean economy faced difficulty, experiencing some side-effects of the government's heavy and chemical industry drive, as well from the second oil price shock. Some heavy and chemical investments suffered from poor export, underutilization of capacity, and heavy debt service burdens. Rapid increase in domestic credit to support the drive also generated substantial inflationary pressure and a spell of rampant real estate speculation.

Entering the 1980's, the Korean government shifted its policy stance towards liberalization, reduced government intervention, and macroeconomic stabilization. Import restrictions were eased, the Competition Law became effective, and financial liberalization was initiated.

Financial liberalization efforts started with the lifting of many operational restrictions on the organization, budget, branching, etc, of banks. More significantly, between 1981 and 1983, the government divested its equity shares in all nationwide city banks, completely transferring the ownership to private hands. Entry barriers to the financial sector were lowered with the establishment of some new banks and many non-bank financial institutions. Compartmentalization of different types of financial institutions was also eased, as the services provided by them became increasingly diversified and overlapping. By 1982, most preferential interest rates applying to various policy loans were abolished, and policy loans started to be phased out.

Impressive as this list of measures may look, the banking sector still remained under the grip of the government. Though all nationwide city banks were privatized, no controlling shareholder ownership existed, since the government capped ownership with an 8% ceiling (subsequently lowered to 4%) for individuals, corporations or business groups. Therefore, the government continued to control banks, de facto appointing bank presidents and selecting board members, while senior officials kept exerting their influence on major lending decisions of banks. Understandably, the government was sympathetic with these banks, since they were heavily used as an important instrument of the government's industrial policy. Given their deteriorated balance sheets, the government kept protecting banks from earnest competition with each other or with non-bank financial institutions. For one thing, it was not until the mid-1990's that significant progress was made in interest rate deregulation.

The government also kept intervening in corporate investment decisions on an ad hoc basis, often through the banking sector. It promoted an implicit belief by large businesses that the government was still willing to be their risk partner, propping the perception of "too big to fail." The result was moral hazard behavior: Businesses kept borrowing to expand without careful evaluation of the investment projects. On the other hand, government monitoring of large enterprises weakened without a sound corporate governance system in family-based enterprises to make up for the weakening. Family-owners thus tried, without much reservation, to maximize their interests at the expense of minority shareholders, and often at the risk of business survival. When the financial crisis arrived in the region and foreign creditors and investors became aware that several business groups virtually went bankrupt, confidence in the economy vanished rapidly, engulfing Korea in a crisis.

Had it wisely managed foreign assets and liabilities as well as capital market opening, Korea might have avoided a financial crisis. Korea pursued capital market opening substantially before it joined the OECD in 1995: Restrictions on investment in various securities and other capital transactions in and out of the country were eased. In response to these measures, some Korean financial institutions became aggressive in short-term borrowing from abroad and capital investment in the developing world. As expected, foreign capital inflow increased significantly. Pursuing capital account liberalization, Korea should have paid more attention to prudential regulation and supervision, so that financial institutions would be more serious about risk management when expanding their businesses into new areas. Korea should also have been better prepared for the possibilities of drastic changes in foreign capital flows. Even though Korea's total foreign debt was within a tolerable level, it was nonetheless too concentrated on short-term debt. Official foreign exchange reserves were too small for the size of short-term debt, and much of the reserves were drained in a futile effort to defend the exchange rate.[7)]

A lesson for Vietnam is that, for it not to fall a victim to a similar crisis, capital account liberalization should be well prepared. The preparation involves many challenging tasks, necessary to build a strong economy anyway. First, weak balance sheets of major enterprises and the banking sector should be addressed. This weakness is the ultimate source of problem that affects the perceptions of the international financial market. The task includes not only clearing existing non-performing loans (NPLs) in the financial sector, but also putting in place right systems that would prevent large-scale accumulation of NPLs in the future. Large-scale problems often result from a serious flaw in the system surrounding the financial sector. Most critical for Vietnam in this respect seems to be reform of state-owned commercial banks (SOCBs).

The experiences of Korea and other countries are witness to the fact that a cozy relationship between the government, the banking sector and big businesses is a recipe for trouble. If the government keeps its control over major enterprises, it should seriously consider loosening its control over the SOCBs so that loan decisions can be made purely on a commercial basis and monitoring their client firms can be done more seriously. Acceleration of ongoing SOCB equitization should include more banks, and the government should not insist on keeping majority equity shares in the equitized SOCBs. Also, it is advantageous to attract foreign strategic investors and let them join the management team. Privatized Korean banks continued behavior reminiscent of government banks when large shareholding was not allowed.

Second, stepped-up efforts should be made to reduce the risk of crisis by more closely watching over risk-taking activities of financial institutions and business enterprises. Standards for prudential regulation and supervision over the banking sector need to be raised for better capital adequacy, improved risk management, more disclosure, and avoidance of regulatory forbearance. Financial safeguards need to be in place, including depositor protection and the central bank's lender-of-last-resort function. However, the safeguards should be designed to minimize moral hazards on the part of depositors and banks. Another essential institutional

7) Korea s total foreign debt, at USD158 billion at the end of 1997, was far from being excessive representing 36% of GDP or 93% of current foreign exchange receipt. However, more than 60% of the total foreign debt was short-term debt right before the crisis, amounting to approximately 3 times the foreign exchange reserves. The useable portion of the reserves was even smaller since much of it was in the form of deposits at the foreign branches of domestic banks. Lack of transparency regarding foreign exchange reserve and total external debt was also responsible for the weakening of market confidence in the Korean currency.

complement is effective mechanisms of exit and restructuring of troubled financial institutions and non-financial corporations. The Korean experience indicates that it is not enough to have the mechanisms incorporated into the law. They need to be tested and refined for effectiveness before a major crisis arises. Lastly, for both the financial and business sectors, a sound corporate governance model should be introduced, so that excessive risk taking can be curbed, among other things. The choice of the model will be closely related to the ongoing ownership reform and organizational restructuring of SOEs.

Finally, sound macroeconomic management, especially within the external sector, will bring about a much stronger buffer - an extra line of defense. Foreign debt size and maturity structure should be well within the level generally considered safe, and the level of official foreign exchange reserves should be increased in consideration of the expected level and volatility of foreign capital flows in and out of the country. A wider margin of exchange rate fluctuation should also be allowed well before capital account liberalization, necessary to alert the banking and business sectors to foreign exchange risk, and to better absorb shocks in the foreign exchange market. Stable domestic interest rates based on price stability are also desired in order to discourage excessive overseas borrowing attracted by nominal interest rate differentials.

Vietnam still has time until full-fledged capital market opening. As is well known, Vietnam should follow the right sequencing of liberalization and external opening. With the entry into the WTO, Vietnam will soon pursue more liberal current account opening. The next step is domestic financial liberalization. Earnest capital account opening should be pursued only after enough progress has been made. Korea spent too much time without much progress on domestic financial liberalization, causing it to be ill-prepared for capital account opening. Vietnam is advised to take serious and harsh measures ensuring that it does not make the same mistake as Korea. In other words, putting in place all the systems mentioned above is not enough. The government should also be willing to throw financial institutions into genuine competition, even if many of them go bankrupt. It needs to demonstrate its capacity to discipline the financial sector and to manage financial restructuring without inviting a crisis. The consequence will be a much stronger and healthier economy including its enterprises and financial institutions.

### *Human Resource Development and Participatory Role of Workers*

Often, skilled labor and other manpower with appropriate know-how and qualification are more difficult to come by than capital. Thus, how to nurture these human resources is an important policy challenge. In the initial stage of economic development, Korea's higher education and technical high schools had limited capacity in producing the manpower needed in the emerging industrial sector. With a shallow history of industrialization, the labor market for managerial and technical human resources was not well developed. Even though many Koreans had experience in modern industrial enterprises during the Japanese colonial period, managerial and technical positions were mostly occupied by the Japanese. Under this environment, larger

Korean firms had no other option but to train their workers in-house.

In Korea, the labor market for experienced workers remained rather thin for several reasons. First, all major enterprises were training necessary manpower in-house rather than recruiting in the market. Making efforts to develop skills mainly through on-the-job training (OJT), enterprises sought to retain skilled workers for the long term, ensuring that their investment on human resources would not be wasted. Seniority-based compensation and progressive severance pay were strong incentives for workers to remain for long periods with an enterprise. Second, since business groups kept growing and required more skilled and experienced manpower, little discharge of people outside of the group existed. Third, Korean business groups, major sources of demand and supply of skilled workers, refrained from recruiting from their rival groups for fear of losing their own people.  Lastly, much of the skills and experience workers accumulated were firm or group-specific, thus little appreciated in other enterprises. Large Japanese firms also followed this model until the early 1990's (Miwa, 1996 and Nam, 2003).

This model is undergoing some changes both in Korea and Japan. In an effort to survive global competition, enterprises are increasingly reluctant to hire people as regulars and train them in-house, preferring flexibility in manpower management. Greater reliance on the market for hiring skilled workers on a short-term basis is made. Many Korean and Japanese enterprises underwent manpower retrenchment, so a large supply of skilled workers was created in the market. Moreover, the ongoing revolution of information technology has brought about drastic changes in the modes of production and service provision, work organization, corporate management, and the required mix of skills making the existing firm or group-specific skills and knowledge less important (Yoshitomi, 1996).

In spite of this new trend, the old system of skill development in Korea and Japan seems to be more relevant to Vietnam. Vietnamese enterprises are now facing a shortage of trained skilled labor, which will become even more serious in the coming years with the progress of industrialization. Given the current limited capacity of educational institutes and a still weak private sector, skill development will largely be undertaken within SOEs. Even though a large pool of workers will be discharged from the public sector, they are unlikely to have skills that are in strong demand. SOEs tend to give regular employment contracts to their workers, and they are likely to be a member of a larger HC. This organizational setting provides ideal conditions for both the employer and workers to invest in human resource development. Once trained to acquire firm or group-specific skills and knowledge, workers will have limited incentive to leave the group, due to the fact that the group usually represents a substantial portion of an industry, and worker skills may not be appreciated by new employers outside of the group. Moreover, assuming that the Vietnamese economy will continue its breakneck growth in the coming decades, thus creating many promotion opportunities within a SOE group, workers will be willing to develop their careers within the group.

In order to better operate this system of employment and human resource development, a GC or HC should pay more attention to training their employees. Individual enterprises will train workers systematically on firm-specific skills mainly through OJT. However, enterprises within a group should also make joint efforts to train their workers on industry-specific or group-specific skills and knowledge. Since the enterprises within a group are operationally related in most cases, this joint training is likely to enhance the synergy effect among member firms. Furthermore, the joint training will facilitate development of a group-wide internal labor market. When the capacity of academic institutions such as business schools is limited in producing intermediate-level managers, larger enterprises will nurture these human resources in-house (Khanna and Palepu, 1999). Since an individual enterprise is likely to be too small as an ideal training ground as well as for efficient functioning of the internal labor market, it will prove wise to expand the boundary of the house to a group level

In the process of industrial catch-up, many Vietnamese enterprises will realize that their competitiveness depends to a great degree on how successfully they encourage their employees to make firm or group-specific investments. In such enterprises, securing and retaining valuable human capital is going to be one of the major managerial concerns. The question then is how to motivate them. Offering long-term employment contracts and seniority-based compensation will probably be insufficient. What may also be needed is to instill a sense of ownership in the employees, a possibility when they are allowed to participate in company's decision making as well as in its financial performance, much like the shareholders.

Traditionally, employees of Japanese firms were the de facto controlling group of their companies. As experienced workers join management through the promotion ladder, there were relatively small differences in status and compensation between managers and workers. The consequence was a tendency of bottom-up decision making and management style, and de facto delegation. Labor workers at shop-floor were (and still are) very much encouraged to make autonomous decisions related to their work, even though employees were rarely represented in formal corporate governance mechanisms. Since employees, with the expectation of lifetime employment, have a large stake in their firms, they generally have a strong commitment to their companies, and often exercise checks on management in order to ensure the long-term viability of their firms. This "unified body of employees" was often seen to have near sovereign power, fairly free from shareholder control. The common perception was that "the firm belongs to the people who have committed themselves to it for long periods. They have the right to make the decisions of basic importance to the firm, and they have priority rights in the distribution of the economic products of the firm's activities." (Itami, 1994)

Across the world, the most common form of an institutionalized body where information sharing and consultation occur between the employer/manager and employees of a workplace in a less confrontational atmosphere than the collective bargaining with a labor union is the works council. Works council called joint labor-management committee (JLMC) in Japan, and labor-management council (LMC) in Korea is expected to contribute to work efficiency, workplace democracy, and enforcement of regulations affecting workers' interests (Rogers, 1995). The Japanese JLMCs seem to have strengthened employee voice for their participation in corporate strategic decision making, while the Korean LMCs have been mainly concerned with wages, working conditions, worker welfare, etc. Another form of employee participation in business decision making is autonomous decision making by workers on the shop-floor, through activities such as quality circles, autonomous teams, and various job enrichment programs. This kind of participation is more important than works council from the perspective of human resource development, and purports to lead to higher labor productivity and improved corporate profits.[8)]

In Vietnam, the role of employees in influencing or participating in management decisions is played mainly by labor unions. A union is supposed to be established in all enterprises with more than 10 employees, even though the organization rate is low in private enterprises. Unlike China, the GOV seems to be willing to give labor unions some space to protect worker interest, even though the unions are very much under the grip of the Party (Chan and Norlund, 1998). Vietnamese labor unions used to act as a bridge between management and workers to resolve conflicts. They also joined the war effort, undertook much of managerial functions related to worker welfare, and mobilized workers to meet production targets. Through these activities, the differences between management and workers have become small in terms of status and compensation. Even though the union's managerial role was denied in the law introduced in the early 1990's, the past legacy may still have an impact on the labor-management relations for some time.[9)]

The Grassroots Democracy Decree of 1998 gave SOE workers further rights and responsibilities. Accordingly, enterprise management is to consult and discuss with labor on various matters. More specifically, labor is given a supervisory role by permitting it to "check on" the management's implementation on certain issues, including: the enterprise's plans, strategies, and operational restructuring; rules and regulations directly related to the interests of workers; measures related to the protection of workers, working conditions, training and retraining of workers, etc. The implementation of the Grassroots Democracy Decree so far seems to fall short of expectations, often being practiced as mere formalities. Nevertheless, this initiative might have the potential to develop into a framework for the productive role of

8) Better corporate performance is expected from several sources. Through long experience on the shop-floor, workers often have ideas about ways to improve efficiency, which are not available to managers. Furthermore, when employees participate in making rules and decisions, they tend to exert stronger work effort, better implementation of the rules and decisions, and better supervision of themselves and managers (to reduce the need for costly formal monitoring). Finally, shop-floor employee participation programs are likely to improve labor-management relations through better communication and cooperation (Nam, 2003).

9) For instance, it seems to be a fairly common practice that union representatives are directly appointed by management or hold management positions in the factories. According to a 2003 survey covering 85 countries and the industrial relations law index (covering three areas including labor unions, worker participation in management, and collective disputes), Vietnam ranked at 17th (followed by Korea at 18th) in terms of the tightness of regulation. In the case of worker participation in management (including workers or unions right to appoint members to the board of directors, works councils mandated by law, and the right to participate in management in the constitution), Vietnam was behind only China, Egypt, and Norway, and was in the same rank as Brazil, Slovenia, Portugal, and France (Botero, Djankov, La Porta, Lopez-de-Silanes, and Shleifer, 2003).

employees at SOEs. These roles may include some governance tasks supervision of management as well as workers' participation in shop-floor decision making. They will enhance workplace democracy, corporate governance and work efficiency.

As discussed above, the nature of SOEs (as well as them being a member of a larger group), and the socialist orientation of Vietnam are likely to provide strong incentives for SOE employees to invest in firm or group-specific investment. The same nature and orientation also provide a favorable environment for cooperation between management and labor in empowering workers for enhanced competitiveness. Equitization of SOEs has turned many managers and workers into shareholders of their enterprises. Strong motivation should now exist for cooperation with the success of the enterprise in mind. This is not a totally new mission for Vietnamese labor unions since they have already played a similar role in the past, although in a different setting. However, strenuous efforts should be made to mitigate inherent problems with SOEs and insider control, such as soft-budget constraints and lack of internal discipline.

## *Conclusion*

Korea's economic take-off has been attributed to a great degree to a strong political leadership seriously committed to economic development, while the Doi Moi reform in Vietnam was the result of a collective search for the right system by the people and the Party. Both countries pursued export-oriented development strategies, making use of a relatively well-educated labor force as well as foreign capital. While Korea relied more on foreign debt, Vietnam relied more on FDI. Compared with Korea, Vietnam has been handicapped from an international embargo, the fall of Soviet Union in the early 1990's, and the burden of newly introducing many laws and regulations essential for the functioning of a market economy.

Korea engaged large business groups and the government-controlled banking sector as its development partners, while Vietnam relies heavily on SOEs. In the process, in Korea, widespread moral hazards resulted and the balance sheets of banking institutions deteriorated. Korean business groups were largely family-based and had many operationally related and unrelated firms. The group structure seems to have been beneficial in the early stage of development: better monitoring, more efficient coordination and utilization of scarce resources, risk pooling, etc. The GOV has also shown a keen interest in grouping SOEs to GCs, and further streamlining them into HCs. The HC structure is likely to bring about similar benefits to those of Korean business groups.

However, moral hazard behavior of large businesses and banks as well as poor corporate governance in Korea encouraged business groups to pursue family interests at the expense of corporate health. These structural weaknesses were responsible for the 1997 crisis. In the case of Vietnamese SOE HCs, it is not clear whether the organizational benefits surpass inefficiencies that might arise from a less competitive market structure, stifled private entrepreneurship, state interference, soft budget constraints, regulatory capture, and management abuse of power to pursue private benefits. Thus, it is essential for Vietnamese SOEs to put in place sound corporate governance mechanisms and an external performance evaluation scheme, and to allow banking institutions to operate on a truly commercial basis.

The financial crisis of 1997 signified failure of the Korean model Korea delayed too much in phasing out the government's development partnership with family-based business groups and the banking sector. The crisis was also the result of poor preparation for capital account opening: Domestic financial liberalization, which must precede capital account opening, was not thorough enough, and foreign exchange assets and liabilities were managed very poorly. The main lesson for Vietnam is that a cozy relationship between the state, banks, and SOEs is a recipe for a financial crisis, and that Vietnam should be more serious about reform of its banking sector.

Finally, the time is appropriate for Vietnam seriously consider human resource development. Vietnamese enterprises, especially SOEs, might introduce a human resource management system similar to the traditional Japanese (and in part Korean) model. Key components of the system include stable (life-time) employment for essential workers, systematic (group-wide) OJT as well as some outside training, and compensation schemes based on both seniority and merit. This human resource management system might be combined with efforts to encourage employee participation in selected managerial decision making, based on their superior work-related knowledge on the shop-floor. This effort has the potential of accelerating skill development and productivity enhancement as well as promoting workplace democracy and better corporate governance. Vietnamese labor unions might play an instrumental role in these efforts, given their past legacy and the current environment that surrounds them.

## References


Baldwin, Robert. 2003. *"Openness and Growth: What's the Empirical Relationship?" NBER Working Paper No. 9578. National Bureau of Economic Research.*

Bardhan, Pranab. 1999. *"Democracy and Development: A Complex Relationship." In Ian Shapiro and Casiano Hacker-Corden, eds., Democracy' Values. Cambridge University Press. 93-111.*

Botero, Juan, Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer. 2003. *"The Regulation of Labor." NBER Working Paper No. 9756. National Bureau of Economic Research.*

Chan, Anita and Irene Norlund. 1998. *"Vietnamese and Chinese Labour Regimes: On the Road to Divergence." The China Journal. Vol. 40. 173-197.*

Dollar, David and Aart Kraay. 2001. *"Trade, Growth, and Poverty." World Bank Policy Research Working Paper No. 2615. World Bank.*

Fforde, Adam. 2004. *"State Owned Enterprises, Law and a Decade of Market-Oriented Socialist Development in Vietnam." Working Paper Series No. 70. Southeast Asia Research Center. City University of Hong Kong.*

Hill, Charles W. L. and Robert E. Hoskisson. 1987. *"Strategy and Structure in the Multiproduct Firm." Academy of Management Review. Vol. 12, No. 2. 331-341.*

Hoang Nguyen Hoc. 2004. *"The Role of State Corporate Governance in Vietnam." Presented at the International Corporate Governance Meeting: Why Corporate Governance Matters for Vietnam (OECD/World Bank Asia Roundtable on Corporate Governance) held in Hanoi, Vietnam on December 6th, 2004.*

Itami, Hiroyuki. 1994. *"The 'Human-Capital-ism' of the Japanese Firm as an Integrated System." In Kenichi Imai and Ryutaro Komiya, eds., Business Enterprise in Japan: Views of Leading Japanese Economists. MIT Press.*

Khanna, Tarun and Krishna Palepu. 1999. *"The Right Way to Restructure Conglomerates in Emerging Markets." Harvard Business Review. July-August. 125-134.*

Miwa, Yoshiro. 1996. *Firms and Industrial Organization in Japan. New York University Press.*

*Nam, Sang-Woo. 2001a. "Business Groups Looted b Controlling Families, and the Asian Crisis." ADB Institute Research Paper 27. ADB Institute.*

Nam, Sang-Woo. 2001b. *"Family-Based Business Groups: Degeneration of Quasi-Internal Organizations and Internal Markets in Korea." ADB Institute Research Paper 28. ADB Institute.*

Nam, Sang-Woo. 2003. *"Employees in Asian Enterprises: Their Potential Role in Corporate Governance." ADB Institute Research Paper 52. ADB Institute.*

OECD. 2005. *OECD Guidelines on the Corporate Governance of State-Owned Enterprises.*

Painter, Martin. 2003. *"Marketisation, Integration and State Restructuring in Vietnam: The Case of State Owned Enterprise Reform." Working Paper Series No. 39. Southeast Asia Research Center, City University of Hong Kong.*

Pei, Minxin. 1999. *"Economic Institutions, Democracy, and Development." Paper presented at the Conference on Democracy, Market Economy, and Development, sponsored by the World Bank and the government of the Republic of Korea, February 26-27, 1999.*

Pham Viet Muon. 2004. *"Overview of Vietnam General Corporations." Presented at the Workshop on Holding Company Model on March 8-9, 2004 in Hanoi, Vietnam. National Steering Committee for Enterprise Reform and Development (NSCERD).*

Rogers, Joel. 1995. *"United States: Lessons from Abroad and Home." In Joel Rogers and Wolfgang Streeck, eds., Works Councils. University of Chicago Press.*

Schmukler, Sergio, Masahiro Kawai, and Richard Newfarmer. 2001. *"Crisis and Contagion in East Asia: Nine Lessons." World Bank.*

Vu Thanh Tu Anh. 2005. *"Vietnam The Long March to Equitization." Policy Brief #33, The William Davidson Institute. University of Michigan.*

Willett, Thomas D. 2002. *"Why Is There So Much Disagreement About the IMF and Reform of the International Financial Architecture?" Prepared for the IMF Seminar on Current Developments in Monetary and Financial Law. May 2002.*

Yoshitomi, Masaru. 1996. *"Labor Market Implications of Changing Corporate Governance in Japan." Macroeconomic Policies and Structural Reform. OECD Proceedings. OECD.*

Chapter 1

# Effective Management Skills and Privatization of SOE in the Socialist Republic of Vietnam

Chapter 1

# Effective Management Skills and Privatization of SOE in the Socialist Republic of Vietnam

*Shin-Il Kang*
*Hansung University*

## Executive Summary

### *Current SOEs Environment in Vietnam*

Since the early 1990s the goals of the government of Vietnam (GOV), as reiterated at the 2001 communist Party national congress, has been to pursue a “socialist-oriented market economy”. The Ninth Plenum of the Central Committee reaffirmed this goal on February 6th of 2004, touting the emergence of a “market- oriented economy following socialist direction.”

Vietnam’s approximately 4,300 state enterprises participate in nearly all sectors of the economy. Up to 2004, state enterprises have remained the most important sector in the economy, representing 39.2% of GDP, accounting for 75% of the national’s fixed capital, 20% of total domestic investment, 50% of total international trade, and contributing to approximately 40% of the state budget. In 2003, less than 40% of SOE had a rate of return equal to, or higher than, the market interest rate. A High ratio of bad debt plus limited repayment capability of financial obligations, backward technology and equipment, low efficiency, overstaffing, low productivity were all characteristics revealed in Vietnamese SOEs.

There have been many measures implemented with the intention to speed up SOE reform in Vietnam during the past 20 years. First, the number of small and profit losing enterprises have been reduced. Second, SOEs have been equitized, diversified, merged, and dissolved. Third, company management has been reformed by strengthening monitoring and evaluation criteria, forcing SOEs to conduct audits, and publicizing business information.

### *Privatization Worldwide*

Between 1977 and 2001, more than 3,535 public enterprises were privatized in the world, bringing governments revenues of over USD 1,127billion. Vietnam’s share of this figure was USD 1.7 billion. The phenomenon involved over 100 countries, and all sectors in which state-owned enterprises usually operate: That is, agriculture, and industry, finance, telecommunications, energy, and public utilities. Extant empirical research has already led to important conclusions on privatization. First, the efficiency of privatized companies in terms of productivity and growth, on average, increased more than that of companies left in public hands. Second, the timing, methods and results of privatization across countries have varied.

Privatization is determined by political preferences and shaped by economic and institutional constraints.

In Korea, 5 rounds of privatization have been processed since the first large-scale privatization program (from 1968 to 1973). On the first privatization round, eight unprofitable enterprises were sold to private firms and financial institutions, which were then themselves public enterprises. This change in ownership had no share limits. The second privatization program was implemented in the early 80's. Four financial institutions were sold to private firms and investors with asset sale methods. Private firm buying was capped at 5%, while individual investors could buy a maximum 5,000 shares, thus preventing them from controlling the financial institutions.

In order to improve the overall efficiency in the public enterprise sector, the government initiated the third and fourth privatization programs in 1987 and 1993, respectively. The third program pursued the sales of ten big public enterprises, while the fourth program added a few more. The privatization process failed to proceed smoothly, in part due to overriding concern that the privatized enterprises might fall under Chaebol control. The fourth privatization tried to focus on the efficiency of public enterprises by improving the corporate governance structure. Individual ownership was capped at a maximum of 7%. Subsequent to the financial crisis of 1997, the new administration launched a restructuring program of the Chaebol, forcing them to decrease their debt-equity ratio (below 100%) and implementing some policies for improving transparency. The fifth privatization program was ambitiously launched in 1999, mainly for the purpose of obtaining hard currencies. A total of 6 large SOEs including POSCO (Then known as Pohang Iron and Steel Company) were sold off, with total revenue of USD 18billion.

POSCO was established in April 1968 as a joint-stock company, and classified as a Government Invested Enterprise (GIE). As of 2004, POSCO's annual crude steel production capacity was 28.1 million tons. In June 1988, the government launched its "people's share" program by publicly offering of the stocks on the Korean stock exchange. In October 1994, and October1995, POSCO was listed on the New York and London Stock Exchanges, respectively. As the share of equities by government and state owned banks decreased, the government exercising its power prescribed in the Securities and Exchange Law limited the voting right of any non-government shareholder to 3%. Positive effects expected from the privatization included increase in profit, productivity and stock price, and decrease in rent seeking. Moreover, strengthened government efforts to control monopoly were accompanied with the privatization.

KT&G (Formerly Korea Tobacco & Ginseng Corp.) is the 33rd largest business group in Korea in terms of total assets (USD4.38 billion). In 1987, succumbing to strong US pressure, the domestic cigarette market was liberalized to imports. In 1996, the red ginseng market was also liberalized, exposing KT&G to competition in all its major products. In 1999, KT&G was listed on the Korea Stock Exchange, and in July 2001, KT&G's monopoly on tobacco manufacturing was finally abolished, with the government completely divesting its shares of KT&G in October 2002.

Until the late 1980s, KT (Then Korea Telecom) monopolized all segments of the telephone service market. In the early 1990s, the Ministry of Communication (MOC) announced plans to deregulate the telecom industry. As the first step, the MOC allowed a private data service company, DACOM, to enter the international calls service market on favorable terms, setting KT's price rates well above that of DACOM. From 1993 to 1996, 28.8% of government shares of KT were sold. In December 1999, KT was listed on the Korea Stock Exchanges, and in May 2002, KT was finally fully privatized.

### *SOE Performance Evaluation System in Korea*

The basic government principle towards SOEs is to reduce intervention in their management, thus allowing operational autonomy and flexibility for GIE, and to put more emphasis on the evaluation of their final performance. The Administrative Council (AC) was created as the top policymaking organization in the government for the rationalization of the GIE's management system. It coordinates major issues such as guidelines for management objectives and budget preparation, performance evaluation, and other matters concerning the management of public enterprises. The AC decides the incentive bonus rate for GIEs according to performance evaluation results, and may suggest the dismissal of poorly performing Chief Executive Officers (CEO) of GIEs. A key feature of the system is its monetary incentives. The incentive bonus is differentiated according to performance evaluation results with an extra annual bonus ceiling of approximately three months salary. The incentive bonus is given to managers as well as workers. In the year of 2005, the maximum variation of annual bonus will be 500% of monthly pay.

### *Economics of State Owned Conglomerates*

Business groups with many member firms (affiliates) create economic or dominant-market power, and can exert influence in the process of policymaking. However, business groups can contribute substantially to economic development, in particular within developing countries. The group structure allows affiliated firms to attain economies of scale and scope, overcoming investment constraints to diversify business risks, and to build a credible reputation at the initial period of corporate growth. In some ways, it accelerates the transition from a state controlled to a market economy. However, SOEs business groups can endeavor to prevent inefficient small and medium-sized SOEs from exiting the market, and also tend to create moral hazards and monopolies within their markets, thereby posing as an impediment towards a market economy transition.

The Chaebols in Korea are defined as family owned business groups with many firms, often enjoying a monopoly or oligopoly power in relevant markets. Their contribution to the economic growth in Korea during the early stages of development was enormous. Even at this moment, over 50% of Korean exports are carried out by the Chaebols. However, the accompanying economic concentration of Chaebols often influences policymaking and political processes. Their dominant market position also leans towards inefficiency as well as wealth concentration and the problem of social inequity. Since the early 1980s, the Korean government attempted to mitigate these problems posed by Chaebols, obviously without much success.

Subsequent to the 1997 financial crisis, the government and business group leaders adopted a MOU, consisting of 5 corporate restructuring policies and 3 other principles (the so called "5 + 3 principles"). The 5 corporate restructuring policies included: improving managerial transparency, phasing out cross-guarantees of debt among member firms, decreasing the debt-equity ratio, selling off non-core businesses, and enhancing accountability towards minority shareholders. The 3 other principles included refraining by Chaebols from control over banks, reduced cross-shareholding among member firms, and zero tolerance for unlawful inheritances.

## *Suggestions for Current Equitization in Vietnam*

Based on a review of the past Korean experience in privatization, some general guidelines might be given for the GOV, which is in the process of pursuing the equitization of its SOEs.

First, Vietnam should be bolder in pursuing privatization. The role of the state will remain important for meeting basic social goals, such as lessening poverty, defense, security, etc. In many industrial sectors, however, continued dominance of SOEs will lead to inefficiencies and weakening growth potential. From a long-term perspective, a market economy, with the private sector as the principal player, might bring better social justice. Second, adequate considerations are needed in the selection of firms to be privatized. Risky businesses and regulated businesses have not shown any improvement of performance after privatization. In the future, deregulation should accompany privatization, and target firms should be carefully selected in consideration of their risks: That is, both general market risks and firm-specific risks. Third, past privatization was generally open only to restricted groups of investors, much like a wide share ownership program. However, whether this kind of design served its purpose is questionable. Exclusion of some groups such as small and medium-sized firms might have sacrificed chances of fostering collaborative relationships with privatized enterprises. Fourth, it is often difficult to find buyers for the assets of public enterprises. Prohibiting foreign investors from participating in the privatization can contribute to this difficulty. Foreign investor participation in the privatization programs is strongly recommended.

Fifth, under-pricing of equity shares (a discount on the company's real/market value) is often necessary to ensure success in its sale, allowing investors who purchase shares at the initial public offering (IPO) to earn significant market-adjusted returns. Sixth, awarding most of equity shares to employees can mitigate their resistance to privatization. However, this should be done with caution, based upon adherence to relevant rules which allows a fixed portions of shares, given its implication in corporate reform and governance. Seventh, successful privatization requires numerous accompanying policies, among others an effective competition law, anti-corruption measures, improvement of corporate governance, development of entrepreneurship, and appropriate ownership and control structure in holding companies. Finally, small and medium-sized SOEs tend to be consolidated irrespective of the market conditions and other characteristics of the industry. If the market is competitive, privatization should be preferred over consolidation.

### *Suggestions for Managerial Performance Evaluation System*

Since Vietnam still possesses a large number of SOEs, the introduction of a systematic performance evaluation will be a very complicated task and needs further study. It might be advisable to adopt a managerial performance evaluation system for 10 or 15 general corporations (GCs); those with over 10,000 employees or a contribution of over VND 100 billion to the government budget. After the system has been successfully tested, it can then be expanded to other SOEs.

First, an Administration council (AC) should be established, consisting of the National Steering Committee for SOE Reform and Development (NSCERD), the State Capital Investment Corporation (SCIC),[10)] the Ministry of Finance, the Provincial People's Committee, and relevant ministries and experts. Second, tasks for the AC should include defining goals, setting the criteria of performance evaluation, setting up incentive systems, and finalizing performance evaluation results. The AC may conclude a MOU with the CEOs for managerial performance evaluations. Third, performance evaluation can be initiated in the beginning for a few large general corporations (GCs), gradually expanding with progress to other GCs. Finally, adopting a good pecuniary incentive scheme is very important as it allows the SOE and employees to share risks.

### *Suggestions for Conglomerates*

As for conglomerates in Vietnam, first, GCs can be privatized some time later with restriction on private shareholder voting rights. If it remains in the form of a SOE, great inefficiencies can be created. Second, the amount of shares to be sold to the private sector is a difficult question with substantial implications for corporate governance. The typical level of equity shares for controlling shareholders should be different across countries, contingent upon the maturity of the capital market, adequacy of protecting small shareholders, business leadership, and the degree of government intervention in the management of SOEs. While the GOV maintains heavy intervention in the market, selling small shares to private hands is unattractive for prospective investors, since worries about state control persist. In the case of privatization, Vietnam might be better advised to allow ownership concentration for the purpose of better firm governance, leading to performance improvement. Third, necessary complementary rules and policies should be in place, including competition policies, deregulation, appropriate tax measures (for example strengthening inheritance tax), law enactment for limited liability firms, etc.

10) The State Capital Investment Corporation (SCIC) is to be set up soon with chartered capital of VND 5 trillion (USD 316.5 million) to manage and invest state capital in various forms of SOEs.

# 1. Current SOEs Environment in Vietnam

## 1- 1. SOEs’ Contribution to Economic Activities

In Vietnam, GDP share by the industrial sector is the highest, at the 40%, with the service sector a close second (see Table1-1).

<Table 1-1> Share of GDP by the Industrial Sector (%)

| | Industry | Services | Agriculture | Total |
|---|---|---|---|---|
| Share of 2003 GDP | 39.7 | 38.5 | 21.3 | 100 |

Source : Economist Intelligence Unit, Vietnam Country Forecast, March 2004

Vietnam’s approximately 4,300 state enterprises participate in nearly all sectors of the economy. Most SOEs are 100% state-owned; the state also retains majority stakes (over 51%) in many equitized firms. Common problems shared by many Vietnamese SOEs include substantial debt with a limited capability of repaying the financial obligations, obsolete technology and equipment, low efficiency, overstaffing, and low productivity.

Vietnam is only slowly beginning to emerge from a centrally planned, socialist economy dominated by state-owned monopolies. In key industries like electricity, aviation and telecommunications, SOEs maintain a monopoly, with a market share of at least 80%. Other heavily regulated industries tend to have some foreign and private sector participation, but are nonetheless dominated by state-owned oligopolistic firms (several large SOEs with a market share of 10-40% each). These include cement, sugar refining and sales, minerals, banking and petroleum, where prices tend to be high with inefficiencies. SOEs, long protected and subsidized under central planning, face the challenge of surviving growing international competition.

## 1-2. Role of the State in the Vietnamese Economy

Since the early 1990s the government’s goals, as reiterated at the 2001 Communist Party National Congress, has been to pursue a “socialist-oriented market economy”. The Ninth Plenum of the Central Committee reaffirmed this goal on February 6 2004, touting the emergence of a “market- oriented economy following socialist direction.” The state is heavily involved in many sectors, such as finance, telecommunications, energy and manufacturing. Private ownership is permitted in some areas, particularly manufacturing; in others, varying degrees of restrictions are still prevalent. Constitutional changes made in November 2001 legally ended official discrimination between the public and the private sectors, though many preferential treatments towards SOEs remain. The close network of contacts and relationships among bureaucrats, politicians and SOE executives distorts resource allocation and creates corruption and social inequity under the fuzzy lines of command and control between ministries, and often unclear and conflicting regulations.

An International Finance Corporation (IFC) study in 2003 found that private sector growth faces multiple impediments: Excessive regulation via over-prescriptive laws, frequent inspections, high taxes, weak regulatory accountability and overlapping jurisdictions, and preferred access to credit and land by SOEs. There have been many measures geared to speed up SOEs reform in Vietnam. As a result, the number of small and profit losing enterprises has been reduced substantially, and SOEs have been equitized or consolidated. Furthermore, efforts have been made to renovate SOE management by strengthening monitoring and evaluation criteria, and forcing them to conduct audits and disclose greater business information.

<Table 1-2> GDP Composition by Ownership (%)

| | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|
| State Sector | 38.53 | 38.40 | 38.31 | 38.33 |
| State-Owned Enterprises | 27.53 | 27.29 | 29.15 | 27.20 |
| Non-state Sector | 48.20 | 47.70 | 47.79 | 47.67 |
| Foreign Invested Sector | 13.27 | 13.90 | 13.90 | 14.00 |

Source: Economic Report, CIEM, Vietnam, 2004

The GOV continues to pursue a gradual approach towards ownership reform of SOEs mainly through equitization - along with parallel efforts to restructure remaining SOEs. Equitization and other restructuring efforts have been motivated by improving efficiency and by supplementing a government budget. Vietnam had 12,300 SOEs in 1990, but the number declined to merely 4,704 by February 2004. Among them, 2,242 SOEs were equitized. The government aims to reduce the total number to a figure below 2,000 by the end of 2005.

Most of the equitized SOEs were those owned by local governments and enterprises in the industrial sector. 59.2% of equitized firms had less than VND 5 billion as their chartered capital. Only 15.2% of the equitized SOEs were sold off completely, with the rest only partially privatized (see Table 1-3).

<Table 1-3> Equitized Firms by Ownership, Industry, Scale, And Type of Equitization as of May, 2005

| Total | 2,242 | (100.0%) |
|---|---|---|
| By Representative Owner | | |
| Ministries | 578 | (25.8) |
| Decision 91-Based General Corporations | 191 | (8.5) |
| Local Governments | 1,473 | (65.7) |
| By Industry | | |
| Industry, Construction & Transportation | 1,469 | (65.5) |
| Service & Trade | 643 | (28.7) |
| Agriculture, Forestry and Fishery | 130 | (5.8) |
| By Scale of State Capital | | |
| Less than VND 5 billion | 1,327 | (59.2) |
| VND 5-10 billion | 500 | (22.3) |
| More than VND 10 billion | 415 | (18.5) |
| By Type of Equitization | | |
| Keep state capital unchanged and issue new shares | 339 | (15.1) |
| Sell off part of state capital | 583 | (26.0) |
| Sell off entire state capital | 347 | (15.5) |
| Sell off part of state capital and issue new shares | 973 | (43.4) |

Source : DSI, MPI

Equitization has not proceeded as far or as smoothly as the authorities envisioned; annual and 5-year equitization targets have consistently gone unmet for more than a decade. 753 firms were equitized in 2004, failing to match the target number of 927 (see Table 1-4). Obstacles to equitization are considerable. SOE managers are reluctant to participate, since tax benefits may be lost and state-owned banks tend to view equitized SOEs as risky borrowers. Concern by employees also exists for job security. Moreover, valuation procedures can delay the equitization process for years. Asset valuation is often arbitrary and leads to excessively high or low valuations of a company's worth, even though new asset valuation guidelines were issued in November 2001 in an attempt to address this problem. Another difficulty is the underdeveloped Vietnamese stock market, which was opened in 2001. At the end of 2004, the market value of the stock market was VND 13,000 billion, representing only 2.4% of GDP in 2004.[11)]

11) It compares with Korea 75%, the US 147%, and Japan 101% as of May 2005.

<Table 1-4> Target Number of SOEs for Equitization

| | 2001 | 2002 | 2003 | 2004 | Total |
|---|---|---|---|---|---|
| Target | 710 | 651 | 636 | 927 | 2, 924 |
| Equitized | 212 | 205 | 164 | 753 | 1,710 (including previously targeted) |

Source: Steering Committee for Enterprise Reform and Development (SCERD)

Despite these obstacles, well-managed equitizations have shown good performances. According to a February 2004 report covering 500 equitized firms, the said firms witnessed increases in annual turnover by 60%, gross profits by as much 130%, contributions to the state budget by 45%, workers' salaries by 63%, number of employees recruited by 13%, and average dividends by 13%. Business environment is also becoming more transparent and less discriminatory. The private economic sector is creating jobs for many people, while simultaneously absorbing those discharged from the public sector.

The government's emphasis has shifted somewhat in recent years towards restructuring SOEs for greater managerial autonomy and giving a wider menu of equitization options to better suit the circumstances of individual firms. Among the restructuring paths, besides dissolutions and mergers, are reorganization as limited liability companies (often using a holding company structure to allow each SOE unit to operate more independently); reclassification as public services; leasing; and subcontracting (Table 1-5).

In February 2004, the National Assembly approved important amendments to the 1995 Law on State-Owned Enterprises. The amendments aim to open up SOEs to a greater number of investment sources, diversify their ownership forms and institutionally separate the state' s roles as investor and manager of SOEs. The definition of SOEs is now expanded to include those partially or mostly owned by the state. Permissible corporate forms will include independent companies, general corporations, joint stock companies, one or more member state limited liability companies and overseas state companies. Shares may now be held by private investors, including those from overseas (previously, such moves meant ending the firms' SOE status). As a scheme to separate the managerial roles of ministries and provincial peoples' committees in restructured SOEs, a state corporation to invest and trade state capital in restructured firms was established. The precise effect of these changes is still unclear, and many important operational details remain to be worked out.

An intensive "business grouping" program was conducted in the late 1990s to establish a strong core of 17 GCs under the central government management and 91 GCs under either central or local management. The 91 GCs include such important sectors like telecom, petroleum, aviation, construction, steel, garments and textiles, with such large corporations as Petrolimex and Seaprodex. For example, sales of Petrolimex are close to VND 19 trillion, and its total asset value amounts to over VND 2 trillion. Total employees of 91 GC number 90.8%

<Table 1-5> SOE Reform and Equitization during the First Plan Period

| | 2000 | 2001 | 2002 | 2003 | 2004 | Total |
|---|---|---|---|---|---|---|
| Total | 620 | 265 | 427 | 1,044 | 1,042 | 3,398 (100.0%) |
| Equitized (partial privatization) | 578 | 204 | 164 | 532 | 753 | 2,241 (65.9) |
| M&A | 17 | 44 | 34 | 152 | 68 | 315 (9.3) |
| Complete sale | 25 | 13 | 17 | 24 | 19 | 98 (2.9) |
| Contracted and leased | 0 | 4 | 8 | 11 | 3 | 26 (0.7) |
| Merger | | | 83 | 152 | 68 | 303 (8.9) |
| Unified * | | | 44 | 47 | 7 | 88 (2.5) |
| Dissolution | | | 27 | 50 | 35 | 98 (2.9) |
| Bankruptcy | | | 2 | 4 | 12 | 18 (0.5) |
| Transferred to the Ministry | | | 48 | 58 | 36 | 142 (4.2) |
| One member limited liability firm | | | 0 | 14 | 41 | 55 (1.6) |
| New SOE | | | 37 | 30 | | |

Source: Economic Report, CIEM, Vietnam, 2004
* Meaning integration.

of total employees by state controlled SOEs in Vietnam. It is unlikely that these mega firms will be equitized, though restructuring and limited liability status are certainly in the cards. Currently, the Vietnam Corporation of Post and Telecommunication (VNPT), the General Corporation of Electricity(EVN), Petro Vietnam, and the Construction General Corporation--the 4 GCs, are being converted into a holding company model to become powerful economic groups.

Changes in the mode of providing public services are the most often used policies in the world to make a small government. For a government to be strong and small, it needs to foster efficient markets. SOEs reform is a necessary condition for a strong and small government but not a sufficient one. While SOEs are subject to reform, new SOEs are needed in certain cases. Examples include areas of strategic importance, new areas (like IT industry) where the private sector has not developed yet, and areas requiring large investment.

## 1-3. Reasons for Unsatisfactory Results of SOEs Reform

Despite recent acceleration in SOEs reform, the restructuring of SOEs has so far progressed at a slow pace and failed to meet its targets. Equitized SOEs account for only 6 % of the total capital, implying that major SOEs remain untouched. Restrictions on equity holdings have prevented the participation of some potential investors from outside. Only 8 % of the legal capital of equitized SOEs is held by outside shareholders. The disbandment of inefficient SOEs has been met with a lot of difficulties due to complicated administrative procedures and other social factors.

There are several reasons for the unsatisfactory outcome of SOEs reforms. First, there has been lack of determination, inconsistency in implementing the restructuring policies, and concerns that equitization would lead to privatization and undermine the role of the state sector in the economy. The pace of equitization has also been affected by interest groups, such as workers and managers, who are afraid of losing their positions. Also problematic was lack of legal frameworks to support the process of restructuring, such as the Law on Competition and the regulations on holding companies. Tedious administrative procedures and the lack of qualified officials have made equitization a drawn out process: On average, around 91days for state corporations, 523 days for ministry-level enterprises, and around 421 days for provincial enterprises.

Currently Vietnam is trying to address these drawbacks. First, in August 2004, the Prime Minister issued a decision promulgating criteria for SOE classification, which considerably narrowed the scale of areas in which Vietnam continues to maintain 100% of equity shares - mainly concentrating on security and social welfare, and other areas and locations that non-state sectors show no interest, for example drainage services for urban areas, exploitation and management of irrigation works, and services for ethnic minority groups. Furthermore the decision also significantly enlarged the range of SOEs forced to equitize. Second, the task of determining the value of enterprises to be equitized has been shifted to professional firms. Third, a minimum amount of stocks is to be sold to the public (not being restricted to enterprise insiders). Fourth, equitized SOEs are allowed to allocate some stocks to sell to their strategic investors. Finally, the Prime Minister clearly named 233 SOEs that have to sell their state holding stocks and whose stocks are to be listed in the stock market. Recently listed big firms include Vietnam Marine Agent, Petroleum Technical Services Company (PTSC), Petroleum Drilling Company, Vietnam Milk JSC (charter capital of VND 1,500 billion), Tuong An Vegetable Oil JSC (charter capital of VND 190 billion), Gas JSC (charter capital of VND 150 billion), Petrochemical JSC (charter capital of VND 150 billion).

## 2. Privatization Policy

### 2-1. Worldwide Trend of Privatization

Between 1977 and 2001, over 3,535 SOEs were privatized in the world, bringing government revenues of over USD 1,127billion. In Vietnam, the share of revenue was USD 1.7 billion. The phenomenon involved over 100 countries, and in all sectors in which SOEs usually operate: agriculture, industry, finance, telecommunications, energy, and public utilities.

Privatization has been a very varied process in different parts of the world, seldom decided upon autonomously, and more often forced by external factors and carried out reluctantly in the suitable legal, political, economic institutions. As a result, privatization has been incomplete and fraught with errors. However, privatization is partly an irreversible process that may lead to institutional innovation and market development.

Extant empirical research has already led to important conclusions on privatization. First, privatization has halved the weight of SOEs in the GDP of developed countries, but has progressed with greater difficulty in less developed countries. Second, the efficiency of privatized companies in terms of productivity and growth, on average, increased more than that of companies left in public hands. Third, when privatization occurs in public equity markets, under pricing (a discount on a company's real value) is often necessary to favor the sale, thus possibly giving significantly positive market-adjusted returns for investors who purchase shares at an initial public offering (IPO). Finally, a large privatization program based on issues on public equity markets helps spur the modernization of a nations' corporate governance system.

Irrespective of the above, however, is the question of why the extent of privatization varies greatly across countries. How do governments trade off their conflicting objectives in designing sales Do governments still hang on to control with direct or indirect means  Finally, how do regulatory and institutional changes affect privatization outcomes

The timing, methods and results of privatization across countries have varied. Privatization is determined by political preferences and shaped by economic and institutional constraints. Indeed privatization is associated with right-wing majorities in office, driven by poor fiscal conditions and a booming stock market, and limited by proportional electoral rules granting power to veto players. Some governments use a wider share ownership to gain credibility over time, and to develop domestic stock markets. The privatization process has usually been partial and incomplete. The government, through "golden shares," still directly (or indirectly) controls a large part of the national economy. This reluctance to sell can be traced back partly to weak legal protection of investors and to a government's reluctance to lose political control over strategic sectors.

## 2-2. SOEs in Korea

Korean public enterprises are classified into central government-owned enterprises and local government-owned enterprises according to the subject of investment. Central government-owned enterprises are divided into Government Enterprises (GEs), Government-Invested Enterprises (GIEs), Government-Funded Enterprises (GFEs), and Subsidiaries of GIEs (SGIEs) according to ownership and autonomy of the enterprises.

In general, GIEs are public corporations of which the government owns over 50% of total capital. Currently 13 Korean corporations are categorized as GIEs, including 5 energy companies , of which one is KEPCO (Korea Electric Power Corporation), and four construction companies such as the Korean National Housing Corporation. Table 1-6 shows the size of Korean public enterprises in the years of 1995 and 2001. As demonstrated, GIEs are a major part of Korean public enterprises, while the extent of reform in Korea in terms of the reduction of employees and budget can also be seen.

<Table 1-6> Status of Central Government-Owned Enterprises in Korea 2001 (1995 figure in Parentheses)

| Classification | No. of Companies | | No. of Employees | | Budget (USD million) | |
|---|---|---|---|---|---|---|
| GE | 4 | (4) | 72,238 | (73,583) | 2.210 | (2,336) |
| GIE | 13 | (20) | 59,113 | (161,694) | 50,377 | (64,255) |
| GFE | 7 | (9) | 53,977 | (47,762) | 32,775 | (17,374) |
| SGIE | 21 | (80) | 15,847 | (65,741) | 11,290 | (15,798) |
| Total | 45 | (112) | 185,328 | (348,780) | 96,652 | (99,763) |

Source: Ministry of Planning and Budget

The Korean government has a two-tiered approach regarding its policies toward public enterprises, particularly GIEs. One is the Management Responsibility System, which is a performance evaluation system, and the other is privatization.

Economic inefficiencies of public enterprises have revealed themselves increasingly as enterprises have grown in size. Low profit rates, over-investment, overstaffing and rigidity in regard to market changes are examples of inefficiencies. Such failure has been caused by the bureaucratic nature of firms, including excessive government intervention, and by the complexities of corporate missions. There still remains, however, an important role for public enterprises.

The government weighs the trade-off between efficiency loss caused by bureaucracy and the benefits (or contribution) of maintaining public enterprises. If the latter outweighs the former, public enterprises are kept by the government, but are subject to the Management Responsibility system. The system increases enterprise autonomy, changes managerial selection procedures, systematically evaluates performance, and provides incentives on the basis of the evaluation. All GIEs are subject to the GIE Management Act. While GIE managers have been granted greater managerial autonomy, they are subject to the government's post performance evaluation in order to maintain management accountability. 14 GIEs are currently subject to the system as of 2005. The Korea Railroad Corporation joined this list from the governmental department enterprise.  In the case that efficiency loss outweighs the benefits, the enterprise faces the possibility of privatization. 6 SOEs are in process of privatization. Although the first privatization was initially undertaken in 1968 in Korea, the abovementioned ideas were actually put into action in 1987, and has been effected ever since.

## 2-3. Korea's SOEs Privatization

The rationale for establishing public enterprises includes the existence of natural monopolies, merit goods, externalities, and the desire for rapid development. Their provisions of services like electricity, telecommunication, finance and education, etc. have corrected market inefficiencies caused by economies of scale, imperfect capital markets, and the nature of public goods. Public enterprises have played an important role in Korea's rapid economic growth since 1961, particularly in the provision of social infrastructure such as hydroelectric power plants, roads, and so forth. In 2004, in terms of value added, public enterprises contributed 10 % of total GDP.

Privatization has been suggested as a sound policy for improving the efficiency of public enterprises. For one, it would prevent the government from paying the costly subsidies used to keep inefficient public enterprises afloat. Privatization is a transfer of assets and service functions from public to private hands. Privatization can take many forms, each of which has different economic effects. The most complete form of privatization is to sell government-owned assets to private buyers, removing the government entirely from any involvement in the enterprise. Less complete asset sales, deregulation, and contracting out, etc. are also often viewed as forms of privatization.

The first large-scale privatization program, which took place from 1968 to 1973, was commenced with the privatization of the Korea Express Co. Ltd. Most public enterprises of the late 60's and early 70's had been established under the Japanese colonial rule, but were nationalized by the government after World War II.  Some of these public enterprises that had been mismanaged were privatized, while others were reorganized into new enterprises for economic development. 18 enterprises were newly established. 8 enterprises were sold off to private firms and financial institutions, which themselves were public enterprises. There was no share limit when they were privatized.

The second privatization program was implemented in the early 80's. Privatization was one component of a general liberalization policy, which the government adopted in 1980. Compared with the real sector of the Korean economy, the financial sector was viewed as underdeveloped mainly due to heavy government intervention to promote national industrial development. For a sustained and more balanced growth of the Korean economy, financial liberalization was believed to be critical. As part of the financial liberalization program, 4 commercial banks including Hanil Bank, Korea First Bank, Bank of Seoul and Trust Company, and Cho-Hung Bank were sold to private firms and investors by method of asset sales. In order to prevent the privatized banks from being controlled by private owners, all private firms were subject to an ownership limit of 5 %, while individual investors had a maximum limit of 5,000 shares.

Addressing the increasing problem of inefficiencies in public enterprises, the government passed the Government-Invested Enterprise Management Law in December 1983, thus introducing a performance evaluation system for public enterprises. From 1984 to 1986, this new evaluation system was applied to 25 GIEs. Although the performance of GIEs improved, the new system was limited since it covered only GIEs, and not other public enterprises.

In 1987, the government initiated the third privatization program. This initiative was aimed at the development of private enterprises in the industrial and financial sectors. More specifically, the program was intended to reduce the inefficiencies of public enterprises, alleviate the budgetary burden of the government, and to enlarge the size of the stock market. Some public enterprises were competing with private firms, while others lost the original goals for which they had been established. The role of these public enterprises had contracted as the private sector grew. Behind the pursuance of privatization was broad-based belief that the private sector is more efficient than the public sector.

The government chose 10 public enterprises for sale: The Korea Stock Exchange, POSCO, the Citizens National Bank, the Small and Medium Industry Bank, the National Textbook Co., Ltd., the Foreign Exchange Bank, the Korea Appraisal Board, the Korea Technology Development Corp., KEPCO, and the Korea Telecommunications Authority. Among them, the Korea Stock Exchange was sold to 25 stock brokerage firms, while POSCO utilized asset sales through a wide share ownership program and public tender sales. Others, except for KEPCO, were sold completely. KEPCO is still in the process for privatization. To alleviate employee resistance, an ESOP (Employee Stock Ownership Program) was developed with a restriction of 20% maximum of total sales.

During the 20 years after the third privatization program, 2 additional privatization programs were launched. The fourth privatization program of 1993 focused on enhancing the efficiency of public enterprises by improving corporate governance structures. As the major component, a new system of the board of directors was introduced, which prohibited government officials from joining the management of GIEs. It also included privatization plans for Korea Heavy Industry, KT&G, Korea Gas Corporation, and KT. Individual shareholders were subject to a ceiling ownership of 7% share. However it did not fare smoothly. Whenever the government planned the sale of big SOEs, its major concern was that Chaebols would purchase the SOEs, thus aggravating the already serious concentration of economic power. Throughout the 1990' s up to before the 1997 financial crisis, there was substantial discussion about corporate governance structure and privatization without any further progress towards privatization.

The fifth privatization program was pursued beginning 1999 when Korea was still coping with the financial crisis by securing more foreign exchange. POSCO, KT, and KT&G were partially sold via DR (Depository Receipts). A DR is a corporate stock issued (but kept by issuing companies) and to be traded in foreign countries like the London and the New York Stock Exchanges. Total revenue from the sales of 6 large SOEs amounted to USD 18 billion. KT, KT&G, and Korea District Heating Corporation were sold, while sales of KEPCO and Korea Gas Corporation are still in progress. Table 1-7 shows the methods of privatization for these 5 large SOEs.

<Table 1-7> Methods of Privatization (as of 2004)

| Enterprises | Methods | Shares composition |
|---|---|---|
| Enterprises | • Public tender offer<br>• Auction bidding<br>• Listed on the London and the New York Stock Exchanges | Completely Sold (May, 2002) |
| KT&G | • Auction bidding<br>• Open for foreign investment (maximum 49%) | Completely Sold (October, 2002) |
| Korea District Heating Corporation | • Auction bidding<br>• Public tender offerCompletely Sold | Completely Sold (August, 2000) |
| KEPCO | • Not yet decided for remaining stocksCompletely Sold | Government: 32.5%<br>KDB: 21.6% |
| Korea Gas Corporation | • Not yet decided | 100.0% |

## *Past Industry Policies including Privatization Programs (1968-1983)*

The Korean economy is dominantly composed of market-oriented private enterprises not directly owned or supported by the government. The private sector accounts for over 80 % of total value added, and about two-thirds of gross fixed capital formation. In spite of the large discretionary power of the government to influence all sectors of the economy through means such as the five-year socio-economic development plans, private enterprises are not necessarily bound by government plans when they invest in new businesses or expand existing ones.

The public sector consists of government services and public enterprises. The former provides public administration, defense, social, recreational, sanitary and related community services. The latter has concentrated on shipbuilding, fertilizers, steel, petrochemicals, finance, social infrastructure, etc. They have produced import-substitutes such as intermediate and capital goods, and focused on strategic industries in the 60's and 70's for economic development. There were 25 GIEs: 4 financial institutions including KDB, 3 natural monopolies such as KT, KEPCO, and Korea Gas Corporation, 7 public goods producing enterprises, including the Labor Welfare Corp., Korea Trade Promotion Corp., etc. The government and public enterprises played an important role in fixed investment, due to substantial investment in social infrastructure and heavy industries. However, their contribution to job creation was modest since the heavy industry is capital intensive.

After the first oil shock, the public sector increasingly began to exhibit managerial inefficiency. The Korean economy had grown large and had gotten too complex to be efficiently managed by a rigid structure of the government. The second oil shock further revealed the problems from over-investment in the heavy industry without adequate technological development. The Korean economy failed to absorb the external inflationary shocks and began to show serious signs of strain by 1979 and 1980 with a significant decline in growth momentum. This forced the government to radically shift its policy direction towards macroeconomic stabilization and reduced government intervention in the markets, eventually leading to the enactment of the Anti-Monopoly and Fair Trade Act (1980), the abolishment of preferential financing for certain sectors of the economy, and the privatization of 4 commercial banks.

### *Details of Major Privatization Programs since 1987*

Most current privatization programs adopt the asset sale method through the stock market. Determination of asset price, timing of sale, etc. depends also upon the size of the stock market. Privatization cannot take place unless there is enough capital in the private sector for state divesture. Korea lacked experience in stock market operations, and faced all the difficulties common to less developed countries before 1980. These include the preference of households for land rather than stock as the form of wealth accumulation, and the lack of information and technical skills to evaluate stock issuing companies.

To reduce corporate reliance on external financing, the government lifted many restrictions on the stock market in the late 60's and early 70's, and instituted a strong control of real estate transactions. Since 1986, the stock market has advanced both qualitatively and quantitatively with the market capitalization increasing from 6.9 % of GDP in 1980 to over 75% in August of 2005. The number of shares traded increased rapidly partly due to the people's share program that was first applied to POSCO in March 1988. Qualitatively, the stock market is better supported by relevant market institutions such as securities analysts, credit rating institutions, and the supervisory body, all of which contribute to the efficiency of the market.

Government policies to foster the stock market were implemented notably in the 70's. They included tax incentives for firms offering shares to the public, and measures to improve efficiency of the stock market. More recent policies for the stock market have been geared to help diversify the supply sources of investment funds, and to allow the current privatization program to proceed without friction.

The major privatization program of Korea was initiated in April 1987 by the Privatization Proceeding Committee (PPC), which consists of 13 government officials and 6 civilians and was chaired by the Vice Minister of the Economic Planning Board (EPB). PPC selected 17 GIEs for privatization. Firms chosen for total privatization had by then lost their raison d' etre, and some of them had already been competing with private firms. Those firms chosen for partial privatization were relatively sound and of large scale, still possessing substantial impact on the Korean economy. Though they would be completely privatized in the long run, the government wanted to remain as a large shareholder until the capital markets matured. Firms chosen for functional privatization had some business in which they compete with private firms, though they had other tasks still needed under the guidance of government.

Privatization has been carried out mostly through asset sales either by public tender offers or people' s share at fixed prices (In Korea this program is used for income redistribution purposes to qualifying low-income people). The primary purchasers were employees, individual investors and firms. 20% of total shares at the initial sale of each public enterprise were assigned to employees (employees' ownership program) who showed strong resistance against the privatization. Most firms used people's share programs with the rest of the shares: POSCO and KEPCO, for example, were partially privatized with a people' s share program. POSCO was completely sold off in October 2000, while KEPCO was, and is, still in the process. Purchasers consisted of 3 groups: a low-income group (75 %), employees (20 %), and individual investors (5 %). The government adopted a discount price (30 %) for shareholders who were willing to hold the stock for 3 years. Otherwise, qualified investors had to pay the market price.

There were 2 problems that surfaced after the privatization with a wide share ownership program. First, since only low-income people were entitled to 7-16 shares per person, general investors had to purchase the shares at a premium. The premium was often twice as large as the initial market price, which distorted the market. Second, 83 % of the qualified investors did not choose the discount price but preferred short-term windfall profits despite incentives for long-run shareholding, which contributes to stability in the equity market. The incentives included free shares, a discount price, and establishment of a "mutual fund," which gives depositors, mostly low-income groups, lower transaction cost than the ordinary market.

There are 3 firms that have not adopted a peoples' share program: the Korea Stock Exchange, the Korea Appraisal Board, and the Korea Technology Development Corporation. Their shares will be sold, but to related firms.

7 firms have been chosen for functional privatization. The Korean Development Bank (KDB) and the Korea Housing Bank are to be reorganized according to a banking sector restructuring program that has not as yet been formulated. The government first sold firms in which KDB had invested. The Korea General Chemical Industry Corp. (KGC) - a holding company of 5 firms, 4 of which had already been sold off was dissolved. The Korea Trade Promotion Corp. (KTPC) has overlapping business with the Korea Trade Association (KTA) and is financed by KTA. Both firms have not yet reorganized. The Industrial Sites and Water Resource Development Corp. was changed into the Water Resource Development Corp. in December 1987, focusing on the development of water resources. The Agriculture and Fishery Development Corp. has been encouraged to stabilize prices, through demand and supply management of agricultural products, rather than having a storage function. Finally, the Korea Overseas Development Corp was transferred to private firms. However, capital exportation for investment and information on labor immigration in domestic and foreign markets will be retained by the government.

## 2-4. Cases of Korean Privatization

### POSCO

#### *Privatization*

POSCO is the fourth largest steel producer in the world. In 2005, its market share for hot ingot in Korea was 100% and 60-70% for other major products. As of 2004, its annual crude steel capacity was 28.1 million tons. The POSCO business group, consisting of POSCO and 17 subsidiaries, is the ninth largest business group in Korea in terms of total assets (USD 24.95 billion). The subsidiaries include a construction company, a data-service company, a research institute, etc. POSCO, established in 1968 as a joint-stock company, was classified as GIE.

In June 1988, the government launched its “people’s share” program by offering stocks publicly on the Korean Stock Exchange. This wider share ownership program was adopted for political reasons as well as in consideration of Korea’s “Chaebol problem”. In 1988, the aspiration by Koreans for political democratization was higher than any at any time before. To secure political support from the middle class, the ruling party suggested widening the share ownership program. Furthermore, the government did not want Chaebols to buy POSCO stocks for fear of deepening economic concentration. Additionally, this program was believed to have a good effect on firm corporate governance that is, monitoring by a large number of stockholders. Discount prices to buyers created excess demand for the stocks resulting in allocation of a maximum of 7 shares to each individual investor. This contrasted with the allocation of over 200 shares to each employee, bringing about an inequity problem.

In October 1994 and October1995, POSCO stock was listed on the New York and the London Stock Exchanges, respectively. As the equity shares of the government and state-owned banks were decreasing, the government exercised its power prescribed in the Securities and Exchange Law by capping the voting right of any non-government shareholder at 3%. After the 1997 financial crisis, the government pursued privatization as a means of generating hard currency as well as promoting efficiency. POSCO's privatization was completed in October 2000.

<Table 1-8> POSCO's Ownership Structure

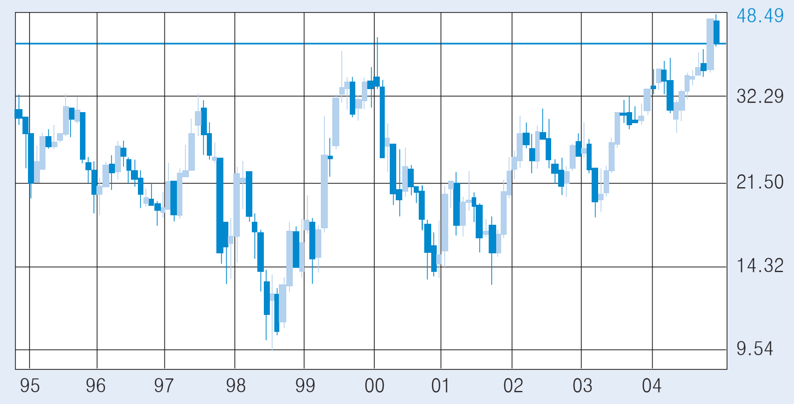
| | Govern-ment | KDB | Other Banks | Korea Tungsten | Postech | Employee Stock Ownership | Other Domestic Investors | Foreign Investors |
|---|---|---|---|---|---|---|---|---|
| Dec 1968 | 56.2 | | | 43.8 | | | | |
| Dec 1987 | 32.3 | 36.8 | 25.3 | 2.4 | | | | |
| Jun 1988 | 20.0 | 15.0 | 25.3 | 2.4 | | 10.0 | 27.3 | |
| Dec 1992 | 20.0 | 15.0 | 14.3 | 0.8 | | 8.1 | 33.8 | 8.0 |
| Dec 1997 | 19.6 | 14.1 | 7.7 | 0.8 | | 0.6 | 32.1 | 25.1 |
| Dec 1999 | | 10.0 | 7.9 | | | | 39.2 | 43.0 |
| Dec 2001 | | | 6.7 | | 3.2 | | 28.0 | 62.0 |

### *Effects after privatization*

After privatization, increase in profit and productivity and decrease in rent seeking behavior might be expected, which is likely to be reflected in a higher stock price. POSCO's stock price about doubled after privatization. Strong monopoly control by the government was accompanied with privatization in Korea in order to minimize any ill effects of market dominating power by large private firms. There are some other issues for consideration after privatization. First, foreign investors, who emerged as the major shareholders (with over 65% of equity shares), tend to prefer more dividends to retained earnings for investment. This may potentially constrain POSCO's future growth. Second, employees are still showing attitudes typical of public workers, indicating that corporate culture change indeed takes time.

Finally, the effectiveness of the newly composed board is yet to be proved. POSCO's board of directors consists of 7 standing directors and 8 outside directors. The audit committee consists of 4 outside directors and reviews the company's human resource management policy. The financial and administration committee, consisting of 3 outside directors and 2 standing directors, looks at major investment plans before they are discussed at a full board meeting. This type of corporate governance structure represents a typical Anglo-American model. There is some concern that this type of corporate governance in POSCO may pose as an obstacle to new investment. In actuality, no new plant has been built since 2000, which caused excess demand for ingots and propelled a Hyundai Business Group to enter the market.

<Figure 1-1> Trends of POSCO Stock Price




## KT&G

### *Privatization*

KT&G is the 33rd largest business group in Korea in terms of total asset (USD 4.38 billion), with 8 subsidiaries. It was a GE under the name of the Office of Monopoly until early 1989. In 1987, the domestic cigarette market was opened to imports under strong U.S. pressure, which triggered the change of the company's corporate status from a GE to a GIE, as well as a change the name of the enterprise. The government still controlled the company in light of its protection of domestic tobacco farmers with a levy on cigarettes. In 1996, the red ginseng market was also liberalized exposing KT&G to competition in all its major products. KT&G's monopoly on tobacco manufacturing was finally abolished in July 2001, and the government completely divested its KT&G shares in October 2002. In 1999, KT&G was listed on the Korea Stock Exchange.

<Table 1-9> KT&G's Ownership Structure

| | Govern-ment | Industrial Bank of Korea | EXIM Bank | KDB | Daehan Investment Trust Securities | Other Domestic Investors | Foreign Investors |
|---|---|---|---|---|---|---|---|
| April 1996 | 69.80 | | 11.25 | 8.13 | | 10.82 | |
| Dec 1999 | 13.83 | 32.37 | 11.25 | 8.14 | 5.64 | 25.96 | 2.81 |
| Dec. 2000 | 13.83 | 35.20 | 7.03 | 6.90 | 7.00 | 25.04 | 5.00 |
| Dec. 2001 | | 29.34 | 7.03 | 6.90 | 7.00 | 32.88 | 16.85 |

### *Effects after Privatization*

In the case of KT&G privatization, the government lifted the entry regulations and abolished the compulsory purchase of raw materials from domestic farmers. Tight regulation on prices may result in inefficiencies. An increase in foreign investors' equity share can also lead to slower corporate growth due demand on higher dividends. Workers and managers seem to have adjusted well to the new environment, becoming more profit oriented and subjecting themselves to market disciplines.

## KT

### *Privatization*

KT is the largest telecom company in Korea. It has a near monopoly on fixed domestic line services. KT is also a leader among high-speed internet service providers (ISP) with a market share of 50%. In the mobile telecom market, KT is followed by SKT, a dominant groups in terms of ownership. KT group is the 8th largest business group in Korea with its total assets amounting to USD 25.71 billion, and with 12 subsidiaries.

Until the end of the 1980's, KT had a monopoly in all segments of the telephone service market. In the early 1990's, the Ministry of Communication (MOC) started to deregulate the telecom industry. As a first step, the Ministry allowed a private data service company (DACOM) to enter the international call service market on favorable terms, setting KT's price rates well above that of DACOM.  In addition, KT was forced to dispose of its mobile phone and paging subsidiaries. In 1996 KT started over and set up a then new mobile phone subsidiary.

From 1993 to 1996, 28.8% of government shares were sold off, and in 1999, KT's stock was listed on the Korea Stock Exchange as well as on the New York and the London Stock Exchanges. In May 2002, KT was completely privatized. In the year of 2004 49% of shares were owned by foreigners, 26% by KT and its subsidiaries, 6% by the employee stock ownership program, and 19% by other domestic investors.

<Table 1-10> KT's Ownership Structure

| | Government | Domestic Investors | Foreign Investors |
|---|---|---|---|
| Dec 1992 | 100.00 | | |
| Dec. 1998 | 71.20 | 23.80 | 5.00 |
| Dec 1999 | 58.99 | 22.30 | 18.71 |
| Dec 2001 | 40.15 | 22.65 | 37.20 |
| May 2002 | | 51.00 | 49.00 |

### *Effects of Privatization*

After complete privatization in 2002, KT's total sales and profitability in basic telephone lines have not been higher than before privatization. This resulted from government regulations on prices and services, which, in turn, were inevitable due to KT's private monopoly and universal service provision. However, in new areas such as internet service provision and mobile phones, KT's sales doubled vis-a-vis before privatization. Its stock price also rose over 25% immediately after privatization, reflecting enhanced future profitability, although it dropped to below the pre-privatization level due probably to the government's heavy regulation. Return on assets has increased, at least partly reflecting improvement in organizational efficiency. Corporate governance mechanisms have also been redesigned to reflect the dispersed ownership. However, dispersed ownership and a high equity share for foreigners as well as heavy government regulation might pose as a constraint on future investment and corporate growth.

## KEPCO

### *Privatization*

KEPCO is the largest electricity supplier in Korea. Its market share amounts to over 90% in power generation, and 100% in transmission and distribution of electricity in Korea. KEPCO has 11 subsidiaries, including 6 generation companies (genco), subsequent to vertical separation of its generation division from its transmission and distribution divisions in 2001. The KEPCO group is the second largest business group in Korea with its total asset amounting to USD 98.3

billion. In August 1989, KEPCO shares were listed on the Korea Stock Exchange. The government sold 21% of KEPCO shares to the public as part of its “people’s share” program. In November 1992, foreigners were allowed to acquire KEPCO shares, and in October 1994, KEPCO stock was listed on the New York Stock Exchange.

<Table 1-11> KEPCO’s Ownership Structure

| | Government | KDB | Other Domestic investors | Foreign investors |
|---|---|---|---|---|
| Dec. 1988 | 100.00 | | | |
| Dec. 1989 | 77.83 | | 22.17 | |
| Dec. 1997 | 69.82 | 5.72 | 13.90 | 10.56 |
| Dec. 1999 | 52.22 | 2.73 | 22.69 | 22.35 |
| Dec. 2000 | 32.35 | 21.57 | 19.55 | 26.53 |

## *Some Considerations after Privatization*

KEPCO has been privatized only in part. It divested into 6 generation firms with equally shared debts, while 1 genco is planned to go on sale. From a strategic point of view, the government wants to keep 60% equity share of generating companies, given the poor prospect of importing electricity from Russia or China in the near future. A lesson from the California crisis in 2001 is the need for caution in the regulation of electricity prices, following deregulation of the entry into the generation market.

## 3. SOEs Performance Evaluation System in Korea

The basic policy direction of the Korean government towards GIEs is reduction of state intervention, thus giving them more managerial autonomy and flexibility, while putting a stronger emphasis on the evaluation of their performance. The GIE Management Act and the associated decree, which have been in effective since 1983, and the 1999 amendment to the GIE Administration Basic Act all support this policy direction.

The major contents of the Act include:

(1) guarantee of autonomy and reduction of government control over management of public enterprises;
(2) establishment of a vice minister-level Public Enterprise Administration Council (hereafter AC) in the Ministry of Planning and Budget (MPB) to evaluate public enterprise performance and to discuss other related matters such as privatization and the new establishment of public enterprises;
(3) separation of policy decision-making from managerial functions;
(4) introduction of the incentive system.

In addition to evaluating the performance of GIEs, the AC has the authority to appoint non-standing directors and recommend the removal of CEOs and appointment of internal auditors. The 1999 amendment changed the structure of GIEs' boards of directors. The board of a GIE consists of standing and non-standing directors, with the majority non-standing. Separate from the performance evaluation of a GIE, its CEO is evaluated each year by the GIE AO on the basis of its management contract (an MOU of sorts) with the CEO.

### 3-1. The Administration Council (AC) and its Function

The Administration Council (AC) was created as a top policymaking organization in the government with a view to rationalizing the GIE management system. The main task of the AC is to coordinate major issues, for example the guidelines for management objectives and budget preparation, performance evaluation, and other matters concerning the management of public enterprises. The AC decides incentive bonus rates for GIEs on the basis of performance evaluation results, and has the power to suggest the dismissal of CEOs in cases of poor management.

The AC is composed of the Minister of Planning and Budget, and representatives from supervisory ministries as well as civilian experts. The Minister of Planning and Budget serves as the chair and can establish and maintain an ad-hoc Public Enterprise Performance Evaluation Task Force in order to assist the AC in its professional work promoting fairness and specialization in evaluation. The Task Force is composed of 30-40 members usually university professors, researchers, and certified public accountants who have expertise in various aspects of performance evaluation.

The major assignments given to the Task Force are to draw up a performance evaluation manual and to conduct evaluation. They are divided into 3 teams: A quantitative criteria team, a qualitative criteria team, and a general control team. The quantitative criteria team is divided again into 3 sub-teams according to primary services and products. The qualitative criteria team is divided into to 5 or 6 sub-teams according to the types of criteria. During 1984 and 2003, 716 specialists worked in the evaluation of SOEs: 441 (61.6%) university professors, 199 (27.8%) public accountants, and 45 (6.3%) researchers.

## 3-2. Managerial Autonomy of Public Enterprises

Before 1999, each GIE had a managing board and a delegate from the government, that is, the relevant director general of the supervisory ministry. Though some chairpersons of the boards and some CEOs were appointed for political reasons, senior executives were usually selected from inside of the organization to ensure management expertise. Those outside the public enterprises are not eligible for CEO positions, thereby ensuring the independence of the top management. After 1999, the board structure of GIEs has taken similarity to the Anglo-American board model rather than the German type dual boards. The direction of government policy and the diverse opinions from interested parties are considered in the decision-making at the board. GIE boards no longer have functional separation between standing executive officers and non-standing directors. Non-standing members of the board comprise a diversity of people outside of the GIE, such as representatives of consumers, professors and specialists in relevant fields. Non-standing directors dominate the CEO recommendation committee, which has the authority to draft a management contracts for the CEO.

Much emphasis has been paid to ensuring the autonomy of the CEOs of public enterprises in budget formulation and implementation. The government is barred from reviewing and coordinating the budget of public enterprises (through abolition of the Public Enterprise Budget Accounting Act). The power to formulate the budget is left up to public enterprises. The common budget guidelines for public enterprise budgeting are provided by the AC each year at the end of October.

In terms of audit and inspection, the Board of Audit and Inspection in each public enterprise has sole responsibility. When the supervisory ministry regards it necessary to inspect a public enterprise, they have to consult with the head of the Board of Audit and Inspection. In procurement, the CEO is allowed to exercise his/her own discretion in purchasing goods without controlling by concerned ministries. However, he/she may commission the Office of Supply to make purchases.

## 3-3. Performance Evaluation

The CEO of a GIE is supposed to submit an annual report on the company's previous fiscal year performance to the Minister of Finance and Economy by March 20 of each year. This report is intensively reviewed by the Performance Evaluation Task Force, which consists of university professors, researchers at reputable institutes, and experienced public accountants. These members of the Performance Evaluation Task Force are contracted each year (usually late January) by the AC for their services. During two months the Task Force reviews performance reports which were written by the public enterprises and visits public enterprises to check the report on site. The Performance Evaluation Task Force submits its final assessment in the performance reports to the AC by early June. The Chief of the AC then reports the consolidated evaluation results to the President of the nation. The government honors GIEs that have achieved excellent performance, and can propose the discharge of top managers in GIEs that perform poorly.

### *Performance Criteria*

GIEs have various social missions, including fulfilling public needs as well as generating profits. As the multiple objectives nature of GIEs makes performance criteria complicated, several standards should be integrated into the general system of evaluation, assigning different weights to the criteria according to their importance. Usually, GIEs are given clear management goals/targets each year by the AC, and the degree of target achievement is reflected in the managerial performance evaluation of the GIEs. For example, a 40 hours workweek schedule is a criterion for the year of 2005. The government wants SOEs to follow government policies (or guidelines) sincerely. In another example, the Korea National Housing Corporation is given a target for providing permanent leased housing for lower-income families.

Any portions of the resulting finances or profits that are affected by factors regarded as exogenous - oil price, foreign exchange rate changes, etc. - is excluded from the evaluation indicators.[12)] Other criteria such as long-term management, R&D, and service improvement, are an important portion of the performance evaluation system. Long-term management criteria are established to induce the formulation of management strategies that can adapt to changes in the national policy and the environment. The criteria for R&D are geared to encouraging technology innovation and productivity improvement through promotion of R&D investment. The criteria for service improvement are introduced to induce service development to continuously reflect changes in consumer needs and preferences.

The criteria for managerial performance are classified into quantitative and qualitative indicators. In the case of quantitative indicators, it is paramount to assign appropriate

12) Evaluation criteria for KEPCO are shown in the Appendix

performance targets. Generally speaking, GIEs, being conscious of the managerial performance evaluation, tend to set easy targets, while the government tries to assign higher targets. In Korea, methods of absolute targets and trend targets are used in the assignment of performance targets for quantitative indicators. In setting absolute targets, the government considers with utmost objectivity the long-term investment plan, comparable performance of similar types of enterprises, and past business results. Target values are sometimes calculated on the basis of standard values estimated by the regression of past performances of around 10 years. In the case of qualitative indicators, objectivism is difficult because the evaluation criteria are often abstract. The weight of quantitative indicators is 60% for the majority of GIEs, but 50% for some other GIEs such as small-scale public service enterprises. The weight for qualitative indicators tends to decline over time.

### *Incentive Bonus and Sanction*

A key feature of Korea's public enterprise evaluation system is a program of monetary incentives. The incentive bonus is differentiated according to performance evaluation results with an upper limit of around 3 months extra pay per year. Managers as well as workers are eligible for this bonus.  In order to strengthen the motivation for performance improvement, the differentiation of bonus has increased. In 1994, the bonus ranged from 165% to 365% of monthly pay. In 2005, the variation increased to as much as 500% of monthly pay. However, in practical terms this disparity is not very significant, since the grades of most firms tend to be concentrated on a middle grade. Still, the managers take the evaluation very seriously, and make their best efforts to get publicly rewarded by obtaining a high grade. Public discretion of performance evaluations that score mediocre or poor is considered shameful.

## 3-4. Lessons Learned from the System

### *Political Leadership*

The government, or interest group within the government representing the general public, is de facto owners of the public enterprise. The question that follows is, how does the political interest group of a country perceive public enterprises If it is regarded as a political prize and abused through nepotism and other private interests, the introduction of an effective performance evaluation system will be very difficult to ensure. Thus, a strong political leadership is the first necessary condition for improving the efficiency of public enterprises. Interest groups must first raise their awareness and concern with improving efficiency, before the responsibility management system can become a powerful tool to achieve its purpose.

In the process of operating the system of performance evaluation for public enterprises, Korea experienced negative effects of political groups attempting to change the scores and to maneuver out of the evaluation system. In 1986, the Korea Broadcasting Corporation was evaluated and consequently received a poor grade. The Corporation tried to change its grade by mobilizing its political connections, yet the efforts ended in vain. However, the Korea Broadcasting Corp. has been excluded from the performance evaluation since 1987. Another example is the appointment of unqualified people to CEO positions in GIEs, though such cases are infrequent in modern Korea.

### *Cooperation among Administrative Organizations*

Public Enterprises operate in various industries and are controlled by different government agencies. The performance evaluation system cannot work effectively if there are disputes or conflicts among government agencies. For better coordination among government agencies, persistent efforts of discussion and consultation should be made among relevant agencies. In Korea, MPB is a leading government agency, and coordination is efficiently performed by the AC. In the case of Vietnam, the National Steering Committee for SOE Reform and Development (NSCERD) and the State Capital Investment Corporation (SCIC) can possibly be the key members of the Administration Council.

### *Technical Competence*

The most critical component of necessary technical competence will be the establishment of a performance evaluation criterion. It is the desire of all those involved to have a simple but objective criteria set. The performance criteria are divided into quantitative and qualitative criteria, and criteria/standard values need to be decided as well as the proper weights be given. In Korea, the government, mostly MPB, collects suggested criteria values from supervisory ministries to which a GIE reports, and determines the value in consideration of expected economic growth, financial conditions, etc.

In addition to the criteria set, the scoring or grading mechanism and the incentive scheme attached to the performance evaluation need to be considered and designed. A profit sharing program, stock ownership, and a bonus system, etc. are candidates for the incentive scheme. In Korea, the ad-hoc Performance Evaluation Task Force, established every year, is responsible for studying problems concerning criteria, index, grading mechanism, incentive system, etc.

# 4. Economics of State Owned Conglomerates

## 4-1. Types and Expected Merits of SOE Conglomerates in Vietnam

In key sectors, the GOV has created state corporations, or General Corporations. Law on SOEs (promulgated in 2004) defines three types of State Corporations: First, corporations with the investment and the establishment decided by the government. The corporation constitutes a form of aligning and rallying independent cost-accounting member companies operating in one or several principal specialized techno-economic branches with a view to increasing capital accumulation and concentration and specialization of business for member units and the entire corporation. Second, corporations invested in and set up by companies constituting a form of alignment through investment and capital contribution of large-scale state companies. Third, corporations that make investment with and deal in the state capital, established to exercise the owner's rights and obligations towards state-run one-member limited liability companies converted from independent state companies.

Building a holding company with member firms (affiliates) creates market power, which, in turn may intervene in the nation's policymaking process. However, holding companies and other forms of business groups can contribute substantially to economic development, especially in developing countries. A business group may have such economic gains as economies of scale or scope, overcoming investment constraints through the operation of group-wide internal capital market, and a creditable reputation in the early stage of investment. In a sense, business groups accelerate transition towards a market economy away from heavy state control over enterprises. However, the group structure may prevent inefficient small and medium SOEs in the group from exiting the market due to cross-subsidization among the member subsidiaries. Business groups of SOEs are also likely to result in monopoly in the markets, and suffer from moral hazards due to soft budget constraints. As such, they might pose as constraints towards a market economy.

## 4-2. Chaebol Policy in Korea

Chaebols in Korea are defined as family-owned business groups with numerous member firms, many of which enjoy monopoly or oligopoly in their related markets. According to the antitrust law in Korea, business groups exceeding KW 2 trillion in terms of total assets are called Chaebols. As of 2005, 55 business groups were categorized as Chaebol, including Samsung, LG, SK, Hyundai, and Hyundai Motors.

The contribution by Chaebols to Korean economic growth during the early stage of development was enormous, culminating in their current accounting for over 50% of exports.

However, the ensuing concentration of economic power has often influenced policymaking process and other political affairs. The consequent wealth concentration has created a problem of social inequity. Also, as was evident through the financial crisis of 1997, Chaebols were often found to maximize family interests in running their businesses at the sacrifice of minority shareholders, sometimes risking the viability of the whole group. The Korean government had made several attempts to solve these problems since 1980 without much success, in part due to the political influence of powerful Chaebols.

On facing the 1997 financial crisis, the government and business group leaders agreed on a MOU, which consists of 5 corporate restructuring policies and 3 other principles (the so called "5+3 principles"). The 5 corporate restructuring policies include improving managerial transparency, phasing out cross guarantees of debt among member firms, decreasing the debt-equity ratio, selling some subsidiary firms to concentrate on core businesses, and strengthening accountability to minority shareholders. The 3 other principles include preventing Chaebols from controlling financial institutions, refraining from cross-shareholding among member firms, and prohibiting unlawful inheritance. Subsequent to the MOU, Chaebol policy has largely moved away from direct regulation in favor of market incentives on the basis of more scientific research work.

## 4-3. Determinants of Ownership Concentration

The optimal ownership concentration for firms will be determined depending on how governance costs are minimized. This, in turn, is generally influenced by market circumstances, product types, behavior of institutions, like the government, vintage of the firm, corporate culture, business leadership, financial system, local business practices, degree of legal protection of small shareholders, and so forth. One cannot conclude that any general solution regarding ownership structure can be found. The implication is that ownership dispersion is not a universally good policy, contrary to what international financial institutions often suggest.

Decisions regarding ownership structure will depend on the tradeoff between costs and benefits of ownership concentration. In the case of Korea, several reasons explain why ownership concentration was prevalent. First, the bank-business relationship in Korea resulted in less intervention in corporate managerial decision-making, in comparison to the Japanese mainbanks, thus making monitoring unnecesary, and possibly contributing to ownership concentration. Second, business leadership has been formed for over 50 years, but still needs time to mature into the developed country level. Third, Korean industries had to change their products quickly to compete with developed and other developing countries, prompting speedy managerial decision-making under concentrated ownership. Moreover, commitment costs associated arbitrary decision-making is likely to be lower under ownership concentration. Economic circumstances and government behavior have changed from time to time, and frequent changes in commitment have been a regular phenomenon in Korea. Under these circumstances, firms were likely to concentrate ownership in order to change their own decisions with less cost. Although ownership concentration itself tends to bring about more arbitrary changes in commitment, firms with concentrated ownership seem to better cushion a system allowing arbitrary and frequent policy changes (see Table 1-12).

<Table 1-12> Corporate Governance Costs in Selected Countries

| | Governance cost related to instability in commitment | Governance cost related to speed and flexibility in decision making |
|---|---|---|
| Korea | Low | High |
| United States | High | Low |
| Japan | Moderately High | Moderately Low |

With a good corporate governance system in place, the ownership structure ceases to be an important policy issue. Nonetheless, many economists and government officers still think that ownership dispersion is the best prescriptive for the country's economic problems, often making this argument on the basis of equity. Even though most policies towards Chaebols target ownership structure, whether concentration or dispersion of ownership is better for Korea is inconclusive. It could be argued that Korea's market circumstances and institutions are such that ownership concentration results in less governance cost in Korea. In the long run, however, the Anglo-American model might be preferable, given that there will be changes in market, changes in law, sounder corporate culture, and strong leadership.

Contracts involving shareholders, managers, workers and suppliers are imperfect. Suggested as a way of minimizing associated transaction costs is the stakeholder model, emphasizing particularly the close long-run relationship between banks and their corporate borrowers. On the other hand, that the right corporate governance model depends on the nature of industries is also argued for. Industries requiring more R&D and outside information are advised to rely on a stock market-based corporate governance for more diffused outside information. In contrast, industries like iron & steel, which is old and further technological innovation may be less important, can find a bank-based or other stakeholder governance model more appropriate. Rapid globalization and information technology have led to changes in corporate organization. There is little point for the government to force firms to change their organization. For a large and risky project, a system that encourages a large number of related firms to participate is necessary.

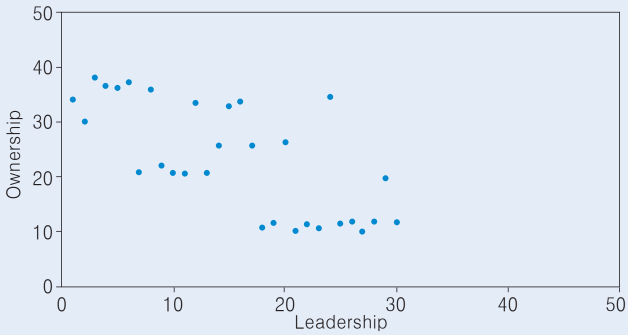
If the government is to pursue ownership dispersion policies, it could possibly exercise indirect policies, which increase governance costs for the firm with high ownership concentration. Such policies include increasing the ceiling on foreign ownership, encouraging banks and institutional investors to actively monitor corporations, and promoting leadership of firms. Leadership of firms helps solve equity and efficiency issues simultaneously. While ownership dispersion may improve equity, strong leadership may be conducive to a firm's growth. The leadership can be developed through a form of patriotism promotion. Such promotion helps an understanding that entrepreneurs seek to contribute to the country. The government has the responsibility to acknowledge and publicize the importance of entrepreneurs and their contribution. Also important is to make markets more favorable to good corporate governance structure.

Other policies include promoting small shareholders to better monitor management as well as checking and balancing arbitrary commitments. These policies are needed to counter the increased governance cost resulting from ownership concentration. Furthermore, a sound CEO market should be fostered to enhance competition in the managerial labor market. Finally, the government should have better long-term strategies and policies to reduce arbitrary changes in commitment.

### *Relationship between the Concentration of Ownership and Leadership*

Good corporate culture fostered by strong leadership lowers coordination and motivation costs of firms. If ownership concentration is a way of lowering transaction cost, strong leadership is likely to reduce ownership concentration. Under the above circumstances, the prisoner's dilemma predicts that everybody will opt for the strategy of "cheating" rather than "honesty" in relationships with top management and subordinates. Good corporate culture induced by strong leadership encourages people to follow the "honesty" strategy. In economics, the significance of leadership has been totally ignored under the context of "perfect competition'". Under perfect information, individual ability, particularly leadership, does not matter. Yet in the real word, leadership is a very important contributory factor in making good corporate culture. Recently, leadership has been acknowledged as pivotal in increasing firm performance, although it is unclear whether its relationship operates separately from other economic circumstances. Because leadership is an unobservable variable, it is difficult to prove empirically.  Figure 1-2 shows the relationship between leadership and owner concentration of 53 Chaebols in Korea in 1995 by making scoring leadership through statistical methods.

<Figure 1-2> Leadership vs. Ownership



## 5. Some Suggestions for SOE Reforms in Vietnam

The GOV has been in the process of reforming SOEs for 20 years: Equitizing SOEs, adopting competition policy, forming large SOE holding companies, etc.  On the basis of analyzing Korean experiences of SOEs management, the following suggestions are made about short-run and long-run SOEs policies.

As a long-run policy, Vietnam should seriously consider more ambitious privatization to follow up on the current process of partial privatization (equitization). Though this may not be readily acceptable politically, given the socialist orientation of Vietnam, people should be aware of the clear tradeoff between efficiency and social equity. Methods of sales can be different depending on the characteristics of products, capital market, etc. Deregulation is a necessary condition for successful privatization. Maximization of revenue from sales should be one of the priorities of SOE reform.

In terms of short-run policies, a performance evaluation scheme combined with monetary incentives is recommended for major SOEs in which the government keeps 100% or a majority equity share.  The evaluation criteria and methods can reflect differences depending upon the industry characteristics, maturity, and future industry strategy, etc. More elaborate competition law (antitrust law) is also needed to ensure the efficiency of SOE conglomerates. The major issues currently facing the GOV include determination of the role of the government in the market economy, efficiency improvement of GCs, and revision of the competition law.

### 5-1. Suggestions for Current Equitization

Even though the current equitization of SOEs is still at a beginning stage, its direction is seemingly good and on the right track. To elaborate, it sorts out the entire spectrum of SOEs by profitability, industry, scale, social functions, and market conditions including the capital market. Firms to be equitized are selected based on whether they still possess “public interest” functions. Obstacles to smooth equitization include: The small size of the domestic stock market, the government’s desire to maintain political control over strategic sectors, debate about the adequate scope of the government in the economy, lack of belief in the efficiency of private firms, creation of big holding companies without appropriate controlling mechanisms, difficulty in determining the value of enterprises, delay in putting necessary legal and other institutions in place, and shortage of relevant expertise. On the basis of Korea’s privatization experience, some suggestions are offered for Vietnam.

The first lesson is on the selection of firms for privatization. Public enterprises whose businesses are generally risky and heavily regulated have not shown any improvement in performance after privatization.  In the future, privatization or ambitious equitization should be accompanied by deregulation, and the selection of firms to be privatized/equitized should be made with due regard to general and specific risks.

Second, it may not be a good idea to restrict the purchase of privatized/equitized shares to specific groups. The Korean government used a wider share ownership program at some discount with a view to widely distribute economic rents from privatization. Most of the purchasers resold their shares for short run windfall gains rather than holding them for a longer term indicating the need to provide stronger incentives for long run holding.

Third, it is important to solve the problem of chronic deficit for public enterprises and to foster the stock market. Large SOEs deficits and the small size of the equity markets often make it difficult to find buyers for the assets of public enterprises. Foreign investor participation in the privatization programs is also strongly recommended, helping mitigate the problem of weak demand for privatized/equitized SOEs.

Fourth, the government's reluctance to privatize is an important factor behind the slow process of privatization. Rigid preoccupation with the socialist orientation may end up bringing enormous injustice by preventing people from realizing their potential. In reality, most governments are unwilling to relinquish their political power associated with control of SOEs. But lack of political will can be traced partly to structural impediments to privatization. Effective privatization needs to be accompanied by structural reform, making privatization a truly cumulative process rather than a list of sales. Also, various preferential treatments given to SOEs should be abolished to reduce the resistance of SOE insiders to privatization.

The fifth lesson concerns the question of SOE valuation. A sustained privatization program together with consistent market-oriented polices can provide credible signals, building up investor confidence and leading to stock market deepening. Privatization with the sale of under priced shares appears to be an appropriate strategy, often necessary to favor the sale. It results in significantly positive market-adjusted returns for purchased shares at an initial public offering (IPO). Albeit the size of the Vietnamese stock market is currently very small, a wide share ownership program with some under pricing will ensure successful privatization. Additionally, the government should lift foreign investment restrictions (3% for individuals, 7% for institutions, and 30% for total foreign ownership).

Sixth, resistance of workers and management to privatization is an issue. The offering of some fixed shares at a discount price can help alleviate their resistance. It will also serve social equity by helping blur the distinction between capital and labor. However, appropriate rules have to be made concerning the extent of providing shares to the employees.

Seventh, Vietnam is now in the creation of large SOEs holding companies in all the key industries, including electricity, telecommunications, and construction. The strength of the Vietnamese economy in the future is likely to depend substantially on the efficiency of these enterprise groups. Their success, however, also depends on many challenging tasks. Thos are effective competition law, avoiding corrupt relations between bureaucrats in the government and SOEs, managerial autonomy and accountability, effective corporate governance mechanisms

Finally, Vietnamese small and medium SOEs are consolidated irrespective of the characteristics or market conditions of the industry. If the market is competitive, privatization is preferred to consolidation.

## 5-2. Corporate Governance System for SOEs

The Vietnamese law on SOEs describes the corporate governance mechanisms inside SOEs in detail, including the function of the managing board, the auditing board, roles of general director, deputy general directors and chief accountants, and supporting apparatus. However, these governance mechanisms are not expected to be effective unless, among other things, the product and capital markets are fully competitive.

Given that there will be a limit to the effectiveness of the internal corporate governance mechanisms, a desire to supplement this limit through some external mechanisms geared to reducing moral hazard problems in SOEs exists. An obvious choice is introducing a Managerial Performance Evaluation system accompanied with a sound incentive system. For Vietnam, however, the introduction of a systematic performance evaluation system will be very complicated and challenging, since, among other things, the sheer number of SOEs is significant. Nevertheless, it is recommendable to adopt such a system for 10-15 GCs (including holding companies) with more than 10,000 employees or a contribution of over VND 100 billion to the government budget. Vietnam Alcohol, VEAM, VINA SHOSE, Vietnam Industrial Construction Corp., Vietnam Glass and Ceramic for Construction Corp., Song Da Construction, Ha Noi Construction Corp., VINACONVEX, Cienco No1, Vinafor, CIENCO No 8, Petrolimex, Industrial and Commercial Bank, Saigon Trading Corp., Saigon Real Estate Corp. are possible candidates. Once the evaluation system is firmly established in these enterprises, it can be expanded to other SOEs.

In operating a performance evaluation system, Vietnam can consider the following practical points. First, an Administration Council (AC) should be established, consisting of the National Steering Committee for SOE Reform and Development (NSCERD), the State Capital Investment Corporation (SCIC), the Ministry of Finance, the Provincial People's Committee, and relevant ministries and a few experts.  Second, the major tasks of the AC will be defining the goals of the SOE, setting the criteria of performance evaluation, setting up an incentive system, and finalizing performance evaluation results. The AC can conclude a MOU with the CEOs for managerial performance evaluation.  Third, the performance evaluation should be started with a limited number of large GCs, given that required skills are inadequate and some trial and error is expected in the initial stage. However, with accumulated expertise and experience it can be extended to include other GCs. Finally, putting in place a sound incentive scheme is a very important complement to the evaluation system. A pecuniary incentive system is preferred.

## 5-3. Challenges for State-Owned Conglomerates

The GOV seems to have a vision of promoting state-owned holding companies (GC) as the key players of the economy. In the case of the holding companies, the government seems to be very cautious about equitizing the parent companies (currently sticking to 100% state ownership), while the subsidiaries are to be equitized selectively in order to maintain a majority or minority state ownership. Though this industrial landscape may fit the socialist orientation of Vietnam, it might warrant serious reconsideration in order to maximize the efficiency of the whole system.

For one thing, the parent companies of some holding companies may be open for equitization for efficiency. Also, more ambitious privatization or equitization might be pursued for other GCs and subsidiaries of holding companies. When the nation's industrial scene is dominated by SOE holding companies with extensive internal transactions among the members, major problems are likely to include: Bureaucrats becoming captured by powerful SOEs, poor corporate governance, restraints on competition, an underdeveloped capital market, and slow development of private entrepreneurship.

Second, the question of how much equity share should be privatized is difficult in relation to corporate governance structure. The level of optimum ownership diversion/concentration is different from country to country depending on the maturity of the capital market and the existence of laws and regulations protecting small shareholders, business leadership, and the degree of government intervention. While the GOV maintains strong intervention in the market, selling a small share to the private sector would not be attractive for potential investors for fear of being robbed by the state, indicating that the state should allow substantial shareholding. In the case of full privatization, concentrated (rather than dispersed) ownership of privatized firms is more desirable in Vietnam to ensure managerial efficiency through the strong monitoring incentives of large/controlling owners.

Finally, also essential is devising an effective corporate governance structure for SOEs. The focus can be placed on the role and composition of the managing board, selection and evaluation of the CEOs, regulation of related-party transactions and other types of conflicts of interests, and improved transparency and public disclosure. Given the inherent limit to the effectiveness of these internal corporate governance mechanisms in SOEs, an outside Performance Evaluation System is desired, as was elaborated above.

## 5-4. Strengthening Competition and Antitrust Law

The GOV is well aware of the merits of market competition: Above all, it makes Vietnamese firms more efficient. However, the authorities are still preoccupied with potential job losses and corporate insolvencies that might follow from giving free rein to market forces. Moreover, there is concern about the fate of consumers: In some industries, public subsidies are the only thing keeping prices stable, and introducing competition might cause price rises over time in those industries. This explains the very slow progress in enacting the Competition and Antitrust law in recent years. However, the pace of reform accelerated in 2003, given the need to bring domestic laws in line with regional, bilateral and prospective multilateral trade agreements. The latest draft of the Competition Law was released in September 2003, and the National Assembly promulgated the Law in late 2004. This law went into effect from July 2005. The Competition Law of Vietnam prohibits four broad types of anti-competitive activity: (1) agreements that substantially restrict competition; (2) abuse of dominant or monopoly market position; (3) "concentrations of market power" that substantially restrict competition; and (4) acts of unhealthy competition.

Unlawful concentrations of market power of large conglomerate groups are defined as any conduct by a firm that aims to control activities of other enterprises, including but not limited to mergers, acquisitions and consolidations. All concentrations of combined market share of relevant firms amounting to 50% or more are prohibited, except where (1) the result is still a small or medium-sized enterprise (a concept not defined in the law), or (2) the Prime Minister grants an exemption. In addition, where the participating parties would have a combined market share of 30-50%, they must notify the competition authorities of the proposed concentration at least 30 days in advance. The competition authorities are to confirm in writing if the concentration is permitted or forbidden within 30 days from receipt of the notification. Failing any response, the proposed concentration is automatically permitted. In complex cases, the competition authorities may have up to 30 extra days to make its determination.

The Competition Law does not deal with the concentration of economic power. Vietnam might consider covering, in the Law, expected problems in the future, such as cross-shareholding by member firms of a group, cross-credit warranty for audacious expansion of size, control of the debt-equity ratio, degree of ownership concentration, and prohibition of non-finance groups from controlling financial institutions.

# References


Bortolotti, B., and Siniscalco, D., the Challenges of Privatization, Oxford, 2004

CIEM, SOE Law in Vietnam, 2004. 1.

Kang, Shin Il, Korea's Privatization Plans and Past Experiences, KDI Working Paper No 8823, KDI, 1988

Kang, Shin IL, Choice of Privatization Methodology: KEPCO and Korea heavy Industry, KERI, 1994(Korean version)

Kang Shin Il, Determinants of Corporate Ownership Structure and their effects on Corporate Governance in South Korea, Ownership Structure of Northeast Asian Countries, Keri, 2003

Lim Wonhyuk, Public Enterprise Reform and Privatization in Korea: Lessons for Developing Countries, KDI, 2003

Shirley, M.M., Improving Public Enterprise Performance. Working Paper, World Bank, October 1989

Song, Dae Hee, a Study for Internal Performance Evaluation System within the National Food Authority of Philippines, KDI Working Paper, No 8803, KDI, April 1988

Song, Dae Hee, The Political Economy of the Korean Public Enterprise Performance: 1962-1991, KDI Working Paper No. 9506, KDI, March 1995

EPB, New Administration System for Public Enterprises in Korea, Sep. 1990

Ministry of Finance and Economy, Guidebooks on Government -Invested Enterprises' Performance Evaluation, 1995

Korea Labor Institute, Public Sector Industrial Relations in Selected Countries: With Special Reference to Korea's Reform Policies, 1990

The Economist Intelligence Unit Limited, Country Commerce Vietnam, April 2004

CIEM, "Accelerating State-Owned Enterprises Reform to Meet the Requirements of National Development and WTO Accessions," CIEM-FES Working Paper, January, 2004

OECD, "Recent privatization Trends in OECD countries," OECD 2002

Appendix : Evaluation Indicators for the Korea Electric Power Corporation

| Indicators | Standard of Evaluation | Method of Evaluation | Weight |
|---|---|---|---|
| 1. Integrated Indicators | | | 22 |
| Productivity of capital | Public profit / fixed capital | Trend Analysis for 12 yrs | 12 |
| Others | | | 10 |
| 2. Major Business Indicators | | | 26 |
| Electricity Sale | | | 6 |
| Load factor | Average / maximum demand | Performance vs. objective | 2 |
| Others | | | 18 |
| 3. Management Efficiency Indicators | | | 27 |
| Total cost management | Total cost = f(total sales) | Trend analysis (12 yrs) | 7 |
| Others | | | 20 |
| 4. Improvement of Service | | | 17 |
| 5. Research and Development | | | 8 |
| **Qualitative Score : 45, Quantitative Score: 55, Total Score : 100** | | | |

Chapter 2

# Integration into the World Trading System: Vietnam's Preparation for Entry into the WTO

Chapter 2

# Integration into the World Trading System: Vietnam's Preparation for Entry into the WTO

*Jaemin Lee*
*Hanyang University*

## Executive Summary

The Socialist Republic of Vietnam and its future now stand at the crossroads. After ten-years of preparation and effort, Vietnam is finally on the verge of being integrated into the world trading system: the World Trade Organization (WTO). Entry into the WTO will bring about fundamental changes in Vietnam, changes that Vietnam has never experienced before. In general, the entire social and economic structure of Vietnam will have to be overhauled, adjusted and transformed as a result of the WTO accession.

So far, the Government of Vietnam (GOV) has done tremendous amount of work in preparation for the entry. For instance, it has submitted over 150 draft laws and implementing regulations to the National Assembly this September, while negotiations with the United States have been conducted around the clock. The GOV's efforts should be duly recognized and commended. The remaining task for the GOV is to wrap up this ten-year process successfully.

Among others, the GOV needs to continue to do its best in the course of bilateral negotiations. Regardless of basic rights and obligations stipulated in WTO Agreements, the bilateral negotiations and resulting WTO Accession Protocol will basically dictate the "specific" terms for Vietnam, the reason why these bilateral negotiations are so crucial. China's current agony due to the special rules stipulated in its Accession Protocol back in 2001 further evidences the importance of concluding a workable and appropriate Accession Protocol for Vietnam.

In terms of bilateral negotiation strategies, the most important thing is to adopt a "cool and controlled" approach. Other countries are well aware of Vietnam's strong desire to join the WTO. If these countries interpret the desire as desperation, however, Vietnam will by pushed into greater concessions through bilateral negotiations. As such, it is important for the GOV negotiators not to look desperate at the negotiation table. The GOV negotiators will have to let their counterparts know that the GOV will not pursue a WTO entry for entry's sake.

In specific areas of bilateral negotiations, the Non-Market Economy (NME) status and the "Vietnam-specific safeguards" issues will affect Vietnam's trade interest significantly in the future. As to the NME issue, the GOV needs to find a mechanism to limit the negative impact in the future. As to the Vietnam-specific safeguards issue, the GOV will probably be able to exclude such provision in the Accession Protocol referring to Vietnam's particular situation. It

is expected that Vietnam will finalize all bilateral negotiations, including the one with the United States, by early 2006.

As the bilateral negotiations are coming to a close, what is paramount for the GOV at this juncture is to identify various projects to be done after WTO entry, and to initiate them immediately. Since WTO entry is likely to be just a few months away, time, in essence, is running out. Other countries will demand, complain and protest immediately after Vietnam's WTO entry, should there be an area that does not fully meet WTO standard or norms. They will also bring legal action against Vietnam at the WTO dispute settlement process. Such being the case, the GOV needs to initiate these projects as soon as possible to defend itself from these legal disputes after WTO entry.

This paper outlines the key projects needed to be undertaken as follows: First, the GOV needs to organize and develop a "WTO Expert Pool" in Vietnam to expand trade law infrastructure and enhance trade law expertise in Vietnam. Second, the GOV will have to create a "WTO Task Force" inside the GOV, probably inside the Ministry of Trade, to deal with emergency situations and initial chaos in the immediate aftermath of WTO entry. Requests and inquiries from foreign governments and companies will explode after WTO accession, and the GOV needs to provide consistent and uniform answers to these requests and inquiries. A WTO task force will be able to carry out this function. Third, the GOV will have to establish an "Investigating Authority" in accordance with WTO obligation as well as laws and regulations relating to the agency. Fourth, the GOV needs to reform its education system in order to introduce subjects and courses to train international trade law experts for the GOV. Fifth, in order to enhance global competitiveness of Vietnamese companies, it is essential for the GOV to introduce a policy to increase English proficiency in Vietnam. Sixth, the GOV needs to amend its existing laws and regulations and introduce new ones to be in full compliance with various legal obligations under the WTO Agreements. Seventh, the GOV needs to reform its judicial system, so that foreign companies and nationals have a meaningful access to the Vietnamese judicial system if their rights are violated in Vietnam. Finally, the GOV needs to consider establishing a network of pro-Vietnamese policy makers and politicians in other countries, thus indirectly promoting Vietnamese trade interest.

Subsequent to the above, this paper then provides Korea's experience in key trade issues and offers suggestions for consideration by the GOV. It discusses Korea's experience in managing antidumping investigations from other countries and hard lessons learned from that experience. Korea's experience suggests that the GOV take a more practical approach in terms of the antidumping investigation defense by helping Vietnamese companies defend themselves behind the scenes rather than directly engaging in a government-to-government negotiation. Regarding the subsidy investigation management, the GOV needs to gradually detach itself from State Owned Enterprises (SOEs). The GOV's support for, and involvement with, the SOEs will make it vulnerable for a subsidy allegation from trade partners. The WTO Subsidy and Countervailing Measures Agreement clearly prohibits such state support of exporting companies. Once it graduates from NME status, subsidy investigations against Vietnam will increase, in addition to antidumping investigations. As to the WTO dispute settlement process, the GOV needs to be more actively involved in the dispute settlement mechanism of the WTO. Korea's experience forecasts that the GOV needs to be more aggressive in pursuing its legal claims at the WTO dispute settlement mechanism. Korea's experience also indicates the importance of cultivating the GOV's own legal experts and practitioners who can represent the GOV at the WTO dispute settlement process. Concerning the operation of an Investigating Authority inside the GOV, the importance of protecting domestic markets from penetration by unfair trade from other countries is another lesson learnt by the Korean experience. Adequate protection of domestic markets also leads to preservation of consistent exports to other countries.

WTO entry will provide a turning point for the future of Vietnam. It will become the first stride for true globalization by Vietnam. This first stride, if appropriately taken, will immediately propel Vietnam in the world market to compete with other countries. On the other hand, a misstep will cost Vietnam incalculable financial and administrative costs in order to rectify the error further down the road.

Many news reports indicate that Vietnam will be able to wrap up all bilateral negotiations by early 2006 and that it will join the WTO thereafter. Once Vietnam achieves entry into the WTO, it will then have to continue the momentum to further develop the Vietnamese economy and invite foreign investment into Vietnam. The hosting of the Asia-Pacific Economic Cooperation (APEC) conference in 2006 will provide a precious opportunity for Vietnam in this regard. In that context, Vietnam will also have to formulate a strategy to take full advantage of the opportunities presented from hosting APEC in 2006.

# 1. Introduction

After ten-years of preparation and effort,[13] Vietnam is finally on the verge of being integrated into the world trading system, accession to the WTO. No doubt, the integration will bring about fundamental changes in Vietnam, changes that Vietnam has never experienced before in its modern history. In short, the basic structure of the Vietnamese economy will have to be overhauled, adjusted and transformed as a result of the WTO accession. It is indeed an enormous task on the part of Vietnam. Since the GOV is currently navigating through "uncharted territory," it is almost natural for all GOV officials to feel a great deal of pressure at this crucial moment.[14]

The successful completion of this enormous task will provide a crucial turning point for Vietnam. The entry into the WTO can be compared to acquiring full membership of an exclusive club: the world trading community. Finally, Vietnam will be entitled to the rights and privileges as a member of the WTO, as is with 148 other countries. At the same time, Vietnam will also undertake significant obligations and burdens in exchange for the membership. The WTO regime requires members to keep their economic and trade policies strictly in line with the WTO framework and norms. Given its heavy dependence on foreign trade, over the years Vietnam will certainly gain from this entry. Yet in the short run, there may be some unexpected visible and invisible costs to be paid. The only way to minimize this cost is to be fully prepared for the entry. Without thorough preparation and prior adjustment, Vietnam will have to pay a higher price for entry than otherwise, a cost that would haunt Vietnam for a long time to come.

As this is an uncharted territory, the success of the WTO entry that is, how much Vietnam takes advantage of the newly acquired WTO membership -- depends largely on what Vietnam does and how it fares during the subsequent months and years. The outcome of Vietnam's future will be determined completely, dependent upon on how thoroughly Vietnam prepares itself for this enormous undertaking and how effectively it moves into this uncharted route.

13) The following is a brief history of Vietnam s WTO entry effort thus far: In January 1995, Vietnam applied for accession and the WTO General Council established the Working Party on the Accession of Vietnam, chaired by Ambassador Seung Ho Choi of Korea. The Working Party was open to all Members and to observers, such as others interested acceding countries. The Working Party met for the fifth time in April 2002, to review Vietnam s initial market access offer and Vietnam s action plans for implementing the WTO agreements on intellectual property (TRIPS), sanitary and phytosanitary (SPS) measures, and customs valuation, its legislative reform program, and answers to questions from trading partners regarding Vietnam s trade regime, as well as Vietnam s subsidy and TRIMs programs. In 2002 alone, Vietnam also met bilaterally with 16 countries to start market access negotiations, including United States, European Union, Japan, Canada, Australia, Switzerland, Norway, Kyrgyzstan, Czechoslovakia, South Korea, Singapore, Thailand, Paraguay, Uruguay, Cuba, and China. The number of countries conducting bilateral negotiations has been expanded to over 30 since then.

14) Almost all GOV officials who participated in the interviews during the pilot study expressed concern over the enormous workload involved in the WTO entry.

Bearing this in mind, the purpose of this paper is to provide Vietnam with the guidelines for smoother and more efficient transition from an "outsider" to the "rising star" of the world trading community.

As of this writing, the WTO membership numbered 148.[15] Accordingly, the WTO has absorbed most of the countries in the world into its system. In addition to Vietnam, there are currently some other countries attempting to join the WTO: In particular, Russia is currently in the process of wrapping up bilateral negotiations, while the possibility of North Korea joining the WTO has also been mentioned.

15) See the WTO website: http://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm.

## 2. Evaluation of the Current Status

### 2-1. Current Situation of Bilateral Negotiations for Vietnam's WTO Entry

That the GOV aims to join the WTO as soon as possible is a well know fact. Originally, it aimed to join the world body by December 2005, during the 6th Ministerial Conference of the WTO in Hong Kong, from December 13-18, 2005. To meet this target deadline, the GOV has been engaged in endless negotiations, both bilateral and multilateral, in the year of 2005 to finalize the entry process expediently, hopefully by the end of September. This plan, however, turned out to be too bold. Although the GOV has finished bilateral negotiations with 21 countries this year,[16] it still has not reached a mutually acceptable conclusion in negotiations with the United States, Australia, Honduras, the Dominical Republic, Mexico, and New Zealand.[17] Particularly, its negotiations with the United States are taking more time than originally expected, and recent reports still indicate that the United States and Vietnam remain at odds over key issues in the entry package. Unless, and until, Vietnam strikes a deal with the United States, its entry into the WTO will be delayed. Given that the two sides are still negotiating, June 2006 rather, than the 6th Ministerial Conference in December 2005, seems a more prudent date for completion of WTO entry by Vietnam.

The issues of contention in the Vietnam-US bilateral negotiations are: The extent to which foreign companies in Vietnam are allowed to import and distribute goods[18]; limitation on industrial subsidies[19]; non-discriminatory treatment of foreign investments at both the national and provincial level[20]; how and when to open the telecommunications and banking markets;

16) They are Argentina, Brazil, Bulgaria, Canada, Chile, China, Chinese Taipei, Colombia, Cuba, European Community, El Salvador, Iceland, India, Japan, Republic of Korea, Norway, Paraguay, Singapore, Switzerland, Turkey and Uruguay.

17) Please note that this information has been updated as of November 22, 2005. Bilateral negotiations with other countries are currently under process, and thus may change in status by the publication of this paper.

18) It is reported that Vietnam is seeking a phase-in period that would permit Vietnams to keep trading and distribution rights closed to foreign business entities, while the United States is seeking elimination of these restrictions immediately upon accession. According to the 2001 Bilateral Trade Agreement (BTA), Vietnam is obligated to open up trading and distribution rights to US companies by December 2008.

19) The United States requests the GOV to reduce and ultimately eliminate industrial subsidies over the years.

20) Vietnam has submitted a draft of its Common Investment Law, which would allow foreign investors to establish joint ventures with Vietnamese companies, but to also cap foreign investor capital contribution in the joint venture at 49 percent. It appears that the United States wants to ensure that the new law upholds WTO commitments to national treatment and ensures that the procedures and standards required are equal among domestic and foreign investors. The United States wants to assure that the law permits the US to invest in all sectors unless specifically prohibited, rather than listing the allowed sectors. INSIDE US TRADE, US, Vietnam To Continue Discussions on WTO Accession Next Week, (Vol. 23, No. 36) (Sept. 9, 2005).

and foreign ownership and capital requirements for insurance.

Among others, it is noteworthy that the subsidy issue was also raised in bilateral negotiations between the two countries. As noted below, as long as Vietnam remains as a NME country, it is basically exempt from subsidy allegations and subsequent countervailing duties, an advantage of NME status under the current trading regime. But from Washington's perspective, stipulating that the GOV make sincere efforts to reduce its subsidization of private sectors as a condition for its entry into the WTO is quite reasonable. For the GOV, on the other hand, contemplation by its trade officials of a gradual phase-out of subsidy measures is necessary, since Vietnam's graduation from the NME status is simply a matter of time. The sooner the GOV deals with the subsidy issue, the more likely it will be able to stave off trade disputes involving subsidies. This in likelihood is what prompts the United States to stave off pushing for the immediate elimination of subsidies, but rather request the GOV to reduce the level of subsidies over time. In this regard, the United States is currently asking the GOV to provide inventory of its current subsidies and the rationale for these subsidies.[21]

During the bilateral negotiations with the United States, and perhaps even during subsequent discussions after WTO entry, the GOV may agree to the basic principle that over time it will try to reduce its support for domestic industries. On the other hand, it would have to refuse to provide specific commitment to reduce the level of subsidization in specific fields, because it is not apparent yet as to what kind of current GOV programs constitute illegal subsidies under the WTO regime, and as to which sectors will continue to need subsidization even after WTO accession. In short, the GOV can agree in principle to eliminate subsidies in degrees, but it needs to preserve the discretion and flexibility on this issue as much as possible.

The GOV has, in fact, done a tremendous amount of work so far. It has submitted over 150 draft laws and implementing regulations to the National Assembly this September. Negotiations with the United States have been conducted not only through official face-to-face meetings, but also through e-mails and teleconferences. According to one GOV official, the GOV has done more work in 2005 than in the previous 7 years since Vietnam officially filed its request to join the world body.[22] The GOV's efforts should be duly recognized and commended. The remaining task for the GOV, the most important one that is, is to wrap up the work successfully.

Given the past diligence by Vietnam, current delay in the negotiations with the United States seems to be simply an adjustment for a finalization of the deal. Indeed, the consensus is that the outstanding issues are not unexpected and can be solved in a timely manner.[23] If the deal with

21) INSIDE US TRADE, US, Vietnam To Continue Discussions on WTO Accession Next Week, (Vol. 23, No. 36) (Sept. 9, 2005).

22) See Statement of Vo Tri Than, at the Final Reporting Conference held in Seoul in September 5, 2005.

23) INSIDE US TRADE, US, Vietnam To Continue Discussions on WTO Accession Next Week, (Vol. 23, No. 36) (Sept. 9, 2005).

the United States ultimately produces positive results, the current delay and entry into the WTO in 2006 would probably serve the interests of Vietnam better than a hasty entry in December 2005.

## 2-2. Status of Accession by Other Countries

The fact that Vietnam's entry into the WTO is timely is further evidenced by the recent surge of entry applications by other non-WTO members. For example, it is also reported that Saudi Arabia has recently reached an agreement with the United States to conclude a tentative market access agreement for WTO accession.[24) ] The United States Trade Representative (USTR) Rob Portman also dismissed criticism from some in the US Congress, and fully supported Saudi Arabia' s entry into the WTO. Riyadh will finally be approved for joining the WTO at the Hong Kong Ministerial Conference in 2005.[25)] Given the close relationship between the United States and Saudi Arabia, Saudi Arabia' s entry negotiation should be much easier and simpler than that of Vietnam. Thus the GOV should not feel frustrated even if Vietnam fails to join the WTO in December 2005, while the Saudis succeed in joining. In any event, Saudi Arabia's entry in December 2005, and any other country' s entry at that time, will provide a political stimulant for Vietnam' s accession in the first half of 2006.

## 2-3. Importance of the Bilateral Negotiations

The final terms for Vietnam's entry are dependent upon the results of bilateral negotiations with trading partners. Once bilateral negotiations are completed, the "terms of accession" reflecting the outcome of the bilateral negotiations will be finalized by the WTO, which will be then submitted to the General Council of the WTO for a final approval in the form of an "Accession Protocol." The Accession Protocol of the WTO is a special agreement concluded between the WTO (and its members) and the country that is applying to join. An Accession Protocol contains lists of concessions that the applicants made as a result of negotiations with other WTO members. When it is submitted to the General Council, negotiations basically come to an end, and a "yes or no" vote by members takes place. For an approval of the entry, a two-thirds majority is needed.[26)]

24) See Inside US Trade, US, Saudi Arabia Close to Market Access Deal for WTO Entry(VOL. 23, No. 23) (August 19, 2005)

25) See Inside US Trade, US, Saudi Arabia Close to Market Access Deal for WTO Entry(VOL. 23, No. 23) (August 19, 2005)

26) See Atricle 25 of the Marrakesh Agreement Establishing the WTO.

Consequently, basic rights and obligations are stipulated in various provisions of the WTO Agreements, but the bilateral negotiations and resulting Accession Protocol will basically dictate the "specific" terms for Vietnam. One can only determine the contours of Vietnam's rights and obligations by looking at these "specific" conditions and terms, leading to the conclusion that these bilateral negotiations are pivotal. For example, the Transitional Product Specific Safeguard Mechanism (TPSSM) is a "special" safeguard measure provided in China's Accession Protocol in 2001, but does not exist in the WTO Agreements. In short, the Accession Protocol for Vietnam will be a special law (lex specialis) applicable to Vietnam only, as opposed to general rules stipulated in the WTO Agreements applicable to all member countries.

## 3. Identification of the Key Tasks

According to GOV officials who participated in the interviews during the pilot study,[27] the two key tasks for the GOV in its bid for WTO entry are as follows: (i) how to maximize the interests of Vietnam in the course of accession negotiations, through effective strategies for the upcoming bilateral negotiations with other countries; (ii) and how to minimize negative impact from accession, through identification of the list of projects to be done by the GOV with respect to WTO entry, followed by prompt initiation of the necessary work. Pursuant to this request, these two tasks will be addressed in depth below.

This paper, however, mainly focuses on the second request for the following reasons. First, as the final stretch of the bilateral negotiations is just around the corner, it does not seem plausible or feasible for the GOV to accommodate advice on specific issues from an outside consultant and reflect it in its ongoing negotiations. Second, due to the confidential nature of the current negotiations, it is almost impossible for an outsider to find out the specific "give-and-take" between the two countries in the negotiations, a crucial element for any sort of meaningful consultation on these bilateral negotiations, and to provide comments on the specific issues. As such, it seems to be of greater benefit and of greater reason for the GOV under the current circumstances to focus on the second request; that is, key tasks and projects to be initiated by the GOV immediately upon entry into the WTO. As to the first task, this paper will only address core issues in general terms to help the GOV successfully wrap up the current bilateral negotiations.

27) The purpose of the pilot study is to conduct initial on-site interviews with various officials of the GOV, in order to get a basic sense of the current status of Vietnam's WTO entry. The first pilot study was conducted between June 4 to June 9 and the second pilot study between June 30 to July 1, both in Hanoi. The pilot studies provided an opportunity to meet with GOV officials "face-to-face" and to ask questions directly. A significant amount of precious information was gathered through the interviews and meetings. More interviews in late June and continued communication with the officials also provided more information about the country in general. Thes information allowed the researcher a more precise understanding of the Vietnamese situation and to prepare a report that is most suitable to the GOV's needs in its effort to join the WTO.

# 4. Strategies for Bilateral Negotiations with Other WTO Members

The core and practical issues on the negotiation table, those that can heavily impact Vietnam, are the NME issue and the "Market Disruption (MD)" rule issue. Simultaneously, it is important for the GOV to maintain a "cool and controlled" attitude in this last stage of negotiations.

## 4-1. Non-Market Economy (NME) Status

NME designation for Vietnam, and its duration, will be one of the most important issues in the upcoming bilateral negotiations. The GOV officials during the pilot study interviews and Interim Conference concurred on the importance of this issue in Vietnam's effort to join the world body.[28] Given Vietnam's potential to penetrate foreign markets, other countries have a strong incentive to designate Vietnam as a NME country under the international trade norm. Thus, efforts by other members to keep Vietnam as a NME designate are both understandable and reasonable. Particularly, the United States will continue to push for Vietnam's NME designation as long as possible, since interest groups in the United States preserve a strong lobbying armada that will mobilize to force the US government to raise this issue and to keep Vietnamese products at bay, even after Vietnam's accession to the WTO.

It is quite encouraging, however, that due to Hanoi's relentless efforts the European Union (EU) has basically agreed to change Vietnam's status from a NME to a ME. Given that the EU is the second largest export market after the United States for the majority of WTO members, and that it is one of the most influential members of the WTO, this change of designation may herald a positive outcome in other countries as well. If properly utilized, this change in the EU can prompt other countries to reconsider its current policy on this issue. As such, the GOV may have to take advantage of the momentum gained from the EU's change of policy to positively affect negotiations with other countries, particularly the United States.

In any event, other negotiating partners will continue to feel threatened by Vietnamese imports after Vietnam's entry into the WTO, and would like to install a safety valve to minimize any possible threats from Vietnam in the future. In this regard, nothing works better than the NME designation for its trade-blocking effectiveness as explained below. As such, some countries will certainly continue to designate Vietnam as a NME in the future, or at

28) See DSI's Dr. Thu's comments and Ministry of Trade's Mr. Thang's comments during the Interim Conference in Hanoi on June 30, 2005.

minimum attempt to use it as a bargaining chip in exchange for Vietnam's yielding in other important issues.

### *Why is the NME designation a problem?*

Why does the NME designation negatively affect Vietnamese exports Although the GOV seems to be "vaguely" aware of the negative impact from the NME designation, the full spectrum of its negative impact seems unclear. The NME designation will keep Vietnam under a perennial threat of antidumping investigations and high margins of antidumping duties for all Vietnamese products in the future. This is important since under the current WTO trading system, antidumping investigations and resulting antidumping duties are the most widely used trade measures worldwide. Antidumping investigations already present the most significant headache for the GOV. This "headache" only shows signs of greater aggravation upon entry into the WTO, since an increase of Vietnam's exports upon accession will only bring about greater anti-dumping investigations by domestic competitors in other countries. In other words, once Vietnam becomes a WTO member, there will be an increase of exports from Vietnam to foreign markets, which will then skyrocket antidumping investigations by these foreign countries against Vietnam.

Statistical data further proves this point. China and Korea, the two most export-oriented countries in Asia, countries whose model Vietnam tries to follow, are the two most frequent targets of antidumping investigations worldwide since the inception of the WTO. In 1995-2004, 359 antidumping investigations were initiated against China, making China the number one target in the area, followed by Korea with 182 investigations. To put it differently, after WTO entry, antidumping investigations against Korea and China continued to increase parallel to the increase of exports from these two countries. As a country showing similar trade patterns with that of Korea and China in their early stages of globalization, it would not be surprising for Vietnam to become another major target of antidumping investigations in the near future after WTO entry.

In addition, by designating Vietnam as a NME country, the United States and other countries following the same path can impose antidumping duties more easily than against imports from other countries such as Korea or Japan. NME designation lowers the threshold for an antidumping investigation. To elaborate on how this works: In the context of antidumping cases, the NME status is disadvantageous for respondent exporters (i.e., Vietnamese exporters) because the so-called NME "surrogate country" methodology can be subjective, unpredictable, and arguably unfair. The surrogate country methodology refers to when an investigating authority (i.e., the United States) does not use the actual data from the company being investigated, but instead uses companies from other "surrogate" countries (for example, Bangladesh) that provide a rough approximation of the costs and prices in the home market of the company under investigation (i.e., Vietnam). Due to the inaccuracy and wide discretion in choosing numbers, this methodology often leads to inflated dumping margins. As a result, in the same investigation, companies under investigation (i.e., Vietnamese companies) are likely to get higher dumping margins than Korean companies or Japanese companies (not from NME designated countries).[29]

This is a potentially serious problem for future Vietnamese exports. Being subject to an easier antidumping investigation rule coupled with an explosion in the number of antidumping investigations will put Vietnam in trouble in the future, depriving the country of a significant portion of the benefits due from WTO membership. Even if Vietnam is somehow given a ME designation at the time of WTO entry, the GOV will be busy defending antidumping investigations throughout the world. With the NME baggage, the aforementioned burden becomes doubled or tripled. The NME designation will haunt Vietnam in the post-WTO era for a long time. In short, the NME issue, a problem for Vietnam pre-WTO membership, will only loom larger once Vietnam joins the WTO.

### *Dealing with the NME Problem*

It is a given that Vietnam's basic economic structure will remain a socialist one, even after WTO accession, a fact that Vietnam's trading partners are also aware of. Under the circumstances, unless Vietnam promises to fundamentally transform its economic structure immediately, which does not seem politically or economically feasible at least in the near future, some countries will have an arguably reasonable basis to continue to treat Vietnam as a NME. The GOV officials seem to also be fully aware of this situation. If Vietnam complains about the NME issue at the negotiation table, other trading partners, particularly the United States, will probably repeat its position to the effect that "we understand GOV's concern and we will regularly review the NME status and will revoke it as soon as we believe the Vietnamese economy meets the standard of a market economy." Thus these countries will maintain Vietnam as a NME country, at least in the initial stage of Vietnam's WTO entry, or until there is significant economic change in the Vietnamese economy.

If the continued NME status is inevitable, the remaining task then becomes how to minimize

29) The problem of the NME investigation was further proved by a recent high-profile antidumping case against Vietnam. In 2003, the American catfish industry, seeing rapid growth in market share of Vietnamese products, successfully lobbied for the imposition of duties -- a decision, which infuriated Hanoi. As a result of tariffs of up to 64%, catfish exports to the US dropped by over 50%. Around the same time, a bilateral agreement imposed textile quotas, intended to dampen booming export growth.

This month, the US Department of Commerce imposed preliminary anti-dumping duties on Vietnamese shrimp, ranging from 12.11% to 93.13%. In this case, the US producers also demanded higher tariffs on shrimp from Brazil, Ecuador, India and Thailand, which, together with China and Vietnam account for 75% of all US shrimp imports. However, the Chinese and Vietnamese cases were handled separately, because they are regarded as NMEs, a classification giving US more leeway in establishing domestic production costs in dumping cases. The Vietnam Association of Seafood Exporters and Producers condemned this practice as violating the spirit of free trade and costing the jobs to millions of Vietnamese employed in the industry. Seafood products rank as Vietnam's fourth-biggest export and the US is its largest shrimp market, or nearly 50% of its shrimp exports. See Asia Pacific Bulletin, WTO Entry Could Lower Trade Hurdles Facing Fast-Growing Vietnam (July 15, 2004) (emphasis added).

the negative impact. The following strategies could be considered by the GOV negotiators to "contain" the negative impact from the NME designation.

### *Official Registration of the GOV's Concern*

Foremost, it would be important for Vietnam to register its concern and complaint in a more official way during negotiations. In the final agreement with the United States and other like-minded countries, the GOV needs to include a provision or two to specifically record Vietnam's concern in this regard. The GOV may want to include a statement stating "although the time constraint does not allow the two countries to fully discuss this issue in the current negotiation, the two countries shall continue to discuss this issue through various channels after Vietnam's WTO entry."

Although this provision itself does not create any direct change to the current system, this language would have some important practical implication in the future. Since the initiating a discussion of the issue itself is sometimes difficult, including a provision, which at least imposes a legal obligation to revisit the issue on a regular basis, is paramount for the GOV. Inserting a provision with a specific obligation would be more appropriate, but an abstract provision would nonetheless be better than nothing.

### *Long-term Efforts for Revocation*

Once Vietnam joins the WTO, revisiting the issue whenever given the chance is most important. A change in the designation will take a long period, and the GOV needs to make a long-term effort in the United States and other countries for this end. In short, the GOV needs to make a "systemic" and "strategic" effort to achieve its goal. The NME designation is a purely domestic legal/administrative issue, irrelevant to the WTO Agreements themselves. Thus, bilateral diplomatic and political efforts are all the more important.

In this context, including a provision in the negotiation package and in the bilateral agreements that ensures that Vietnam can request revocation of the NME status at any time through relevant domestic procedures is important. The GOV will also have to include a provision, even if hortative, stipulating that once a request is filed, the investigating authorities of respective countries review the application in good faith.

In the case of the United States, the investigating authority (that is, the United States Department of Commerce) looks at a "totality of the facts." That is, it does not take an approach comparing the subject economy with a perfect laissez faire economy.[30] Instead, the procedure is fairly subjective and flexible and thus can be favorably affected by the efforts of the GOV in the future. Hence it is crucial for the GOV to make a long-term strategic effort to

30) See Section 771(18)(b) of the 1930 Trade Act of the United States for factors determining whether a country has met the standard of a market economy.

change the atmosphere in the United States and other countries.

### *Challenging the Issue in Every Antidumping Case*

In the same context, it is also necessary for the Vietnamese companies and industries to raise this issue in every future antidumping investigation against Vietnam by other WTO members. As an official from the GOV's Ministry of Trade (MOT) also pointed out,[31] technically, each industry and company can raise the NME issue in each antidumping investigation by arguing, "albeit we cannot speak for Vietnam as a whole, our industry operates based upon market economy principles."

Mere argument and allegations are not sufficient, however. The companies and industries then need to provide material and data that support their claims of being a market economy entity. Given the fact that the NME designation and its revocation is basically a political decision, it would not be easy to win such an argument for a particular industry in a particular antidumping case. Nonetheless, it is still helpful to raise the issue as frequently as possible, thereby imposing a burden on the investigating authorities. As such, the GOV needs to request Vietnamese companies to challenge the issue more aggressively in the future. The GOV may contemplate a systematic assistance mechanism for each Vietnamese industry and company in an antidumping investigation to carry out this mandate.

### *Reasonable "Surrogate Country" Selection*

The core problem with respect to the NME status is the possibility of data manipulation through the use of the surrogate country selection. During the negotiations, in addition to the NME problem in general, the GOV needs to voice concern regarding surrogate country selection methodology and practice. The GOV then needs to include a statement or provision to make sure that any surrogate country selection in the future be conducted on a reasonable basis.

For example, during negotiations at any time with the United States, if given the room, the GOV should provide a list of countries that can be used as surrogates that it believes to be reliable, with the exception of Bangladesh or India, common surrogate countries for Vietnam. Moreover, the GOV may conduct research into recent antidumping cases where a surrogate country was unreasonably selected, including a look into the relevant data. These efforts require basic research on the part of the GOV in approaching this issue in future negotiation tables. Providing material and documents will prove greater effectiveness than merely presenting its argument.

31) See Comments of Mr. Thang from the MOT at the Midterm Conference in Hanoi on June 30, 2005.

## 4-2. Possible Inclusion of the “Market Disruption (MD)” Rule

Although there is a slender chance, other countries may also try to adopt an easier-to-invoke safeguards investigation mechanism against Vietnam. These countries may be concerned about the surge of Vietnamese imports under “fair trade,” and may want to restrict Vietnamese imports using a safeguard measure easier than the WTO’s Agreement on Safeguards, thus following the Chinese example. The easier-to-implement safeguards are usually called MD measures as used in the Chinese Accession Protocol.[32)]

Although it is not entirely clear yet whether other countries will seek to include a similar provision against Vietnam, given the importance of the provision it is necessary for the GOV to be prepared for this issue. Needless to say, if indeed it rears its head, the GOV needs to resist requests from other countries for this exception clause to the fullest extent. In the case of China, giving in to the pressure from other countries, the country accepted this condition when it joined the WTO in 2001.[33)] As a result, other countries can easily restrict Chinese imports without establishing any clear wrongdoing by the producers. This has created a significant problem for China. China, however, is locked into this system until 2016.[34)]

Assuming that other countries raise a similar issue in the upcoming bilateral negotiations, the GOV therefore needs to develop a persuasive rationale to exclude such a clause in the accession protocol. The following rationales can be presented during negotiations, as necessary.

First and foremost, the GOV can stress that safeguards themselves constitute an “exception” clause under the WTO regime.[35)] The GOV can then argue that such an exception should thus be interpreted and applied as strictly as possible and is not susceptible to a more flexible implementation under the WTO principle. Only truly extraordinary circumstances would allow

32) The following table compares the obligations under the WTO and China’s WTO Accession Protocol.

| Art. 4.2(a) of the WTO Agreement on Safeguards (Serious Injury) | Section 16.4 of China’s Accession Protocol(Material Injury) |
|---|---|
| - The competent authorities shall evaluate all relevant factors of an objective and quantifiable nature having a bearing on the situation of that industry, in particular<br>- Rate and amount of increase in imports of the product concerned in absolute and relative terms<br>- The share of domestic market taken by increased imports<br>- Changes in the level of sale, production, productivity, capacity utilization, profit and losses, and employment. | - WTO Members shall consider objective factors including<br>- the volume of imports<br>- the effect of imports on prices of like or directly competitive products<br>- the effect of such imports on the domestic industry producing like or directly competitive products. |

33) See the Chinese Accession Protocol attached as an Annex to this document.

34) See id.

35) See the Preamble of the Agreement on Safeguards.

expansion of the exception clause. The GOV may then add that Vietnam's entry into the WTO does not, and cannot constitute such a truly exceptional situation.

Secondly, the GOV can argue that Vietnam is different from China. As such, the GOV can point out that Vietnam's exports do not pose such a significant threat to other countries as China's, which further undermines a special MD rule for Vietnam.

Third, the GOV can also stress that rampant safeguard invocations would kill Vietnamese exports altogether. Despite the safeguards action, China can contain the damage by maintaining exports in other products, which is not the case with Vietnam. To restate, Vietnam's export product mix is not as broad as China's, and therefore Vietnam is unable to absorb the shock as China can. Consequently, safeguards action in one product group could fatally damage the Vietnamese economy as a whole. This would also support the position that an easier safeguards application through a MD rule is inappropriate in the context of Vietnam, the first argument presented above.

Through these arguments, the GOV can resist any attempt to include a Vietnam-specific safeguards (i.e., MD) rule. It is not yet entirely clear whether other trading partners, particularly the United States, will try to include a MD rule vis-à-vis Vietnam, but any such effort must be strenuously countered by the GOV. Unlike the NME issue, the GOV seems to have a reasonable chance of excluding a MD rule, if there is such an attempt.

## 5. Projects to Be Undertaken Following Entry into the WTO

Under the current schedule and pace of progress, it appears that bilateral negotiations will be able to be completed by the first half of 2006, and the accession package for Vietnam will be formulated thereafter. The June 2005 summit between the Vietnamese Prime Minister and the US president, where the United States expressed its continued support for Vietnam's entry, provided a crucial momentum to accomplish this goal. Given the likelihood of approval of accession and the short time period before full membership, the most important issue for Vietnam now is what comes next after all this hard work and hassle; that is, what to do right after WTO entry (possibly in June 2006). Given the enormity of the task, there will be numerous things to be done in the aftermath of WTO accession. Listing them all in one paper would be impossible. Thus, among various things, this paper suggests that the GOV initiate steps to address the following, as listed below.

### 5-1. Organizing and Developing a "WTO Expert Pool"

By any measure, the most important task after WTO entry seems to be to developing a "WTO Expert Pool" inside the GOV. Once Vietnam becomes a member of the WTO, Vietnam will be required and expected to fulfill its obligation immediately, unless otherwise provided in the accession protocol, since there is no "grace" or "honeymoon period" for new members. As a result, other members, such as Korea, will simply regard Vietnam as an ordinary member, with the same level of expectation from Vietnam. These countries will not necessarily sympathize with Vietnam and take into consideration the lack of experience and absence of necessary infrastructure in the initial stage of WTO membership, maintaining that all rights and obligations of Vietnam become due right upon the entry date without exception.[36] The moment Vietnam becomes a member of the WTO, 148 countries will be ready to bombard officials in Hanoi with numerous requests, questions and complaints for various issues affecting the WTO Agreements, basically covering all subjects in economic, financial and judicial policies. To cope with this reality, it is essential for the GOV to have a sufficient level of manpower with enough capabilities to deal with the issue. If any GOV official makes a mistake or erroneous statement in the initial stage, not fully aware of the legal implication of his or her statement, such a statement will haunt Vietnam for a long time, and will definitely become a source of trade dispute. This kind of mistake has been a significant problem for the governments of new members in the early stage of the WTO membership, including Korea.

Furthermore, the WTO regime is highly technical and complex. The whole regime is treaty-

36) The Protocol of Accession can indeed provide otherwise. However it is unlikely that other members will accept such exception clause.

based, operating on the basis of legal arguments and legal claims. Any communication and correspondence that the GOV undertakes after WTO entry will carry certain legal importance and implication irrespective of the true intention of the policymakers or GOV officials. Basically, in measuring any violation of the WTO Agreements, what matters is not the intention, but rather the effect. Above all else, all positions and arguments of Vietnam at the WTO need to be formulated and expressed in "legal" terms and accepted by other members as expressing Vietnam's "legal" position under the WTO Agreements. When there is a dispute at the WTO or at any other legal forum interpreting Vietnam's WTO rights and obligations, the GOV will have to defend its rights and force other members to abide by their obligations through a "legal" procedure, that is, at the WTO dispute settlement procedure, or domestic courts of other members, all of which are entirely legal frameworks.

The importance of being prepared for upcoming "legal" disputes can also be evidenced by statistics. Table 2-1 shows the 10 most frequent users of the WTO Appellate Body process, the second choice for WTO dispute settlement after the panel review. Interestingly, most are key trading partners for Vietnam. These countries will also be relentless in pursuing their trade interests through the WTO dispute settlement process after Vietnam's entry into the WTO in 2006.

<Table 2-1> Frequency of Participation by WTO Members in Appeals: 1996-2004[37)]

| WTO Member | Appellant | Other Appellant | Appellee | Third Participant | Total |
|---|---|---|---|---|---|
| Australia | 1 | 1 | 4 | 10 | 16 |
| Brazil | 5 | 3 | 7 | 9 | 24 |
| Canada | 8 | 6 | 14 | 8 | 36 |
| EU | 8 | 11 | 24 | 28 | 71 |
| India | 5 | 1 | 5 | 11 | 22 |
| Japan | 4 | 4 | 8 | 17 | 33 |
| Korea | 3 | 2 | 4 | 6 | 15 |
| Mexico | 1 | 1 | 3 | 12 | 17 |
| New Zealand | - | 2 | 5 | 4 | 11 |
| United States | 19 | 8 | 37 | 20 | 84 |
| Others | 10 | 7 | 20 | 75 | 112 |
| Total | 64 | 46 | 131 | 200 | 441 |

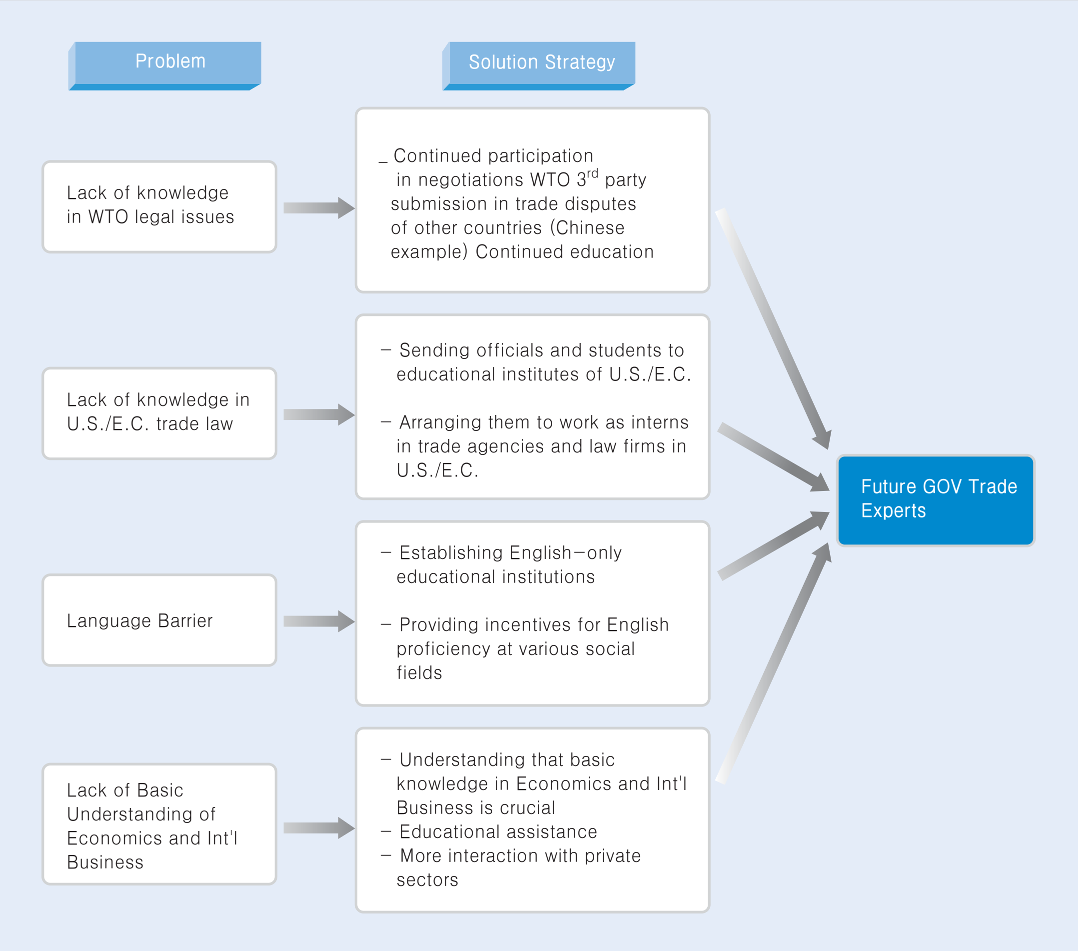
Such being the case, it is crucial for the Vietnam to expeditiously start organizing a WTO

37) WTO, Appellate Body Annual Report for 2004, at 25-26.

expert pool in Vietnam. The GOV can mobilize professional personnel both from the public sector and the private sector, and create one single "pool" for each sector and for each issue. The GOV can utilize their experience to cope with the initial "emergency" situation after the accession, should one arise. More fundamental however, the GOV needs to start developing a trade expert pool, step by step, with a long-term plan in mind.

The GOV needs to adopt a public program to cultivate professional capabilities for talented officials and young scholars, so that they will possess expertise in international trade law to defend the interest of Vietnam in the future. Korea's experience demonstrates that the most important trait for trade experts in the WTO setting is the combination of diplomatic skill, negotiation skill and legal knowledge of the WTO trade law. To be successful in the current WTO regime, the emergence and expansion of trade experts should not be limited to a particular sector, issue or ministry, but rather applied to all corners of Vietnam for the long run, as summarized in the following diagram:

<Table 2-2> Cultivating WTO/Trade Experts in Vieatnam



## 5-2. Introduction of a "WTO Task Force" inside the GOV

As the cultivation of an expert group in Vietnam would take some time, the GOV needs to first initiate the cultivation within the GOV itself. GOV officials are in the front line when disputes arise, so any renovation measure would have to start with them. To this end, the GOV may consider following measures.

First, the GOV needs to select competent trade-related officials from various GOV agencies the central government or provincial governments. There are various agencies where trade-related projects have been taken care of. During the pilot study, it was confirmed that each agency and ministry has at least a core group of people with strong dedication and high potential in trade work. The first step for the GOV would be to identify and list those officials in the core trade group of various GOV agencies.

Second, the GOV can consider creating a "WTO Task Force," mobilizing those trade officials identified above. The purpose of the WTO Task Force is to bring officials from all WTO-related agencies under a single organizational umbrella, at least temporarily. This is basically to create a centralized focal organization that can be the contact point and outside window for all WTO issues for Vietnam. To be sure personnel change and transfer to create such a centralized team is not always an easy task, but despite some side effects, a centralized system may overall be more efficient for Vietnam, at least in the initial stage of WTO entry. Once the initial chaos is taken care of and Vietnam enters "cruise control," these officials can go back to their original agencies, or the GOV may want to keep this organization as a permanent entity or to build upon it. If the GOV decides to keep the WTO task force as a permanent entity, the original agencies where the officials came from may have to cultivate trade experts themselves to represent each agency's trade interest in the long run.

Based upon the experience of other members of the WTO, the GOV may encounter an "explosion" of issues and enormous workload in the first couple of years of the WTO accession. This is inevitable, and all other new members have gone through the same process in the initial stage. This "initial stage chaos" is usually caused by lack of logistical support, lack of coordination among various domestic interest groups, and the increase in requests/inquiries from the WTO, other WTO members, private companies of WTO members, and Vietnamese businessmen and companies. Korea went through the same process and all these factors are equally applicable to Vietnam. In fact, due to Vietnam's fundamental discrepancy in economic structure with the major players in the trade norm, the GOV may encounter more logistical stress and heavier administrative burden than any other newcomer in recent history. Unless adequately prepared, the GOV will be put under unprecedented chaos and will have to pay a hefty price.

A centralized system can reduce this possibility. To be sure, a centralized system is not a panacea for all WTO related problems. That is, a centralized WTO task force cannot, and must not, take over all WTO-related issues and solve them. It would simply be impossible. Instead, the centralized WTO task force can play the function of a conductor of an orchestra, actively guiding members of the "orchestra," while simultaneously looking ahead to upcoming "musical segments," or tasks to be performed. As with any other governmental work, the most important task under the enormous workload is to "prioritize" among various competing and equally important issues. A centralized WTO task force could effectively carry out this function. Through such "prioritization," the GOV can address the most urgent issues first, and then move on to the next, which will prove paramount since starting from 2006, all foreign governments and companies will probably claim that their issues are the most urgent, as will all Vietnamese businessmen and companies. In addition, other GOV ministries, agencies, and provincial governments will also claim to the central government (i.e., the MOT or the State Council) that the issues of their interests are the most important. Under these circumstances, someone needs to hear all these arguments and claims at the same time, evaluate them, and determine which one needs to be addressed first (i.e., prioritize). Without such prioritization, the GOV will encounter an even uglier and longer chaos than otherwise would be the case.

Another key benefit of having a centralized WTO task force would be a more effective utilization of limited resources. For example, efficient coordination by a centralized task force could minimize redundancy in work by each agency. This is particularly important in the WTO context, because multiple ministries can claim their respective authorities over the same trade issues, given that currently a single trade issue frequently stretches over various areas and easily spills over other sectors. By way of example, in Korea these days three agencies are involved in trade negotiations in the telecommunications sector: The Ministry of Foreign Affairs and Trade, as a ministry in charge of trade issues, the Ministry of Information and Communication, as a ministry in charge of telecommunications issues, and the Ministry of Commerce, Industry, and Energy, as a ministry in charge of domestic industrial sector coordination. There are instances when the cooperation between these three ministries' is not optimal. In the early stage of Vietnam's WTO entry, the GOV may experience such overlapping jurisdictions and authorities among ministries and agencies, which could even escalate into a turf war. Lack of coordination would lead to more agency competition and overlapping work, which will then lead to a waste of limited GOV resources. All in all, a WTO task force, if effectively operated, will reduce this problem, thereby allocating the limited resources more efficiently. Furthermore, officials from other agencies assigned to the WTO task force could also play the role of a "liaison officer" for their ministries, which would facilitate the policy coordination inside the GOV.

In the same context, without a central task force, different foreign governments and companies may contact different GOV agencies for the same topic. As there is one GOV from the eyes of the WTO and other member countries, all agencies must give the same or consistent responses for the same or similar issues. Without a central coordinating entity, different agencies may give different answers. This particular problem is more likely to appear in Vietnam, as basically all WTO-related infrastructure is to be established from scratch and the government officials themselves do not have a clear idea of what to say and what not to say about a particular issue in a particular situation.

As long as the task force is equipped with the tools to coordinate the WTO related issues, its location within the GOV is of little importance. Based on pilot study interviews and information, however, it seems plausible to locate the task force inside the MOT, which is, and will remain in charge of international trade negotiations. In this case, the task force will be a core group inside the MOT in charge of daily operation of the WTO related issues under the supervision of the Minister of Trade.

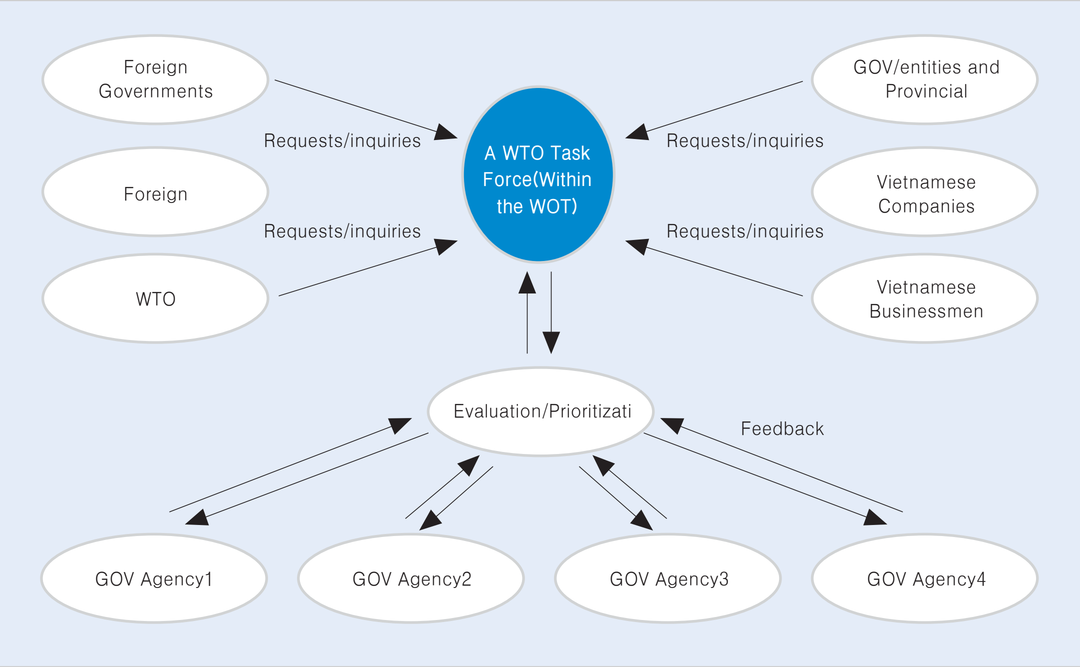
Ultimately, the GOV may consider creating a stand-alone agency to deal with trade issues, much like the Office of the USTR, which has complete authority over all trade negotiations and dispute settlements. The current MOT, while generally in charge of trade issues, does not appear to possess the authority to lead other GOV ministries and agencies in terms of trade negotiations and dispute settlement; rather, as it currently stands, it seems to be a coordination entity among the GOV agencies. Unlike the MOT, a new, stand-alone entity may possess sufficient authority and delegation of power to lead trade negotiations and dispute settlement.

Nevertheless it would be wise to consider establishing such an entity only in the long run, while having a task force inside the MOT deal with pressing requests immediately upon entry, because establishing a new, stand-alone entity at this crucial juncture may aggravate the confusion further. For example, such effort may inevitably invite a turf war among various agencies of the GOV at this time, which is not an ideal situation when full cooperation and coordination among agencies are crucial. In other words, creating another agency will probably entail more confusion to the GOV, on top of the "ordinary" confusion accompanying WTO accession as explained above. Thus, having the task force (whether located inside the MOT or elsewhere) play the central role in WTO issues for now could guarantee sufficient consistency and continuity of the current WTO policy.

At the same time, it is also important to make sure that the WTO task force in particular, and the MOT in general, become neither a super agency that outshines all other agencies, nor a maverick, which does not consider other important national agenda administered by other ministries. For example, a complex trade issue cannot be separated from political/diplomatic consideration. Vietnam's 2001 Bilateral Trade Agreement (BTA) with the United States is a good example. The BTA involves all elements of the GOV national agenda. Likewise, consultation and coordination with other GOV agencies are also crucial because trade negotiations are inherently "give-and-take" of national interests, necessarily affected by other diplomatic/political considerations. Therefore, the WTO task force and the MOT need to be in close consultation with the Ministry of Foreign Affairs (MOFA) and other GOV ministries in the course of conducting key trade negotiations after WTO entry. In the Korean case, over the years following WTO accession in 1995, two different systems were attempted: Between 1995 to 1998, trade function was distributed among related ministries, and from 1998 the Ministry of Foreign Affairs and Trade (MOFAT) took charge of trade issues in addition to its diplomatic function. Based on Korea's experience, there seems to be pluses and minuses to both systems. This issue is further discussed below.

The following diagram shows the possibilities for the basic functions of the WTO task force after the WTO accession.

<Table 2-3> The WTO Task Force's Interaction with Other Entities




## 5-3. Early Creation of an "Investigating Authority"

In addition to the WTO task force, the GOV also needs to create a unique key agency in the WTO. Under the WTO Agreements, Vietnam assumes the obligation to create an "investigating authority" to conduct antidumping investigations, anti-subsidy investigations and safeguards investigations against products from other countries. Rather than a choice, this is an obligation that the GOV needs to accomplish immediately. The investigating authority is an administrative entity that is in charge of antidumping, anti-subsidy and safeguards investigations (so-called "trade remedy" investigations) when there is a petition filed by Vietnamese industries against foreign imported products. This authority is supposed to be placed under a ministry or as a stand-alone organization, composed of trade regulation experts who are independent, neutral and objective.

As the GOV does not have experience of a "trade remedy" investigation before, creating this authority does not seem to be an easy task for the GOV. GOV officials confirmed during the pilot study that Vietnam has yet to initiate its first trade remedy investigation. Many other countries have undertaken extensive experience in these investigations even before their WTO membership. Accordingly they had regulations, precedents and a work force already in place at the time of their WTO entry. The United States or the EU are good examples. Korea also introduced its own investigating authority the Korea Trade Commission (KTC) in 1987, well before its WTO accession. Nonetheless, Korea still faces structural weakness in its trade remedy investigation system. Since the GOV basically will be creating the organization from scratch, it will probably face greater confusion and logistical obstacles than other countries.

Although Vietnam is mainly export-oriented, it still needs to find a mechanism to deal with the surge of imports after WTO accession. Accession will lead to more market access and penetration by foreign imports into the Vietnamese market, and sooner or later, there will be complaints from various Vietnamese industries about the increase of foreign imports. China offers a good example in this regard. At present, China has become the number one target of antidumping investigations worldwide, as noted above: In an average of every seven antidumping cases worldwide, one involves Chinese products. At the same time, China has itself become one of the most robust users of antidumping investigations against foreign products. For example, in 1995 to 2004, China initiated 72 investigations in this field, making the country the 10th most frequent user of antidumping investigations against foreign imports. Korea followed as the 11th, with 71 investigations. In other words, the two countries have been the most frequent victims of antidumping investigations traditionally, but they have now become frequent users of antidumping investigations themselves, particularly so after their WTO entries. More ironic is that recently Korea has become the number one target of the Chinese antidumping investigations and China has become the number one target of Korean antidumping investigations due to the surge of Sino-Korean trade.

The situation will not be that much more different in Vietnam. As much as it cares about export markets, the GOV will have to care about its domestic market and protect that market from "unfair" trade practices, probably mainly from China, India and Thailand, given their geographical closeness and their increasing dominance in the world's consumer product markets. To protect the Vietnamese markets from unfair foreign penetration, the GOV needs to initiate a process to create an investigating authority as soon as possible. China, for example, adopted its domestic law regulating trade remedy investigations in 2001 and amended it significantly in 2004 to reflect new developments.

## 5-4. Reforming the Education System to Produce Trade Law Experts

During the pilot study, many officials and observers pointed out general problems with the educational system in Vietnam. This system might have been effective in producing a workforce under the old-regime, a planned economy, but it certainly is not adequate to cultivate a workforce to defend the interests of the GOV and Vietnamese companies in the upcoming new environment. The completely unprecedented environment requires a new workforce with new sets of skills. There are numerous areas and issues where a new education and new experts are in order, but none of them are in dire need more than the trade law sector.

As to the trade law education system in Vietnam, the Development Strategy Institute (DSI) officials mentioned during the interviews that Vietnam does not possess such education as of yet. Moreover, they added that there had been sporadic short-term education programs sponsored by the WTO, but that otherwise no full-scale trade law education course in Vietnam existed. The GOV officials also confirmed that law schools in Vietnam do not have a program or teaching staff for international trade law. As the WTO system is entirely based on legal rights and obligations and interpretation thereof, it is essential to cultivate young scholars and officials in the trade law area as soon as possible through proper education. The GOV officials appear to be in full concurrence in this respect. The education project needs to be initiated sooner rather later because, again, it takes time to educate trade law experts, possibly a minimum of 5-10 years since initiation. In this regard, it is noteworthy that having realized the necessity to cultivate legal experts in the WTO regime, China has recently decided to send 5,000 young students and professors overseas to train them as WTO experts.

The cultivation of expertise is necessary not only for the governmental sector but also for the private sector. Officials from the Vietnam Chamber of Commerce and Industries (VCCI) were specifically concerned with the increase of antidumping investigations against Vietnamese products, including within the United States. They added, however, that despite increasing antidumping investigations, Vietnamese companies and industries do not possess adequate expertise in dealing with antidumping investigations by other countries and under the WTO. Such being the case, it seems urgent that the GOV initiate an introductory program for the Vietnamese companies to cultivate their strategy and skill in this field. As the Table 2-4

<Table 2-4> WTO Agreements Covered in Appellate Body Reports Through 2004[38]

| Circulation Year | DSU | WTO Agreement | GATT 1994 | Agri-culture | SPS | ATC | TBT | TRIMs | Anti-Dumping | Import Licensing | SCM | TRIPs | GATS | Safe-guards |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1996 | 0 | 0 | 2 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| 1997 | 4 | 1 | 5 | 1 | 0 | 2 | 0 | 0 | 0 | 1 | 1 | 1 | 1 | 0 |
| 1998 | 7 | 1 | 4 | 1 | 2 | 0 | 0 | 0 | 1 | 1 | 0 | 0 | 0 | 0 |
| 1999 | 7 | 1 | 6 | 1 | 1 | 0 | 0 | 0 | 0 | 0 | 2 | 0 | 0 | 1 |
| 2000 | 8 | 1 | 7 | 2 | 0 | 0 | 0 | 0 | 2 | 0 | 5 | 1 | 1 | 2 |
| 2001 | 7 | 1 | 3 | 1 | 0 | 1 | 1 | 0 | 4 | 0 | 1 | 0 | 0 | 2 |
| 2002 | 8 | 2 | 4 | 3 | 0 | 0 | 1 | 0 | 1 | 0 | 3 | 1 | 1 | 1 |
| 2003 | 4 | 2 | 3 | 0 | 1 | 0 | 0 | 0 | 4 | 0 | 1 | 0 | 0 | 1 |
| 2004 | 2 | 0 | 5 | 0 | 0 | 0 | 0 | 0 | 2 | 0 | 1 | 0 | 0 | 0 |
| Total | 47 | 9 | 39 | 9 | 4 | 3 | 2 | 0 | 14 | 2 | 14 | 3 | 3 | 7 |

38) Excerpt from the WTO Appellate Body 2004 Annual Report, at Annex 7. No appeals were filed in 1995.

demonstrates, although antidumping investigations still occupy a major portion of all WTO disputes involving subsidies, a wider range of issues are implicated in the current WTO trade disputes.

Vietnam will also be implicated in these disputes and thus Vietnam needs an education system to raise personnel who can defend Vietnam's interests in these issues.

Above all else, the most serious problem is that current universities in Vietnam do not have a curriculum and teaching staff for international trade law. Given the lack of expertise in this field, it is highly recommended that the GOV establish an educational institute or introduce curricular teaching of international trade law and the trade law of major trading partners (the United States, the EU, China and Korea) to young students and officials. Following the Korean example, the GOV may want to adopt a program to send young officials overseas to have them study international trade law in foreign educational institutions. Each year, a rough score of young Koreans are sent overseas for education, including some officials, to focus on trade issues. This is a long-term capacity building project for the government of Korea as a whole, and the GOV may want to adopt a similar project.

The Korean system, however, seems to have some fundamental weaknesses. Foremost, under the current education/training system of the Korean government, an official going abroad for study does not have an obligation to specialize in trade issues. As such, Korea does not have a "systemic" structure of raising trade experts, which has been a fundamental problem for the government's trade agencies these days. In the MOFAT, the total number of dedicated trade officials is roughly 50 to 80, most whom have no education in trade issues, and have not received any since being hired by the Korean government. Even during an overseas study, only a few number focus on trade law. Lack of adequate education turned out to be a critical limitation for trade officials in the MOFAT. As a result, in the fall of 2004, the MOFAT started to recruit trade experts from the private sector, to complement the existing governmental work force. It is believed that trade experts from private sectors will occupy a significant portion in the future trade section of the Korean trade agencies.

Given this experience, it would be better for the GOV to select those Vietnamese officials who are dedicated and will be dedicated on trade issues in the future, and subsequently send them to foreign educational institutions for further education. Sending officials overseas without any particular mandate would result in officials majoring in other easier subjects as opposed to trade sectors, a highly technical and complex area. The Korean experience is telling that such an "open" or "general" overseas education system without any mandate to specialize in trade issues would not be able to generate a sufficient pool of officials in the trade sectors in the long run, and that the GOV will encounter a chronic shortage of trade law experts. In short, a "select-then-study" program would work better than a "study-then-select" program. It is also noteworthy that China, having realized the importance of trade law and the lack of Chinese trade law experts, has recently started to send young professors and scholars overseas for their education in the field of trade law. The Chinese system could also be regarded as a form of "select-then-study."

At the same time, the GOV may also adopt a program to invite foreign teachers and scholars to Vietnam to teach international trade law in Vietnamese universities and educational agencies. Given the surge of interest of many countries in Vietnam, if properly suggested and addressed, there will be countries that are willing to send their professors and scholars to Vietnam for trade law education. Up until this point, it appears that almost all the foreign professionals sent from international organizations and foreign countries are economists, technicians, engineers or statisticians. Although these professionals are also in high demand, in the post-WTO era, it is important to include trade law experts in this foreign assistance professional pool. Once the GOV realizes such necessity and makes a specific request, other countries should be able to dispatch trade law experts to Hanoi through their own expenses or on a shared-expense basis.

For example, it is reported that Seoul National University in Seoul, Korea is considering founding its first foreign branch campus in Hanoi in the near future. The suggested departments to be incorporated in the Hanoi branch campus do not seem to include an international trade law department or a legal department. Although this is simply an initial blueprint idea, this does not seem appropriate, considering the crucial necessity of trade experts in Vietnam in the future. The GOV might want to make a specific request to Seoul National University, or to any other foreign university for that matter, to include a trade law education curriculum or legal education curriculum in the Hanoi branch, should such a branch be established.

## 5-5. Increasing English Proficiency

Many GOV officials and businessmen in the private sector collectively indicated that English is a significant barrier in WTO negotiations and processes. For example, the DSI also expressed their frustration in the language barrier in trade negotiations. They are of the view that as all negotiations and debates are done in English at the WTO, the GOV is seriously concerned about the lack of officials who are truly fluent in English.

The VCCI expressed the same opinion during the pilot study interviews. The VCCI mentioned that the biggest obstacle for the Vietnamese industry is the deteriorating education system in general and the language problem in particular. Current Vietnamese companies require skills and abilities that are not taught at ordinary Vietnamese companies, according to the interviews, expressing a strong frustration with the lack of adequate English education in Vietnam, and arguing that the success of Vietnam in the WTO regime is dependent on the cultivation of a domestic English education.

Vietnam needs to increase English proficiency in the general public not only for successful integration into the WTO, but also for any chance of long-term prosperity. As to the governmental level, following WTO entry, there will be a surge of foreign companies and businessmen in Vietnam, accompanied by endless contacts and communication with the GOV ministries and agencies for a wide range of different issues. The lack of English proficiency will create an almost insurmountable barrier to these contacts. This problem will be further amplified since the WTO regime is basically a legal system and all communications carry exclusive legal meaning and implication. An oral communication from a Vietnamese official, which may be entirely appropriate for a casual setting, may be used to hold the GOV liable in a subsequent legal proceeding. Hence exact and accurate English command is imperative for the GOV.

The importance of English proficiency with respect to private business cannot also be emphasized enough. Foreign direct investment and business transactions will increase to a certain extent in the future, but will encounter a fundamental “nag,” without a English capable workforce. The lack of English capability leads to an increase of business transaction costs, and over time the Vietnamese market will lose its strength and Vietnamese businesses would be driven out of international competition. Foreign investors will move on to Malaysia, Singapore, India, or even China, where English is more common than in Vietnam.

The Korean experience in this regard may further evidence the necessity for the GOV to promptly initiate an English proficiency project. Although Korea has focused on English education for a long time and its overall English proficiency level seems to be higher than that of Vietnam, Korea unfortunately still experiences severe problems with English in conducting various business transactions in general and in carrying out WTO-related work in particular. This experience shows both the difficulty and the length of time in raising English proficiency on a national level.

As a first step, the GOV may consider the following measures. As with other countries, the GOV can initiate English education from elementary schools. Earlier education of English will help Vietnamese children get acquainted with the language in the long run. In addition, the GOV may consider establishing an English-only college, an increasing trend in Korea. An English-only college or university will assist young Vietnamese students in mastering the language before being hired by domestic or foreign employers. Likewise, the GOV is required to introduce English education programs for GOV officials. Intensive coursework could enhance the level of English of those GOV officials to the extent that they can carry out future English negotiations more effectively and without the support of interpreters. The GOV could also consider introducing an “incentive” system where an official with good English command gets additional points in promotion and job assignment reviews, a system also in place within the MOFAT of the Korean government.

In devising and implementing these programs, the GOV may seek assistance from other countries. To restate, the GOV needs to seek educational assistance and financial support from other countries. This kind of “educational” or “professional” assistance will offer more valuable assets for Vietnam than a fixed amount of monetary support.

## 5-6. Amendment and Introduction of Law and Regulation

Under the WTO-regime, a country is obligated to keep its law and regulations consistent with the WTO Agreements. As is well known, in Vietnam there still exist many laws and regulations that should be changed and amended. At the same time, various new laws and regulations must be adopted in the immediate aftermath of WTO entry. Furthermore, all Vietnamese statutes and regulations will have to be translated into English, at least gradually; something that will also turn out to be a logistical difficulty for the GOV. Here again, an earlier planning is necessary to spread out the workload and to let other members and the WTO know that the GOV is making efforts in this respect.

Needless to say, this is easier said than done. Amendment or adoption of laws and regulations are an enormous, time-consuming task. After 10 years of accession, Korea is still in the process of changing and adopting relevant laws and regulations. In fact, this is not merely a one-time measure, but an ongoing project for all WTO members.

What is more important to the GOV is that this WTO obligation is applicable not only to national laws or statutes, but to governmental regulations and directives adopted under such statutes and legislations, or adopted by the voluntary decisions of each ministry. Furthermore, not only regulations and directives, but also governmental "unwritten" practices are subject to scrutiny by the WTO and other member countries. For example, during the pilot study interviews the officials from the Ministry of Justice said that their main concern these days is about the intellectual property right (IPR) protection law. No doubt, the IPR area is where foreign countries and companies have the most serious concern in terms of their Vietnamese operations. Although a law to punish IPR violators is to be adopted in the near future, it is not entirely clear yet whether the GOV indeed has the willingness and the ability to crack down on violators. Under these circumstances, even if legislative amendment is completed, it is nonetheless likely that other countries will challenge the Vietnamese "practice" at the WTO.

The full alignment of the entire set of statutes, regulations and practices in all governmental activities cannot be done overnight. It certainly takes a long time, but at least it is necessary to change major laws as soon as possible. To this end, the most urgent task for the GOV is to implement the following two: (i) confirm what law, regulations and practices are inconsistent with the WTO norms and need to be changed; (ii) and prioritize which one should be changed first under the limit of resources and time constraints. The same prioritization is also necessary for the adoption or introduction of new law and regulations.

## 5-7. Refinement of the Domestic Judicial System

Another key requirement under the WTO is to adopt a domestic judicial system where the interests of foreign exporters and investors are adequately protected and their rights are effectively enforced. The GOV has a judicial system similar to that of any other country, including a three-level judicial system. The three-level judicial system is composed of district courts, appeals courts and the Supreme Court. There is also an independent prosecutors' office, which is not related with the Ministry of Justice, unlike other countries.

Despite the superficial completeness, substantive changes are in order to make it compatible with the WTO norms. Under the WTO regime, member countries are required to guarantee a reliable judicial review system once an administrative judgment is rendered (such as antidumping investigations or safeguard investigations, etc.) by the "investigating authority." It is not entirely clear yet whether the current Vietnamese judicial system will meet the standard of the WTO. Thus, the GOV will probably have to contemplate on measures to enhance the effectiveness, expertise and neutrality of the judicial bodies in Vietnam.

For example, whether the judges in the courts are neutral and objective from the perspective of general standards is still in question. In the same context, whether foreign companies and nationals have any restriction, statutory or de facto, in the access to the Vietnamese courts and legal system also is in need of clarification. If any discrepancy in the treatment of foreign companies and nationals in the operation of judicial system exists, it will be a potential target of legal dispute in the WTO regime. China, for example, has also recently undertaken reform of its judicial system as a result of its WTO membership.

## 5-8. Expansion of a Pro-Vietnamese Atmosphere

Regardless of WTO membership, the trade interest of Vietnam will be continuously affected by the domestic procedures and measures of key trading partners. It is important for Vietnam to note that many loopholes exist in the WTO regime which other members can take advantage of when necessary, and that each member basically retains much discretion under the WTO in implementing each measure. This explains the importance of paying attention to bilateral relationships, even under the multilateral trading regime of the WTO. In light of this truth, it is still important to monitor and enhance bilateral relationships with the United States, Vietnam's largest trade partner, and the EU even after WTO accession.

For example, in the United States, Vietnam does not seem to have a supportive group in government and Congress, as opposed to Japan, Korea and China. The existence of a supportive group cannot change the fundamental direction of policy, but it can certainly tip the balance in "borderline" cases (as a legal matter, substantial trade issues these days involve such borderline cases). Accordingly, having a supportive group for Vietnam in US Congress, and in the domestic political arena of major trade partners, will help maintain Hanoi's long-term trade interest.

The most effective task in this respect would be to initiate a long-term effort to establish a pro-Vietnamese group of congressmen inside the US Congress. This is particularly true, since Congress rather than the executive branch, retains the ultimate authority of trade issues in the US. Taiwan, Israel, and Japan have been quite successful in organizing a friendly congressional group and mobilizing them to protect their key trade interests. Having realized this, Korea also established in 2000 a group called “Korea Caucus” in the US Congress, sometimes exercising influence in adopting legislation that may affect the economic and trade interest of Korea. The GOV should also take similar steps.

The importance of lobbying efforts in the context of trade negotiations is further evidenced by the recent effort of the pro-Israeli members of congress in the United States. In opposition to Saudi Arabia’s effort to join the WTO in 2005, 45 members of the House of Representatives submitted a letter to the Bush Administration on May 25, 2005, asking the administration to reject Saudi membership due to Saudi’s boycott of Israel.[39] On July 29 of that year, 13 Senators also submitted a similar letter to the administration.[40] Regardless of whether the Saudis succeed in acquiring WTO membership, this incident indicates the importance of lobbying in the government of major trading partners. These facts indicate that Vietnam needs to formulate its own friends inside the US congress. A strategic approach may be necessary.

39) See Inside US Trade, US, Saudi Arabia Close to Market Access Deal for WTO Entry (Vol. 23, No. 23) (August 19, 2005).

40) See id.

## 6. Korea's Experience and Suggestions for Vietnam

This section of the paper provides practical suggestions for the GOV based on experience of the Korean government since 1995. This paper focuses on four main issues of greatest effect to Vietnam's trade interests as a result of WTO accession: (i) Antidumping investigation management; (ii) anti-subsidy investigation management; (iii) WTO dispute settlement process management; (iv) and investigating authority operation and management. Other miscellaneous issues are also included as well.

### 6-1. Antidumping Investigation Management

#### 6-1-1. Korea's Experience

Since the early 1980's, antidumping investigations have been a constant threat to Korean exporters. As noted above, Korea is the second most frequent target of antidumping investigations worldwide after China. As such, to many Korean businessman and officials, the term "antidumping investigation" is analogous with the term "trade dispute." Antidumping investigations still pose the most potent threat to Korean exporters, both large and small. It is true that some Korean exporters have adopted "dumping" practices to penetrate foreign markets, but more frequently the dumping investigations were initiated and maintained by the domestic industries of Korea's trade partners simply as a tool for legal harassment.

When Korea first began to receive accusations and to prepare for antidumping defenses, Korea made mistakes in dealing with the investigations. Above all else, the Korean government failed to fully acknowledge the unique aspects of trade disputes involving antidumping investigations. Erroneously believing in the effectiveness of political and diplomatic solutions, as with any other bilateral disputes, the Korean government attempted to resolve antidumping investigation disputes through government-to-government negotiations. Most of the time, however, it did not turn out the way the Korean government wanted; before long the Korean government realized that the antidumping investigations were purely legal procedures where diplomatic/political maneuvering is limited. In addition, it realized that governments can do little in the course of an antidumping investigation defense and that specific results are basically up to the companies being investigated.

Over the years, however, the rampant number of antidumping investigations trained the Korean government and Korean exporters. Gradually, they have become more familiar with the antidumping investigations and resultantly have been able to respond to antidumping investigations by foreign countries more promptly and efficiently than before. The Korean government and major exporting companies have accumulated experience in addressing antidumping investigations overseas.

Nevertheless, antidumping investigations still threaten Korean exporters worldwide, and Small and Medium Enterprise (SME) exporters of Korea are particularly vulnerable. Korean SME exporters, with less experience and financial resources than major Korean exporters, are still harassed by antidumping allegations from their foreign competitors. This causes a significant trade barrier to these SME exporters, sometimes even forcing them to forfeit their major markets. For example, recently, Korean Diamond Saw Blade producers, composed of mostly SMEs, are being investigated by the US Commerce Department for dumping in the US market, pushing some to the verge of deciding to quit the US market entirely. This is basically analogous to the experience Vietnamese catfish and shrimp producers have recently had in the US.

### 6-1-2. Summary of What Korea Has Learned in Antidumping Investigations

Through this agonizing experience over the past two decades, Korea has learned the following. First and foremost, Korea realized the harsh reality: The government can basically do little for the Korean companies being investigated. The outcome is up to the preparation and legal efforts of the individual exporters. From the government's perspective, therefore, two things matter. First, how to "educate" and "assist" the exporting companies to prepare for antidumping investigations in major markets, and second, how to make sure that an antidumping investigation is carried out in a fair and reasonable manner by the investigating authority of the importing country.

As a result of this acknowledgement, the Korean government established a Foreign Import Restriction Task Force inside the MOFAT. Its main task is to deal with antidumping investigations by foreign governments against Korean products. Although it also covers other trade restriction measures, antidumping investigations are by far the most important assignment for the task force. Whenever an antidumping investigation is initiated, the Korean government sends this delegation to the foreign country to deliver its serious concern and the government' s sincere interest in the matter. The head of the task force is an official ranked at the deputy director-general level.

It is believed that visits by the task force have created a friendly environment for antidumping investigations. In other words, although diplomatic pressure by the Korean government does not usually terminate the investigation, it does create an environment for a fairer investigation, and a fairer investigation usually means a lesser margin, which in turn means continuance of exports to the country. This effect was particularly visible in the case of developing countries where the investigating authorities have a lot of "unwritten" discretion in the course of investigations due to the lack of clear rules and procedures for the antidumping investigations in their respective countries.

In sending a delegation, coordination between the government and the related industry has turned out to be quite crucial. A more effective visit was usually made possible through a thorough coordination between the Korean government and the target industry. The Korean government needs to receive feedback and input from the industry to develop an effective argument and a workable strategy for the meeting.

### 6-1-3. Implications for the GOV

Korea's experience in antidumping can provide helpful insight for the GOV once Vietnam joins the WTO. Above all, it shows the importance of a more "practical approach" to antidumping investigations. In the initial stage of antidumping investigations, it is natural for a government and the companies involved to overreact, partly from being agitated by the unfounded or unreasonable allegation, the exact experience of Korea in the early 1980's. This is probably what the GOV and the Vietnamese producers are feeling about increasing antidumping investigations by other countries.

More correctly understood, antidumping investigations and ensuing margins have become more or less an unavoidable "business cost" for participating in international trade and for exporting products to developed countries. Under the current antidumping rules, where the investigating authority has a lot of discretion in conducting the investigation (more so in an investigation involving a NME state), irrespective of what the GOV does or Vietnamese companies do, an increasing number of dumping allegations and antidumping investigations will take place, something the GOV and Vietnamese exporters are powerless to avoid. Domestic competitors of developed countries simply file an antidumping petition to harass the Vietnamese exporters and to force them out of their markets. The Southern Shrimp Alliance of the United States is a good example: Unable to compete with less expensive, better quality Vietnamese shrimps, the only remedy left was to to file an antidumping petition. By simply filing an antidumping petition, the domestic producers can disrupt the market by creating a "chilling" effect among domestic consumers, making them reluctant to continue purchasing from foreign exporters who have become the target of an antidumping investigation, parties with the potential of quitting the market or increasing the price.

Likewise, from the perspective of Vietnamese companies being investigated, the defense strategy needs to be premised on more practical considerations. In other words, once an antidumping investigation is initiated, it is almost impossible to stop. The only instance when the investigating authority stops the investigation is through a "non-initiation," which is quite rare. As such, from the more practical perspective the key point is how to "minimize" the damage, in part by making sure the investigations by the foreign investigating authorities are "reasonable."

To this end, it is crucial for the GOV to express interest in and monitor the investigation process and apply "diplomatic" and "political" pressure as necessary. In the recent shrimp antidumping investigation, the Thai government effectively applied such diplomatic and political pressure against the US government, arguing that the antidumping investigation will increase the Islamic fundamentalist movement in the southern part of Thailand, where a lot of shrimp farmers are located, possibly undermining US efforts to fight global terrorism in the region. Although there is no direct evidence that such diplomatic pressure tipped the balance, the Thai producers managed to receive a much smaller dumping margin than producers from any other country.

At the same time, when an antidumping order is rendered against Vietnamese exporters through a dubious investigation, the GOV needs to challenge it aggressively and immediately. The legal challenge can be conducted both at the domestic court of the investigating country and at the WTO, as necessary. This kind of aggressive challenge may cause financial and logistical burden at first, but will pay off in the long run by demonstrating the GOV's (and that of Vietnamese exporters) willingness to fight to foreign countries' domestic industries and investigating authority, thus helping deter frivolous antidumping investigations and harassment allegations in the future.

Korea's experience in Agricultural Product Import Testing dispute with the United States in 1995 proves this reality. At first, Korea did not want to initiate a trade dispute with its key ally and tried to avoid the dispute as much as possible, willing to yield to US demands in many respects. Unreasonable US demands, however, forced Korea to pursue the dispute settlement procedure at the WTO. Once the dispute settlement procedure was initiated, Korea presented its legal argument aggressively. This aggressive tactic surprised the United States causing it to reconsider settling the dispute through negotiation. As a result, Korea achieved an acceptable compromise from the United States. The United States became more cautious in approaching trade disputes with Korea ever since. This experience taught the Korean government an important lesson: The more aggressive in defending your rights, the more cautious your trading partners will be in brining a case against you. This may be equally applicable to Vietnam and the GOV.

## 6-2. Subsidy Investigation Management

### 6-2-1. Korea's Experience

During the Interim Workshop held in Hanoi on June 30, 2005, a Vietnamese commentator suggested that this paper include Korea's experience in managing the relationship between the Korean government and private sector in terms of trade context. This issue is directly related to the subsidy issue, which is regulated by the WTO Agreement on Subsidies and Countervailing Duties (SCM Agreement), prohibiting all WTO member countries from providing illegal subsidies to their domestic industries or companies.

As of now, Korea is increasingly concerned about illegal subsidy allegations by other countries. As is well known, during the period of economic development from the early 1960's, the Korean government has been involved in key Korean industries and companies within many respects, as with any other country in a similar situation. This "direct involvement" or "close relationship," however, is not the case any more, even if some areas still require further adjustment or separation. Korea has overhauled its economic system and financial structure since the 1990's, more particularly as a result of its entry into the Organization for Economic Cooperation and Development in 1995 and through its efforts to overcome the financial crisis in 1997.

Despite this significant change, however, foreign perception has failed to evolve. Many countries still view Korea as a country subsidizing "favored" industries including the steel industry, semiconductor industry, automobile industry, etc. This remaining perception still leads to subsidy investigations against Korean exporters. For example, since 2002 Korea has been the target of subsidy investigations by the United States, the European Community, and Japan regarding Korea's semiconductor industry and shipbuilding industry. The resulting hefty countervailing duties have created a significant barrier to Korean exports.

The subsidy investigations and extra duty (countervailing duty) have led to bilateral trade disputes and WTO disputes between Korea and other countries involving the SCM Agreement. After experiencing continued surge of subsidy allegations and trade disputes, the Korean government is now making efforts to expedite the process of distancing the government apparatus from private industries as much as possible. For example, the Korean government has abolished almost all direct or indirect subsidy programs and plans for Korean industries.

Despite the efforts of the Korean government, however, Korean exporters are still exposed to subsidy allegations by other countries. First of all, the lingering perception from the past is still haunting the Korean government and Korean exporters. Secondly, since the "dividing line" between illegal subsidy and appropriate government function is sometimes blurry, other countries sometimes portray even legitimate Korean government regulatory policy as illegal and disguised subsidization. Such being the case, currently the subsidy issue is by far the most significant headache for the Korean government and will be so for the time being.

### 6-2-2. Summary of What Korea Has Learned from Subsidy Disputes

Dealing with the new threats from subsidy investigations, the Korean government has learned important lessons. First, the it has realized that subsidy disputes are completely different from antidumping disputes in that the former are directly targeted at the government and investigate governmental polices and programs, as opposed to the individual companies or industry. Therefore, in order to avoid a subsidy allegation and to prevail in a subsidy dispute, long-term efforts by the entire government are crucial.

Second, the Korean government has also learned that subsidy disputes carry more far-reaching damage to Korea's trade interests than antidumping disputes, because they target government's policies and programs themselves, which may involve a wide range of industries and companies covered by such policies and programs. On the other hand, antidumping investigations are simply aimed at individual companies and individual industries, and consequently the negative impact from the antidumping investigations is more limited.

Third, the Korean government realized that the role of the government is much more important in subsidy investigations than antidumping investigations. Antidumping investigations are all about "price comparison" of exporters, and the defense strategy and efforts basically remain in the realm of private companies. Due to this unique aspect of the antidumping investigations, it appears that major Korean exporters have brought antidumping investigations under their own control. For example, Korean companies such as Samsung Electronics, Hynix Semiconductors, Inc., and POSCO have successfully managed themselves antidumping orders in the United States in the 1990's. Consequently, the impact from the antidumping investigations or resulting orders have become quite minimal for these major companies, permitting their exports to continue pace. Again, once companies attain a certain level of familiarity in antidumping, little remains for the government to do.

### 6-2-3. Implications for the GOV

It should be noted that the subsidy issue will not be a problem for the GOV as long as Vietnam maintains a NME status. Although no explicit provision in the WTO Agreements exists, it is generally understood that a NME state is not subject to subsidy or countervailing duty investigations since, by definition, a NME is an economic entity where the government controls, directs and supports the private sectors. In fact, this can be seen as a "positive" aspect of the NME designation.

Therefore, given the fact that Vietnam will likely remain a NME country, at least for the time being, after WTO entry, the subsidy or countervailing duty issue will not be a significant problem for the GOV in the immediate future. However, upon entry into the WTO, the GOV needs to contemplate a long-term strategy to "dilute," step by step the relationship between the GOV and Vietnamese industries. This is necessary because Vietnam's graduation from the NME status seems to be simply a matter of time, in which case Vietnam will have to face this subsidy issue immediately. To avoid unnecessary confusion during that period, it is appropriate to consider a future course of action at an earlier stage. Furthermore, as the GOV is well aware, detaching the government function or reducing the government role in the private sector takes a long time.

The GOV, therefore, needs to think about the issue sooner rather than later. Although this issue is also directly related with the GOV's so-called "equitization" process, it should be noted that this has nothing to do with equitization; this is simply suggested purely from the trade law perspective. That is, even if the GOV completes its equitization process in the future, it is nonetheless possible that other trading partners initiate subsidy investigations against Vietnam, as long as the GOV maintains a certain level of control over the equitized company. From the trade law perspective, therefore, what counts is not the official relationship between the government and industries, but rather the actual relationship between the two. To sum up, during the period when the GOV continues its effort to equitize key industries, a process that may take a long time, the GOV will be vulnerable to a subsidy attack when it graduates from the NME status. The GOV will still remain vulnerable to a subsidy attack even if the GOV finishes its equitization process in the future, as long as it maintains an "illegitimate" relationship with Vietnamese industries.

As such, the GOV needs to be aware that graduating from the NME status is a double-edged sword. It certainly is a great stride forward in antidumping, but at the same time it opens the door for subsidy investigations, far more expansive and damaging. As a matter of fact, this is reportedly the current dilemma for China in its pursuit of NME graduation.

To sum up, given that Vietnam's graduation from NME status is simply a matter of time, gradual detachment of governmental apparatus from key industries seems necessary. At the least, the GOV's official and open subsidization programs need to be abolished gradually.

## 6-3. WTO Dispute Settlement Process

### 6-3-1. Korea's Experience

Since its entry into the WTO, Korea has registered a quite remarkable record at the WTO dispute settlement process. As noted above, initially the Korean government was quite conservative in bringing a legal action against another countries, particularly against major trading partners and allies. The Korean experience in the period of 1995-1999 caused it to reconsider its strategy. Today, the Korean government is quite aggressive in settling disputes through the WTO process.

A brief overview of the Korea's record evidences a successful handling of this matter. Since 1995, 23 disputes have been initiated either by Korea or against Korea. 7 of them have been settled through bilateral consultations. 15 have been resolved by the decisions of the Dispute Settlement Body (either panels or the Appellate Body). 1 dispute is currently pending at the WTO[41)]

Out of the 15 disputes where the Dispute Settlement Body reached substantive decisions, Korea prevailed in 10 cases. Given that the average winning percentage of a WTO member in the WTO dispute settlement procedure is roughly 50% or greater, Korea's record of 67 percent is significantly high. Particularly, Korea prevailed in 3 of the 6 "defensive" cases, where Korea was the party complained against. The 50 % winning rate in defensive cases is remarkable compared to the 10 % average in ordinary defensive cases at the WTO. The summary of all WTO disputes involving Korea is attached herewith. Table 2-5 illustrates Korea's participation in the WTO dispute settlement system as parties, and Table 2-6 is its participation as a third party.

41) This dispute is between Korea and Japan regarding Japan's import quota system for Korean laver. The panel hearing was held in September 2005 and the decision is expected to be rendered in late 2005.

<Table 2-5> Korean Record of WTO Disputes
(12 as complainants and 11 as respondents as of August 31, 2005)

<table>
<tr><th>Case (DS number)</th><th>Opponent</th><th>Korea</th><th colspan="2">Current Status</th></tr>
<tr><td colspan="5">(In Progress)</td></tr>
<tr><td>Japan Import Quotas on Dried Laver and Seasoned Laver (DS323)</td><td>Japan</td><td>Complainant (1)</td><td>Panel Established</td><td>Oral argument held on August 30, 2005</td></tr>
<tr><td colspan="5">(Resolved as a result of Panel/Appellate Body decision)</td></tr>
<tr><td>EU Countervailing Measures on Dynamic Random Access Memory Chips from Korea (DS299)</td><td>EU</td><td rowspan="5">Complainant (8)</td><td>Panel Report adopted (2005.8.3)</td><td>Complainant Partially prevailed</td></tr>
<tr><td>US Countervailing Duty Investigation on Dynamic Random Access Memory Semiconductors (DRAMS) from Korea (DS296)</td><td>US.</td><td>AB Report adopted (2005.7.22)</td><td>Respondent prevailed in AB (Complainant prevailed in Panel)</td></tr>
<tr><td>EU Measures Affecting Trade in Commercial Vessels (TDM system) (DS301)</td><td>EU</td><td>Panel Report adopted (2005.6.20)</td><td>Complainant prevailed</td></tr>
<tr><td>US Definitive Safeguard Measures on Imports of Certain Steel Products (DS251)</td><td>US</td><td>AB Report adopted (2003.11.10)</td><td>Complainant prevailed</td></tr>
<tr><td>US Definitive Safeguard Measures on Imports of Circular Welded Carbon Quality Pipe from Korea (DS202)</td><td>US</td><td>AB Report adopted (2002.3.8)</td><td>Complainant prevailed</td></tr>
</table>

| | | | | |
|---|---|---|---|---|
| US Continued Dumping & Subsidy Offset Act of 2000 (DS217) | US | Complainant (8) | AB Report adopted (2003.1.27)) | Complainant prevailed |
| US Anti-Dumping Measures on Stainless Steel Plate in Coils and Stainless Steel Sheet and Strip from Korea(DS179) | US | | Panel Report adopted (2001.2.1) | Complainant prevailed |
| US Anti-Dumping Duty on Dynamic Random Access Memory Semiconductors (DRAMS) of One Megabyte or Above Originating from Korea(DS99) | US | | Panel Report adopted (1999.3.19) | Complainant Prevailed |
| Korea Anti-Dumping Duties on Imports of Certain Paper from Indonesia(DS312) | Indonesia | Respondent (6) | Panel Interim Report Issued (2005.6.24) | Respondent prevailed |
| Korea Measures Affecting Trade in Commercial Vessels(DS273) | EU | | Panel Report adopted (2005.4.11) | Respondent prevailed |
| Korea Measures Affecting Government Procurement (DS163) | US | | Penal Report adopted (2000.6.19) | Respondent prevailed |
| Korea Definitive Safeguard Measure on Imports of Certain Dairy Products(DS98) | EU | | AB Report adopted (2000.1.12) | Complainant prevailed |
| Korea Taxes on Alcoholic Beverages(DS75/84) | EU, US | | AB Report adopted (1999.2.17) | Complainant prevailed |

| (Settled at Stage of Bilateral Consultation) | | | | |
|---|---|---|---|---|
| European Community Measures Affecting Trade in Commercial Vessels (Measures other than TDM)(DS301) | EU | Complainant (3) | Bilateral Consultation (2004.7.23) | Measure Terminated |
| Philippines Anti-Dumping Measures Regarding Polypropylene Resins from Korea (DS215) | The Philippines | | Terminated as the measure was withdrawn (2001.11) | Measure Withdrawal |
| United States Imposition of Anti-Dumping Duties on Imports of Colour Television Receivers from Korea (DS89) | US | | Terminated as the measure was withdrawn (1998.8) | Measure Withdrawal |
| Korea Laws, Regulations and Practices in the Telecommunications Procurement Sector (DS40) | EU | Respondent (5) | Reached a mutually agreed solution(1997.10) | Bilateral Consultation |
| Korea Measures Concerning Bottled Water(DS20) | Canada | | Reached a mutually agreed solution(1996.4) | Bilateral Consultation |
| Korea Measures Concerning the Shelf-Life of Products(DS5) | US | | Reached a mutually agreed solution(1995.7) | Bilateral Consultation |
| Korea Measures Concerning the Testing and Inspection of Agricultural Products (DS3/41) | US | | Reached a mutually agreed solution(1996.6) | Bilateral Consultation |

<Table 2-6> Korean Third Party Participation

| Title | DS number | Complainant | Respondent | Result |
|---|---|---|---|---|
| US OCTG Sunset Reviews | DS268 | Argentina | US | Complainant Prevailed |
| US Lumber ITC Investigation | DS277 | Canada | US | Complainant Prevailed |
| US Corrosion Resistant Steel Sunset Review | DS244 | Japan | US | Complainant Prevailed |
| EU Bed Linen | DS141 | India | EU | Complainant Prevailed |
| US - Byrd Amendment | DS217/234 | EU, Japan and other 9Countries | US | Complainant Prevailed |
| India Autos | DS146/175 | EU, US | India | Complainant Prevailed |
| Brazil Aircraft | DS46 | Canada | Brazil | – |
| US Hot-Rolled Steel from Japan | DS184 | Japan | US | Complainant Prevailed |
| Canada Autos | DS139/142 | EU | Canada | Complainant Prevailed |
| US Section 301 | DS152 | EU | US | Complainant Prevailed |
| Indonesia Autos | DS54/55/59/64 | EU, Japan, US | Indonesia | – |
| EU Computer Equipment | DS62/67/68 | US | EU | - |
| US Laws, Regulations and Methodology for Calculating Dumping Margins (Zeroing) | DS294 | EU | US | Pending |
| US Countervailing Measures Concerning Certain Products from EU (Artcle21.5) | DS212 | EU | US | Pending |

## 6-3-2. Summary of What Korea Has Learned from WTO Dispute Management

It should be noted, however, that the successful results at the WTO have been made possible through "outsourcing." All cases have been represented and argued by foreign attorneys, although with varying degrees, either from the United States or Europe. Using Korean attorneys has become impractical due to the language barrier and lack of legal expertise in this field. As a result, it appears that most of the time Korean attorneys and trade officials have taken supportive roles.

This foreign outsourcing has caused structural problems for the Korean government. First of all, this outsourcing has created a "vicious cycle" as time progresses: As Korean attorneys do not have adequate expertise, the Korean government has to resort to foreign legal counsel, and the utilization of foreign legal counsel further deprives Korean attorneys of the precious opportunities to train themselves and obtain the experience, which then leads to more reliance on foreign legal counsel.

Second, the Korean government has increasingly faced the problem of discrepancy between the objectives of foreign legal counsel and the national interests of Korea. Although the foreign legal counsel and the government have the same objective winning the dispute -- private practitioners sometimes have different perspectives and objectives in a particular dispute. Generally speaking, the foreign legal counsel turned out to be more focused on case-specific issues (that is, less concerned about the long term implication for Korea flowing from the case at hand) and more profit-driven, while the Korean government is more contemplative of long-term implications and economy-wide impact from the case.

In addition, the Korean government has also experienced the discrepancy between the interest of the Korean company involved (that is, the subject of the underlying bilateral trade dispute) and the interest of the Korean government. Needless to say, the company is more focused on promoting its own economic interest through the WTO procedure while the Korean government again needs to consider wider implication and broader impact. Most of the time, the interest of the company and that of the Korean government go hand in hand, but in some critical instances they may differ. This particular problem is sometimes further complicated when the company finances the WTO dispute settlement process (when the company hires legal counsel for the Korean government and pays for the legal fees). More than anything else, under the current circumstances, with trade progressively more complicated, relying on foreign attorneys and foreign professionals causes significant problems.

Based on this awareness, the Korean government is currently making efforts to "Koreanize" the WTO dispute settlement process. There seem to be structural obstacles in this regard, however, them being (i) lack of manpower and skilled practitioners inside the Korean government; (ii) lack of incentives for Korean government officials to specialize in this field as a career path; (iii) lack of adequate legal education system in Korea to produce attorneys to take up these tasks in international tribunals; (iv) lack of financial incentives for Korean law firms to specialize in this field. All in all, these underlying problems seem to be chronic and structural, and pose a significant barrier for "Koreainizing" the WTO dispute settlement process in the immediate future. It is believed that Japan is currently struggling with similar problems.

As a result of the above, Korea and Japan have been "outsourcing" their legal needs in the course of WTO disputes and other bilateral trade disputes. Outsourcing bilateral disputes is reasonable, given the need to hire a local legal counsel since the procedure is before a domestic court of another country. The WTO disputes are completely different, however. The disputes are before an international forum, that is, the WTO Dispute Settlement Body (either a Panel or the Appellate Body), and each disputant is represented by a counsel of its own choice. Given the importance of the disputes and the widespread long-term implication of the results, that the Korean government and the Government of Japan (GOJ) have had to rely upon the expertise of foreign attorneys is of concern. Even if a particular dispute is between Korea and the United States, or Japan and the United States, the legal battle is conducted by an American attorney representing Korea, or Japan, versus another American attorney representing the US (attorneys from the USTR).

The limitation presented by the above problem at the WTO dispute settlement process is proved by a recent incident. In the course of a panel proceeding at the WTO regarding the Korea-Japan laver dispute, the GOJ used its own local attorneys for its representation, probably the first such instance. Although not easily quantifiable, it is widely believed that the Japanese attorneys made key blunders at the proceeding, an example of the chronically shallow depth of expertise of Japan in this field. Although Korea did not experience such incident, since it was represented by foreign attorneys (as in all other disputes), undoubtedly Korea would have experienced the same problem of Japan should it have chosen to utilize Korean attorneys for the process.

### 6-3-3. Implications for the GOV

Korea's experience further proves the importance of long-term cultivation of trade experts, both in the economic sector and the legal sector. The "chronic" problems of Korea identified above may equally apply to Vietnam. In fact, the problem may be more acute for Vietnam since it appears to have less experience and expertise than Korea when it joined the WTO in 1995. Needless to say, in the initial stage of WTO entry, foreign outsourcing may be inevitable for the GOV. Yet it is crucial to minimize the role of foreign attorneys and to increase the role of the GOV gradually. Otherwise, the GOV will follow the same path of the Korean government and the GOJ.

When considering the above lesson, the necessity for the GOV to have trade officials "stay put" rather than rotate from ministry to ministry or from agency to agency is manifest. In the same context, the GOV might need to contemplate introducing enough incentives for these officials and to create a centralized "task force" in the initial stage of the WTO entry, as suggested earlier.

As noted above, in the long run the GOV may ultimately have to create a centralized trade agency which has strong authority over trade negotiations and dispute settlement and which can coordinate the interests and positions of other GOV agencies. As to the basic structure of trade agencies of the GOV, relevant issues and suggestions are discussed in the following section. Similarly, the GOV needs to staff the Permanent Mission to Geneva with sufficient trade officials, so that the Vietnamese mission can deal with a wide range of ongoing projects in Geneva the Doha Development Agenda (DDA) negotiation, trade disputes management, bilateral trade negotiations, etc.

With respect to the dispute settlement expertise enhancement, it is crucial that the GOV accumulate “hands-on” experience. The easiest way seems by participating in other countries’ disputes as a third party, as China, Taiwan, Korea or other countries currently do. Without incurring significant burden, the GOV can take advantage of a golden chance to accumulate precious experience.

## 6-4. Operating an Investigating Authority

### 6-4-1. Korea’s Experience

As a WTO member, the Korean government has the obligation to establish and operate an “Investigating Authority” to investigate “unfair trade” practices by foreign companies, practices such as dumping, subsidization, safeguards, intellectual property right infringement, etc., in the Korean market. Originally, the Korean government established the KTC under the Ministry of Commerce, Industry and Energy (MOCIE) in 1987.

The KTC has accomplished various tasks. Given that Korea is an export-oriented economy, the Korean government did not pay much attention to protecting domestic markets. Korea has been more interested in expanding Korean exports in foreign markets than protecting the Korean market from foreign imports. As such, the Korean government apparently did not fully understand the importance of the KTC and its contribution to the protection of domestic markets. Recent surge of imports due to further liberalization under the WTO regime and Free Trade Agreements (FTAs), however, taught the Korean government the importance of the KTC as the Korea’s investigating authority.

As a result, the KTC is has been making efforts to expand its role and diversify its function since 2004. The KTC holds frequent workshops with Korean SME companies to help them understand the role of the KTC and disseminate information on how to file a petition and what to provide as underlying materials. The KTC also tries to disperse consensus among the Korean society and the Korean government on the necessity to protect the Korean market from dumped and subsidized foreign imports. To keep up with the enhanced role of the KTC, the Korean government is currently considering expanding staff and workforce at the KTC. The Korean government is also reviewing whether it needs to change rules and regulations relating to the KTC to accelerate trade remedy investigations in Korea within the boundary of the WTO regime.

### 6-4-2. Summary of What Korea Has Learned from KTC Operation and Management

Over the years, the Korean government realized that having a strong and effective investigating authority in place serves two purposes: To protect innocent Korean domestic producers from unfair foreign import penetration, and to suppress future trade cases by foreign governments against Korean producers. The second element is based on the Korean government's realization that more aggressive defense of the domestic market also tends to guarantee a fairer investigation by foreign investigating authorities against Korean exporters in their own trade investigations. The reason for this is because foreign governments are propelled to do a "double take" before taking actions against Korean producers, making sure that their exporters are not retaliated upon in the Korean market by the Korean government.

As the KTC expands its function, trade disputes are also on the rise. Other trading partners closely monitor the KTC's antidumping and other trade investigations, and raise legal claims when they believe that the KTC's antidumping orders or other decisions are erroneous. They bring the case either to the WTO dispute settlement body or to the Korean court. For example, in 2005 Indonesia brought a WTO dispute against Korea regarding the KTC's antidumping order against papers from Indonesia. It is reported that the panel ruled in favor of Korea in this dispute. Indonesia also brought a case against the KTC at the Korean court, which also ruled in favor of the Korean government in September 2005.

Recent victories of the KTC at the WTO and the domestic court strengthened confidence in the KTC and enhanced respect by other agencies for the KTC. As a result of these recent disputes, the Korean government further acknowledged the importance of beefing up the KTC as the Korean government's investigating authority. In addition to strengthening its organizational structure, the KTC is fine-tuning and revamping its investigation practice and procedure in order to prevail in other possible disputes at the WTO in the future. In sum, Korea fully recognizes the importance of having an effective investigating authority in the WTO regime.

### 6-4-3. Implications for the GOV

It appears that the situation is not that much different with respect to Vietnam and the GOV. Although Vietnam is also an export-oriented country, it is important to establish a mechanism inside the GOV to protect the domestic market from "unfair" foreign imports. The GOV has to create an investigating authority in any event when it joins the WTO, so it would be more beneficial for the GOV to introduce an effective and efficient organization in the first place.

This new investigating authority will be essential to protecting the trade interests of Vietnam, because foreign imports will definitely surge in the domestic market following WTO entry. Under these circumstances, unfair imports, if left unchecked, would promptly undermine the competing Vietnamese industries and producers. Destruction of production bases for domestic industries would seriously jeopardize the Vietnamese economy. Furthermore, as shown in Korea's experience, having an effective investigating authority is another way to guarantee fair antidumping investigations and other trade remedy investigations by foreign governments against Vietnamese products through "checks and balances."

Considering these factors, this paper suggests that the GOV establish an investigating authority as soon as possible. It should be organized and structured as an independent entity under the WTO; otherwise, it would be found inconsistent with the WTO norms. In this regard, the GOV needs to adopt laws and regulations to establish, support and regulate investigations by the new investigating authority. Chinese laws and regulations seem to provide good examples for the GOV in this regard, as China has gone through similar experience with Vietnam.

## 6-5. Other Issues

### 6-5-1. Trade Ministry Organization

As noted above, in the initial stage of WTO entry the GOV is encouraged to operate a special WTO task force. Once the initial emergency situation is taken care of, the GOV will then have to consider a long-term organizational structure of its trade related agencies. As of now, it appears that there are three main streams of trade agency structures in the world: The system where the foreign ministry takes the lead; the system where economic ministries take the lead with the foreign ministry's coordination assistance; and the system where there is an independent agency in charge of all trade issues.

#### 6-5-1-1. Foreign Ministry-Led Trade Structure

This is the system followed by Korea, Australia, and Canada. In this system the foreign ministry is in charge of all trade negotiations and disputes settlement except for specified issues carved out for other agencies. After a long controversy, Korea adopted this system in 1998. Thus, the MOFAT is in charge of all trade negotiations and disputes inside the Korean government. Before key negotiations with other countries, the MOFAT usually engages in in-depth discussions with other agencies that are in charge of the issues in the domestic context. For example, the MOFAT is currently cooperating with the Ministry of Agriculture for the issue of Korean rice market access negotiations. For WTO disputes concerning semiconductors, steel, or shipbuilding, the MOFAT has undertaken consultations with the MOCIE in preparation for the strategies for the disputes. Officially, however, the MOFAT represents the Korean government in these trade issues.

There are pros and cons to this system. For the positive side, the negotiation can take into account various elements of the government-to-government relationship. For example, in dealing with a particular trade dispute with another country, the MOFAT can consider a wide range of factors relating to the dispute; the political dimension, diplomatic dimension, economic cooperation dimension, as well as the particular trade issues posed. Thus, one could say that a multi-dimensional approach is available in approaching a specific trade dispute.

In terms of the negative element, the foreign ministry's inherent tendency to think about other issues sometimes puts political issues before trade issues. Sometimes the foreign ministry will be reluctant to aggressively pursue a trade dispute with another country when there is a rising political tension between the two. In short, the most fundamental risks for this kind of system is that the trade function or the trade sub-agency inside the foreign ministry has the potential to become a second-class organization in the foreign ministry.

#### 6-5-1-2. Economic Ministry-Led Trade Structure

The pros and cons of the foreign ministry-led system is exactly the opposite in the economic ministry-led trade structure, where the economic ministries take the responsibility for international trade negotiations and dispute settlement while the foreign ministry takes the coordination function. Japan, China, Thailand and many other countries have adopted this formula. As it currently stands, the GOV seems to take this approach since its MOT takes the leading role in all WTO negotiations.

Although the MOT is a trade-specific agency, it appears that the agency is better classified as an economic ministry, rather than as a stand-alone trade agency discussed below. The MOT seems to mainly "coordinate" the arguments and interests of other GOV agencies rather than "lead" the trade negotiation and dispute settlement with a strong authority of its own. In other words, other ministries and agencies of the GOV have almost equal voice in terms of trade negotiations and dispute settlement as the MOT. Thus the MOT is properly categorized as an economic ministry with trade coordination function, just like the Ministry of Economy, Trade and Industry of the GOJ.

Under this system, trade issues would get more adequate attention from the decision makers as the economic ministries can provide sufficient "input" in implementing trade negotiations. At the same time, confusion is created when trade officials lose the big picture of the bilateral relationship and only focus on short-term gains in trade sectors.

#### 6-5-1-3. Independent Agency Structure

Under this system, a special, independent entity in charge of all trade negotiations and dispute settlement is created. The Office of the USTR is a good example. The EU also has a special entity that is devoted to trade negotiations and dispute settlement.

Under this system, the negotiations and problem shooting are quite expeditious and straightforward because the independent agency has sufficient discretion and authority. This is neither an economic ministry nor a foreign ministry; rather it is an independent agency in charge of all trade issues. However, even under this system, the independent agency also needs to conduct consultations with other related agencies. However, it is clear from domestic statutes and regulations that the trade authority is exclusively given to this agency.

Among these three systems, it appears that the third system (independent agency system) would be most efficient for the GOV. Since the GOV may continuously need a strong leadership in trade issues, more so after joining the WTO, this kind of strong independent trade agency system may turn out to be more appropriate for the GOV. In Vietnam, it seems that all ministries and agencies are traditionally assertive in their own areas of specialty, and do not easily defer to another agency. Considering this aspect inside the GOV, it may be necessary to establish a new agency (or officially expand or strengthen the MOT for that matter) to be fully in charge of trade negotiations and dispute settlement. This agency can issue a single voice against other countries. As explained above, until the GOV makes a determination on the basic structure of the trade-related ministries, it needs to temporarily establish and utilize a WTO task force inside the MOT.

### 6-5-2. Service Sector

During the Final Conference held in Seoul on September 5, 2005, a Vietnamese participant asked that the final paper include a brief overview of the Korean government's current policy regarding the service trade. Having realized that its service providers were not necessarily ready for full competition with foreign service providers, Korea has been traditionally quite defensive in terms of opening the service sector. Since the days of the Uruguay Round negotiations in the late 1980's and the early 1990's, the Korean government's objective in service negotiation has been to open up its service market to minimum necessary extent, as a result of the "give-and-take" multilateral negotiations. This "cautious" approach, however, has recently shown slight change. Increasingly, the Korean government and private entities understand the positive aspects as well as the negative aspects of opening the service market. This realization is largely due to a bitter experience from the 1997 financial crisis, when the weakness and fragility of the financial service sector were dramatically exposed. After the financial crisis, the Korean government expedited the process to liberalize its service market and enhance competitiveness of the domestic service providers. As of now, the Korean government's basic approach to the service market opening could be summarized as below.

#### 6-5-2-1. Realizing that the Korean Service Market will Ultimately Have to Liberalize

Pressure by foreign trading partners to open up the Korean service market is ever increasing both at the multilateral DDA and bilateral FTA negotiations table. In addition, the importance of the service sector in the Korean economy is rapidly growing: It accounts for roughly 50% of the total Korean GDP and it employs roughly 70% of the whole Korean workforce. Under these circumstances, the Korean government has realized that being "defensive" no longer provides a viable solution; the need is to be more "aggressive." There is now general consensus that regardless of what Korea desires, the Korean service market will have to be opened to other trading partners sooner or later. The only remaining issue is when and how. Thus, the focus of the recent domestic discussion on the service market opening has been about how to adjust the pace of liberalization, rather than whether to open a particular service sector or not.

#### 6-5-2-2. Adopting a More "Positive" Negotiation Strategy in the Service Sector

Based on the above understanding, the Korean government is now more actively participating in the DDA and FTA service negotiations. For example, in its Revised Offer submitted to the WTO on May 30, 2005, the Korean government promised to open almost all key service sectors with varying degrees. Although some sectors are not included in the Korean government's Revised Offer (news dissemination service, radio/TV service, etc.), the current package is regarded as a "bold" step under the Korean standard. This change of basic strategy was triggered by the realization that the service market will have to be liberalized to foreign service providers.

Vietnam's large population and high educational level will definitely make it an attractive market for foreign service providers. The pressure to liberalize the Vietnamese service market will escalate once Vietnam joins the WTO. If service market opening is inevitable, the GOV should formulate an opening strategy in a way that causes the least amount of impact. Service sectors that are related to Vietnamese cultural identity, such as mass media production service or education service, would be more vulnerable to foreign penetration than technical sectors, such as medical service or financial service. All these dynamic elements need to be considered by the GOV in formulating the service trade strategy.

#### 6-5-2-3. Recognizing the Need to Implement Policies Enhancing the Competitiveness of Domestic Service Providers

Unlike manufacturers, Korean service providers are not considered sufficiently competitive vis-à-vis their foreign counterparts. As such, domestic service providers are seriously concerned about foreign penetration once the Korean service market is further liberalized for foreign competitors. For example, it is expected that the domestic legal service market will undergo a drastic change once the market is opened to foreign legal service providers. Korean legal service providers have enjoyed de facto monopoly in the domestic legal service market for quite some time, but will now have to compete with foreign competitors. In this process, it is possible that the Korean legal service market becomes completely devoured by American/British law firms, as in France or Germany.

This is currently a source of dilemma for the Korean government. On the one hand, the Korean government would like to invite foreign competition to the domestic market, so that Korean consumers can choose and enjoy better quality service. On the other hand, the Korean government will have to avoid the situation where a particular Korean service sector is annihilated by the surge of foreign competitors. The key task for the Korean government as of now and in the near future, in terms of the service sector, is to adjust the pace of the opening to achieve a balance between the two competing goals.

In the same context, the Korean government's remaining task in the service sector in the post-liberalization period is to adopt and implement a legitimate government policy to provide necessary assistance to the domestic service sector in order to help them sharpen their edges of competitiveness in the future. Such policies may include educational reform or further globalization of respective service sectors. The Korean government's current effort to overhaul the half-century old legal education system in Korea is a good example in that regard.

### 6-5-3. Utilization of Safeguard Measures

As is well known, a safeguard measure is a special exception allowed to a WTO member, when the member is suffering from a "surge" of imports for a particular product and the domestic industry of the member state is on the verge of annihilation with "serious injury." While other trade remedy measures are aimed at "unfair trade," a safeguard measure is for "fair trade." In other words, it is an emergency action to deviate from otherwise dutiful obligations as a WTO member. The "serious injury" requirement certainly possesses a higher threshold than the ordinary "material injury" standard applicable in antidumping or countervailing duty investigations. A heightened threshold was adopted, because it targets "fair trade," as opposed to "unfair trade," meaning that the foreign exporter has not engaged in illegitimate activity.

Due to the unique nature of the safeguard measure as an emergency action, developing countries newly participating in international trade have a tendency to prefer this measure to other trade remedies. By resorting to safeguard measures, developing countries do not have to go through a myriad of legal requirements as in antidumping or anti-subsidy measures. All that is required is demonstrating the "surge" of foreign imports and the "serious injury" its industry is suffering due to the surge. As such, it is relatively easy to implement the safeguard investigation.

Korea is no exception. Korea also significantly resorted to safeguard measures in the early part of its operation of the KTC. As noted above, the KTC was established in 1987. Ever since that point, there have been 33 safeguards investigations initiated by the KTC. Interestingly, out of the 33 cases, 29 cases were investigated before 1995 when the WTO regime set in, and only 4 safeguards investigations were conducted after 1995. In short, the bulk of the safeguard investigations were conducted in the early stage of the KTC operation, when the Korean government was not fully equipped with expertise and knowledge in the area of international trade.

The same may also apply to Vietnam. Needless to say, Vietnam will see a drastic surge of foreign imports in certain sectors after the trade liberalization as a result of WTO accession. Vietnamese domestic producers may try to apply to the Korean government antidumping or anti-subsidy investigations, or other remedial actions, as the case may be, but will realize that sometimes meeting the requirements for those respective measures is quite difficult. Meanwhile, the Vietnamese industry may suffer substantial damage from the surge of foreign imports. If that is the case, the only legal avenue available for the GOV and the Vietnamese industries would be a safeguard measure. Hence, the GOV is encouraged to initiate thinking about basic strategies for safeguard measures and adopting necessary domestic legislation and regulation for such action. In fact, this is another reason why it is important to establish an effective GOV investigating authority as soon as possible and staff it with competent officials.

### 6-5-4. Employment within the WTO

At the same time, Vietnam needs to expand employment by its nationals in trade-related international organizations, particularly the WTO. Once Vietnam becomes a member of the WTO, its nationals will be able to apply for any vacancy. Such employment is important because it provides an opportunity for Vietnamese nationals to get more “hands-on” experience in the real world and because Vietnam’s interest can be adequately represented inside the WTO. For successful candidacy, the GOV will have to provide full support for the respective applicant and gather support from other countries through campaigning.

As of now, Korea maintains only two nationals in the WTO, which constitutes under-representation given its trade volume and the level of financial assistance to the WTO. As time passes by, Korea will increase it efforts to expand its presence in WTO staff, although it has not been so successful yet.

### 6-5-5. Utilizing the 2006 APEC conference

Luckily for Vietnam, it will assume the role of the APEC forum chair in 2006. Given that the APEC is a trade-focused entity, the GOV may consider taking full advantage of the 2006 meeting in Hanoi for its benefit. There will be a series of meetings throughout 2006 at various levels, culminating in the summit meeting of 21 member states in November 2006.

Utilizing this precious opportunity, Vietnam should try to pass through its outstanding issues. For example, it can raise its NME issue at the meeting in 2006, or it can consider laying the groundwork for subsequent bilateral negotiations. Since the APEC meetings are likely to be held immediately following WTO entry in early 2006, the GOV may continue the positive momentum gained from entry throughout the meetings in the year.

To do so, the GOV needs to promptly establish its strategy. It is reported that the GOV has sent sufficient number of officials to the 2005 APEC meeting in Busan in order to get familiarized with the topics and issues discussed at the APEC meeting. As Korea tried to take advantage of hosting APEC in many respects, the GOV will also have to mobilize all its national apparatus to utilize the momentum of 2006 APEC in Hanoi. The GOV needs to analyze and prioritize key trade issues to be discussed next year so as to show its leadership as a hosting country. Such leadership, when well exercised, may help the GOV find a breakthrough in various pending issues, including the NME status, in key trading partners.

### 6-5-6. Business Association Involvement

Considering that most of Vietnamese companies are SME companies, it is important that the GOV support the establishment and expansion of business associations of various industries, so that they can adequately represent the interest of these industries in foreign countries as well as in Vietnam. These associations can produce a synergy effect by formulating a more organized industry voice in particular trade negotiations with other countries and by establishing a joint defense line in the face of foreign trade remedy cases. Most notably, an antidumping investigation in a foreign country would be better defended by the joint effort of a business association than separate efforts by individual companies. For example, a business association can jointly hire attorneys for an antidumping investigation by a foreign government. As such, the GOV may consider adopting a policy to encourage the establishment of business associations of various industries in the near future.

In the meantime, however, the GOV will have to refrain from providing direct financial support to these business associations, as such support may be found to be an illegal subsidy once Vietnam becomes the target of subsidy investigations, particularly after it graduates from the NME country status. In other words, its support should be formulated in more general terms and conditions without reference to specific industries or companies of Vietnam.

### 6-5-7. Change of Overall Attitude and Perception

For a long time, Vietnam has been defensive in terms of trade disputes. This, however, needs to be changed once Vietnam is fully integrated into the world trading system. It needs to be aggressive and assertive. Korea’s experience demonstrates that avoiding a particular dispute through concessions by the government at a particular point in time does not ultimately bring about a benefit for Korea. Trading partners and their domestic industries, more emboldened by the Korea’s soft stance, will raise other trade disputes in the near future. On the other hand, once Korea sent a signal of its will to aggressively pursue its right at the WTO or at other international fora, other countries tended to think twice before raising a trade case against Korea. As a result, trade disputes have tended to become more streamlined and organized than before, and the Korean government and companies are able to better manage these disputes.

Likewise, once it is clear that a trade dispute is without merit or a frivolous allegation to drive out Vietnamese products from a market, the GOV and Vietnamese companies need to aggressively pursue all legal means available. This will incur financial resources and logistical assets in the beginning, but will pay off in the long run.

No matter what the GOV or Vietnamese companies do, trade disputes will arise and will increase at all times. The disputes, therefore, should be understood as an unavoidable business cost. The more appropriate strategy then is how to manage them rather than to avoid them entirely.

## 7. Conclusion

The WTO entry project will provide a turning point for the future of Vietnam.[42] As it is so important, however, it is all the more crucial to be fully prepared for all impacts, both positive and negative, resulting from accession. Particularly, no matter what the GOV does, there will be significant side effects in the immediate aftermath of entry. The GOV will experience the explosion of numerous tasks including endless requests and inquiries from various entities, both domestic and foreign. The GOV will also experience a great deal of confusion stemming from lack of guidance and experience.

The GOV, however, does not seem to be aware of the "full spectrum" of all implications from WTO entry. It is certainly concerned about the upcoming tough negotiations with other countries including the United States and the huge amount of workload to be done before and after WTO entry, but it does not seem to be fully ready to promptly reformulate the country's economic and financial structure as required under the WTO.

As of now, the key task is how to minimize the negative effects and how to be smoothly integrated into the world body. One agency's effort in one specific sector is not enough, and only a comprehensive, multidimensional approach will help the GOV effectively deal with the problems. Furthermore, most of the work is structural in nature, which means that a significant amount of time is necessary for preparation and implementation. As such, the GOV's prompt initiation of the key tasks and continued efforts to achieve the completion not long after WTO entry is crucial.

The current somewhat "slow pace" in Vietnam is not surprising given the fact that a WTO membership requires a fundamental change of the country's economic regime, trade regime and social structure. No matter what the GOV does at the current stage, some confusion and shock will be inevitable. In the case of Vietnam, however, the GOV needs to be more adequately apprised of rights and obligations from WTO membership, and more thoroughly prepared for the transition to minimize the confusion and shock.

As of now, Vietnamese businesses as a whole are experiencing a lack of marketing expertise, skilled workforce, modern technology and information. Vietnam's entry into the WTO can provide an important momentum to change this trend. Integration processes taken as a result of WTO entry will be a bitter pill to swallow at first, but will turn out to be a panacea for the entire

42) One commentator put it this way. "Weighing the benefits and costs of joining the WTO, at first glance we see more threats than benefits. But since there is no other way than to join the WTO, the Vietnamese Government, farmers, business and industry people must have a broad, committed approach based on self improvement in order to face up to these challenges. With good governance, this determination can be realized, and then a modernized Vietnam can stand tall in the global community. See Vo-Tong Xuan, Vietnam and the WTO, Angiang University.

Vietnamese economy as a whole by enabling domestic businesses to enter a fiercely competitive world market and ultimately survive.

Unfortunately, there is no “grace period” for a new member of the WTO. Other countries will not be so friendly and will attempt everything to hold Vietnam liable once a violation occurs. The GOV’s lack of experience as a new member will not provide a viable defense. As such, it is highly likely that there will be a surge of disputes against Vietnam once it joins the WTO. Some of them may be triggered by “malicious intent” to harass Vietnamese producers and some of them by simple misunderstanding and lack of information. At any rate, it is crucial for the GOV to be fully prepared for this situation.

In addressing these disputes, it should be kept in mind that a more aggressive trade strategy will ultimately pay off. The Korean experience provides good evidence for this proposition. As such, instead of trying to avoid disputes through concession and stopgap measures, the GOV is encouraged to aggressively and actively pursue all of its legal claims in various multilateral and bilateral disputes. Such positive and active strategy will not only provide precious opportunities for the GOV to enhance its expertise, but will also suppress frivolous trade investigations against Vietnamese producers in the coming years.

## *PROTOCOL ON THE ACCESSION OF THE PEOPLE'S REPUBLIC OF CHINA (EXCERPTS)*

### Preamble

The World Trade Organization ("WTO"), pursuant to the approval of the Ministerial Conference of the WTO accorded under Article XII of the Marrakesh Agreement Establishing the World Trade Organization ("WTO Agreement"), and the People's Republic of China ("China"),

*Recalling* that China was an original contracting party to the General Agreement on Tariffs and Trade 1947,

*Taking note* that China is a signatory to the Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations,

*Taking note* of the Report of the Working Party on the Accession of China in document WT/ACC/CHN/49 ("Working Party Report"),

*Having regard* to the results of the negotiations concerning China's membership in the WTO,

Agree as follows:

(Omitted)

### 15. Price Comparability in Determining Subsidies and Dumping

Article VI of the GATT 1994, the Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994 ("Anti-Dumping Agreement") and the SCM Agreement shall apply in proceedings involving imports of Chinese origin into a WTO Member consistent with the following:

(a)In determining price comparability under Article VI of the GATT 1994 and the AntiDumping Agreement, the importing WTO Member shall use either Chinese prices or costs for the industry under investigation or a methodology that is not based on a strict comparison with domestic prices or costs in China based on the following rules:

(i) If the producers under investigation can clearly show that market economy conditions prevail in the industry producing the like product with regard to the manufacture, production and sale of that product, the importing WTO Member shall use Chinese prices or costs for the industry under investigation in determining price comparability;

(ii) The importing WTO Member may use a methodology that is not based on a strict comparison with domestic prices or costs in China if the producers under investigation cannot clearly show that market economy conditions prevail in the industry producing the like product with regard to manufacture, production and sale of that product.

(b) In proceedings under Parts II, III and V of the SCM Agreement, when addressing subsidies described in Articles 14(a), 14(b), 14(c) and 14(d), relevant provisions of the SCM Agreement shall apply; however, if there are special difficulties in that application, the importing WTO Member may then use methodologies for identifying and measuring the subsidy benefit which take into account the possibility that prevailing terms and conditions in China may not always be available as appropriate benchmarks. In applying such methodologies, where practicable, the importing WTO Member should adjust such prevailing terms and conditions before considering the use of terms and conditions prevailing outside China.

(c) The importing WTO Member shall notify methodologies used in accordance with subparagraph (a) to the Committee on Anti-Dumping Practices and shall notify methodologies used in accordance with subparagraph (b) to the Committee on Subsidies and Countervailing Measures.

(d) Once China has established, under the national law of the importing WTO Member, that it is a market economy, the provisions of subparagraph (a) shall be terminated provided that the importing Member's national law contains market economy criteria as of the date of accession. In any event, the provisions of subparagraph (a)(ii) shall expire 15 years after the date of accession. In addition, should China establish, pursuant to the national law of the importing WTO Member, that market economy conditions prevail in a particular industry or sector, the nonmarket economy provisions of subparagraph(a) shall no longer apply to that industry or sector.

### 16. Transitional Product-Specific Safeguard Mechanism

1. In cases where products of Chinese origin are being imported into the territory of any WTO Member in such increased quantities or under such conditions as to cause or threaten to cause market disruption to the domestic producers of like or directly competitive products, the WTO Member so affected may request consultations with China with a view to seeking a mutually satisfactory solution, including whether the affected WTO Member should pursue application of a measure under the Agreement on Safeguards. Any such request shall be notified immediately to the Committee on Safeguards.

2. If, in the course of these bilateral consultations, it is agreed that imports of Chinese origin are such a cause and that action is necessary, China shall take such action as to prevent or remedy the market disruption. Any such action shall be notified immediately to the Committee on Safeguards.

3. If consultations do not lead to an agreement between China and the WTO Member concerned within 60 days of the receipt of a request for consultations, the WTO Member affected shall be free, in respect of such products, to withdraw concessions or otherwise to limit imports only to the extent necessary to prevent or remedy such market disruption. Any such action shall be notified immediately to the Committee on Safeguards.

4. Market disruption shall exist whenever imports of an article, like or directly competitive with an article produced by the domestic industry, are increasing rapidly, either absolutely or relatively, so as to be a significant cause of material injury, or threat of material injury to the domestic industry. In determining if market disruption exists, the affected WTO Member shall consider objective factors, including the volume of imports, the effect of imports on prices for like or directly competitive articles, and the effect of such imports on the domestic industry producing like or directly competitive products.

5. Prior to application of a measure pursuant to paragraph 3, the WTO Member taking such action shall provide reasonable public notice to all interested parties and provide adequate opportunity for importers, exporters and other interested parties to submit their views and evidence on the appropriateness of the proposed measure and whether it would be in the public interest. The WTO Member shall provide written notice of the decision to apply a measure, including the reasons for such measure and its scope and duration.

6. A WTO Member shall apply a measure pursuant to this Section only for such period of time as may be necessary to prevent or remedy the market disruption. If a measure is taken as a result of a relative increase in the level of imports, China has the right to suspend the application of substantially equivalent concessions or obligations under the GATT 1994 to the trade of the WTO Member applying the measure, if such measure remains in effect more than two years. However, if a measure is taken as a result of an absolute increase in imports, China has a right to suspend the application of substantially equivalent concessions or obligations under the GATT 1994 to the trade of the WTO Member applying the measure, if such measure remains in effect more than three years. Any such action by China shall be notified immediately to the Committee on Safeguards.

7. In critical circumstances, where delay would cause damage which it would be difficult to repair, the WTO Member so affected may take a provisional safeguard measure pursuant to a preliminary determination that imports have caused or threatened to cause market disruption. In this case, notification of the measures taken to the Committee on Safeguards and a request for bilateral consultations shall be effected immediately thereafter. The duration of the provisional measure shall not exceed 200 days during which the pertinent requirements of

paragraphs 1, 2 and 5 shall be met. The duration of any provisional measure shall be counted toward the period provided for under paragraph 6.

8. If a WTO Member considers that an action taken under paragraphs 2, 3 or 7 causes or threatens to cause significant diversions of trade into its market, it may request consultations with China and/or the WTO Member concerned. Such consultations shall be held within 30 days after the request is notified to the Committee on Safeguards. If such consultations fail to lead to an agreement between China and the WTO Member or Members concerned within 60 days after the notification, the requesting WTO Member shall be free, in respect of such product, to withdraw concessions accorded to or otherwise limit imports from China, to the extent necessary to prevent or remedy such diversions. Such action shall be notified immediately to the Committee on Safeguards.

9. Application of this Section shall be terminated 12 years after the date of accession.

(Omitted)

Chapter 3

# Strategies for Human Resource Development in Vietnam

Chapter 3

# Strategies for Human Resource Development in Vietnam

*Chonghoon Rhee*
*Myongji University*

## Executive Summary

### *Analysis of Vietnam's Labor Market*

Although 20 years has passed since "Doi Moi" started in 1986, the expected job creation has not been so successful in the Vietnamese labor market. Underemployment exists in the agricultural sector and redundant labor in the public sector, implying that "too many people have been hired." Employment in the private sector should be sufficiently created in order to absorb and solve the surplus labor in agricultural and public sectors. Qualitatively, job creation from "small size companies in the service sector" takes up a much bigger portion. Employment in the service sector comprises mostly self-employment and small companies in the urban informal sector (UIS). Even though the UIS has large employment elasticity, possible technology advancement in order to self-generate high growth cannot be expected in this area. Moreover, income generation in the upper-tier of the UIS is possible by continual demand derived from the growth of industry sectors, while high reliance on small and medium size companies within the manufacturing sector will result in difficulty in improving competitiveness in the international market. Job creation through foreign direct investment (FDI) is increasing, but still insufficient.

On the labor supply side, a large percentage of Vietnam's population is in the younger age group (age group of 15 to 44 years consists of 80%of the population). Moreover, Vietnams is also marked by a low illiteracy rate (4.3%). However, the major obstacle for economic development is that there still exists an insufficient amount of workers who are skilled and have good work discipline at the industrial site. In 2003, the portion of unskilled labor in rural and urban areas was 86.5% and 54.5%, respectively. In addition, there exist problems of work discipline, i.e. frequent absences, high turnovers, and the lack of concentration in the work process. Liberal and unrestricted lifestyle in rural areas might be the reasons for these problems. Furthermore, the employment and working conditions are not attractive enough for workers to stay in the industrial sector. The attractiveness of employment in the urban area may not that much different from that in the rural area.

High unemployment rate among the highly educated youth labor is a big problem. In 2002, the unemployment rate of highly educated youth (15-24 years, 4&2-year colleges) was 10%, due to low demand, which may be partially attributable to the low quality of the education level. Since the minimum wage for college-educated workers is 2.34 times higher than the minimum wage of average workers, reservation wage for this group can hardly decline. Because they have been better educated in the principles of capitalism and market economy than their senior generation, a good strategy is badly needed to make the best use of this generation

Due to the political consideration of possible conflict with the workers, the speed of state owned enterprises (SOE) restructuring and privatization has been relatively slow compared to the reform in agricultural sector. Apart from the privatization of SOEs itself, another issue of major concern in enterprise reform is how those enterprises will transform to operate efficiently and become more competitive. One of the keys to enterprise reform is human resource development in the high-tech sector; that is, a research and development (R&D) workforce who can lead technological development, and a top and middle management workforce who has sufficient business mind and ability to lead a company with efficient management.

Some labor protection regulations are simply ill-advised. In particular, limiting total overtime working hours to 200 hours per year (300 hours for labor intensive manufacturing, e.g. garment) is overly restrictive. Overtime work plays a role as a buffer to ease the burden of regular worker's permanent (long-term) employment. If employers avoid hiring workers with long-term employment, instability of employment and the loss of opportunities to learn and gain skills within the firms will follow. On the workers' side, owing to low salary, workers may desire to work overtime to cover their minimum living expenses. If irrational regulations intended to protect the labor continue to exist and be supported, rigidity in the labor market will increase and thus deteriorate the motivation for capital investment. Its consequences would be unemployment and underemployment, a disadvantage for the workers with absolute poverty.

## *Directions and Strategies for Labor Market Reform*

Assuming that "USD 1/day/person"is the criterion for the absolute poverty line, the poverty rate in Vietnams is still as high as 29% in 2002. Since 90% of the poor people live in the rural sector, the poverty reduction policy should target primarily the labor force in rural areas. The prime strategy should be "job creation."

In the beginning of Korea's economic development, many workers in the absolute poverty range lived in rural areas. Two strategies for both a significant increase in agricultural productivity (known as the "New Village Movement") and the maximization of job creation in the industrial sector were taken. In order to encourage the supply of investment capital (other than attracting foreign capital), the Korean government created a competitive structure for the labor market, which generated larger profits and a higher (lower) propensity of savings (consumption).

Although vocational training institutions in Vietnam have continually increased in number, more vocational training centers still need to be established (especially in rural areas). From the qualitative side, the problem is that the training program is largely supply-side driven. The contents of the curriculum, facility, and quality of instruction all lag behind. For the required skills in small-scale industry (such as garments in the manufacturing industry and motorcycle repairs in the simple service industry), no problem exists in the demand and supply of training, since the low cost of training (short time period) and little financial constraints create enough demand for the training. The low initial investment cost and low entry barrier result in sufficient supply. However, private training for high-skilled and high-tech workers proves to be insufficient.

Whether the government should be actively involved in solving the problem depends on the following three conditions: First, the government should have information about the required (demanded) skills at the industry (enterprise), and have the ability to train the skills (i.e. government should be the technology leader). Second, the government should actively confront the changes in industrial demand and possess enough incentives to provide a high quality occupational training service. Third, the government should have sufficient funds for occupational training investment. Unless the government of Vietnam (GOV) meets the above conditions, completely rebuilding the job training system would be better than considering supplementary measures for the existing public vocational training system.

For solving the problem of lack of work discipline, we need to review the Japanese experience. In Japan, the most important criteria in hiring workers are basic academic skills (i.e. reading and writing and computation, etc.), social skills (loyalty, teamwork, communication, etc.) and learning skills, rather than job skills. Furthermore Japan succeeded in introducing a personnel management system in FDI firms in other Asian countries, which differentiates the benefit and compensations for good and bad performance in worker's attitude, such as work attendance rate. In terms of the problem by Vietnamese workers to tend to return to the rural area rather than staying in the industrial sector for a long period, the Japanese model of lifetime employment can be a good example of making the company a more attractive workplace than the agricultural sector. Companies also have incentives to maintain their workforce for longer periods, since retrieving the cost of training would be impossible if the workers move someplace else after training.

The GOV needs to re-examine the rationality and validity of labor protection regulations. If labor protection weakens the attractiveness of capital investment and thus deteriorates the ability of job creation in the economy, then it will exert a negative impact on the reduction of poverty. Depending excessively on the "government's direct regulation of labor contract," causes the level of legal protection to tend to meet the "desirable average level" and not the "publicly acceptable minimum condition." In the beginning of industrialization in Korea, great dependence existed on the government's direct regulation of the labor contract, resulting in a very high level of legal protection. Since its enforcement was rarely effective in actuality and thus had a minimal effect, it was necessary to redirect the labor protection policy: That is, reducing dependence on the government's direct regulation of labor contract, and recovering the function of collective bargaining as the device of wage determination.

In Vietnam, the five major reasons for labor strikes are summarized as follows: Delay in the payment of wages (including overtime pay), excess overtime working hours, failure to pay social security and insurance, ambiguity of the contents (language) of labor contracts, and failure to pay severance pay. All these reasons are related to violating the legal protection of the "government's direct regulation of labor contract," implying that collective bargaining does not function as a device of wage determination, and the government's direct regulation of labor contract has a limited impact on the current situation.

A key point is whether Vietnamese SOEs are able to transform themselves so as to be equipped with an efficient management system. Foremost, it is important to increase the size of these SOEs in order to enjoy economies of scale in R&D and price advantages. Essential for inducing both size enlargement and managerial innovation is fostering a market friendly environment, where free and fair competition is ensured. In such a market, non-competitive enterprises are eliminated while competitive enterprises can increase their revenue and size through mergers and acquisition. Even with equitization of SOEs, the state still remains their dominant shareholder. If the government has a high motivation to reform the public enterprise sector, they are advised to accelerate the equitization/privatization process.

For a high-tech workforce, the priority should be given to educational reform for excellence in college education. College-education reform is not about improving the hardware (i.e. facility), but mostly about improving the quality of the faculty. Globally competitive foreign companies can supplement and support technical education in Vietnam. Another very important factor is holding and maintaining domestically "produced" high-tech workers within Vietnam, rather than creating a brain drain overseas.

### *Reform of the Vocational Training System*

There are several problems with Vietnam's vocational training system. First, there are only a small number of vocational training facilities for a large number of unskilled workers. Increasing the number of vocational training facilities is especially critical in the rural sector. Second, major efforts should be directed, not to low-level skills that are required in the light or services industries, but to producing high-skills that are much needed, both in terms of quantity and quality, for the development of a heavy industry. Finally, the training curriculum is not up to the need of the industry; facility and training method are obsolete, and the trainers' capacities are not adequately enhanced.

Korea basically followed the Japanese strategy for training technically skilled workers, later supplementing it with a German strategy. Large-scale enterprises were able to train and supply the necessary skilled workers through their own training, but small and medium scale enterprises lacked such abilities. As the government led and expanded vocational training by directly establishing public training facilities, there was limited room for private training institutions to play a role. In order to secure necessary training, the government introduced "vocational training levy" system: requiring large-scale enterprises (with the ability to provide knowledge, facility, and finance) to provide vocational training, and imposing a levy for public training on those enterprises that fail to fulfill this requirement. In order to increase the quality of public training, they attracted talented people by paying much higher wages for the instructors of vocational training centers than the teachers of general education. Furthermore, establishment of a national college for technological education helped to produce more instructors.

However, as time progressed, government failure caused by the principal-agent problem started to occur. Laying-off teachers is a difficult task, and thus, even if there is less demand, the courses continue to be offered for the sake of the teachers. As a result, schools are very reluctant to set up new courses, simply because it gives them new burden. Consequently, vocational programs were too rigid to meet industry demand.

Vietnam can avoid the mistakes Korea made. First, make clear the role of public training, and gradually establish an enterprise-based training system. Second, mandate large-scale domestic and foreign enterprises to train their employees (introducing a vocational training levy system). Third, link industrial, regional, and human resource development policies to promote training by "industrial/regional" sector. Establishment of a "joint training center for each industrial sector" for the training of industry-specific skills can be a good strategy. Fourth, if globally competitive enterprises enter into Vietnam, induce them to establish "enterprise-initiated technology university," where the enterprise directly designs education programs and the enterprise personnel joins the faculty, etc.

### *Reforms for Increasing the Competitiveness of Labor Market*

Reform strategy for the excellence of college education needs to benchmark China's university reform model. The key is to induce colleges to reform Human Resource Management (HRM) of the faculty with full financial support from the government. Note that the government should financially support the selected universities by helping them become world-class institutions. Meanwhile, other universities should operate based on a competitive system. Moreover, the GOV can consider introducing a "credit bank system" to lessen the burden of student tuition and to make universities more competitive with each other.

If the task of training and educating high-level science technology within the country to students proves to be difficult, highly qualified and talented students should be sent to first-rate universities overseas. First, choose, in advance, industrial sectors with urgent demand for top-quality elites and prioritize the national support for them. Second, it might be more advantageous to send their students to semi-developed countries, like Korea. Korea has more technologies and skills that are quickly applicable in Vietnam, and tuition in Korea is much cheaper than other countries.  Currently, many of the students in Korea shun majoring in science and engineering, thereby piquing Korean firms' interest in engineering workers from overseas (especially from developing countries).

Obliging these overseas trained students to work at their home country for certain period of time is not appropriate for preventing brain-drain. Instead, there should be sufficient opportunities and compensations for them to actively participate in Vietnam. In the case of Korea,  research institutes were successfully able to keep well-educated workforces with excellent financial support from the government. However, during the economic crisis in 1997, reduction in R&D budget for the government, as well as business enterprises, resulted in the deterioration in the status and compensation for scientists and engineers. This caused a brain-drain: Many talented domestic scientists and engineers started to move to other countries (especially Silicon Valley in the US). Additionally, there was a tendency for more talented scientists to move first, showing an adverse-selection problem.

Next, re-examination is needed for the subject of "limiting total overtime working hours." Overtime work is an absolutely necessary practice to safeguard permanent employment for regular workers. If conflicts and protests are expected, the government may start a pilot program with a new overtime scheme in a certain region, and expand the scheme depending on the performance of the pilot program.

# 1. Analysis of Vietnam's Labor Market

## 1-1. Insufficient Quantitative and Qualitative Results in Job Creation

### 1-1-1. Insufficient Quantitative Results

Although 20 years has passed since "Doi Moi" started in 1986, the expected job creation has not been successful in the labor market. The problem of underemployment in the agricultural sector and redundant labor in the public sector is present. The fact is, "too many people have been hired," and if more jobs are created and absorb the surplus labor, the labor force can then be distributed more efficiently.

After Doi Moi, there was dramatic productivity increase in the agricultural sector due to recognition of civil property rights for the personal use of farmland and disposal of agricultural products. As a result, the size of redundant labor in the agricultural sector has increased. During 1993 to 1998, the percentage of underemployed labor in the agricultural sector, whose working hours are less than 40 hours per week, decreased from 66% to 57%. However, during 2000 to 2002, the percentage increased again from 47% to 56%, still showing a high level of underemployment (MOLISA: Employment Survey). Employment in the agricultural sector consists of 70% of civilian employment (34,072 thousands employed in 2001, 90.4% of all employment). This means that over 60% of total workers are involved in the production of agricultural products. Therefore, the solution for the problem of surplus labor in the agricultural sector can play an important role in the successful performance of the labor market.[43)]

In the public sector (3,604,000 employed in 2001), the redundancy ratio is estimated to be around 20%.[44)] Surplus labor in SOEs (1) may damage the competitiveness of their industries, (2) may be a barrier to the privatization process, and (3) can encumber restructuring processes after privatization (e.g. mergers and acquisition of privatized SOEs, exit from the market, etc.).

Employment creation in the private sector should be large enough to absorb and solve the surplus labor in the agricultural and public sectors. Most poor people are in the agricultural sector, such that resolving surplus labor in this sector will be a key task for poverty reduction. Resolving surplus labor in SOEs will be the first barrier for the possibility of "sustainable employment through improved competitiveness of SOEs."

43) Nguyen et al. (2005)

44) CIEM (2004)

### 1-1-2. Problems of Qualitative Structure

Job creation in the private sector is not only quantitatively insufficient, but has a structural or qualitative constraint on supporting "sustainable employment creation through industrialization and rapid economic growth."

The first thing that can be pointed out is that job creation in small size companies in the service sector takes up a much bigger portion than from the manufacturing and/or large industry. Investigating the changes of employment structure in the private sector by industry, the manufacturing and construction sector showed only 1% point increase (9% → 10%), while the service sector had a 3% point increase (13.4% → 16.4%) during 1995 to 2001.[45)]

Employment in the service sector is mostly composed of the self-employed and those in small companies in the UIS. Larger employment elasticity in the UIS can help absorb unemployment faster during the period of economic expansion, offering a possible solution to overcoming unemployment in underdeveloped countries. Because of the heterogeneity and the co-existence of upper-tier (relatively high-income self-employed) and low-tier (underemployment) jobs in the UIS, expansion of the UIS is recognized as "employment friendly economic development strategy." In fact, most retired workers from public enterprises successfully re-enter the labor market by self-employment in the UIS with capital accumulation from their previous jobs.

At first glance, although the employment elasticity is higher in the UIS, ensuring that the UIS will bring about technology advancement (i.e. productivity improvement) for self-generating high growth cannot be done. Even though it can temporarily absorb unemployment at the initial stage of economic growth, it cannot be a steady base for sustainable employment generation. Secondly, relative high-income upper-tier may also have a limitation for sustainable employment creation. It is a common experience in other countries that the upper-tier is substituted by formal sector capital in the process of economic growth (e.g. mega-supermarkets of a large corporation take up market shares from local stores). At least, the income creation in the upper-tier is possible by continual demand (consumption) derived from the growth of industry sectors.

High reliance on small and medium size companies within the manufacturing sector will make it difficult for local companies to become competitive in the international market and continue to generate enough jobs. Compared to large sized companies, small and medium sized companies, lacking economies of scale, have a less competitive position in capital accumulation, research and development, and ability to control costs/prices. Therefore, it is important to pay attention to the strategy used by China, where attempts are made to capture the international market through the brands of large companies.

45) Nguyen et al. (2005)

Job creation through FDI is increasing, although it is still insufficient. Therefore, extra efforts are needed to secure more investment in the future. The share of new jobs created by foreign invested companies has greatly increased from 20.6% in 2001 to 28.0% in 2002. However, the absolute size of the employed is only about 200,000.

## 1-2. Advantages and Disadvantages of Vietnam's Labor Force

Looking at the supply of labor, we can summarize the advantages and disadvantages as follows: Quantitatively, Vietnam has a high younger age population, and qualitatively, a low illiteracy rate. However, that there are still an insufficient number of workers who are skilled and have good work discipline at the industrial site is a major obstacle to economic development.

Vietnam's current population is above 82 million people, characterized by a "young" structure with the age group of 15 to 44 years comprising 80% of the total. If we look at the changes in generational structure from 1996 to 2003, the age group of 25 to 34 consists of the highest portion within the population (nearly 30%).[46)] This indicates the necessity to adopt an economic development strategy which can explore the advantage of a young generation workforce in Vietnam.

Vietnam has a low illiteracy rate of 4.3% and the average education level has steadily increased due to expansion in public education. However, the speed of increase still remains slow, and the large education gap between urban and rural areas indicates another problem. Among the workforce, the percentage of high school graduates is about 40% in the urban areas (approximately 8% point increase from 1996 to 2003) and remains at 10% in the rural areas (showing no changes since 1996). Even with a low illiteracy rate, there still are insufficient amount of workers who can maintain and utilize work skills at the industrial sites. The percentage of unskilled labor in the rural areas, where education level is generally low, still remained at 86.5% in 2003 (some improvement from 92.6% in 1996). In the urban areas, the percentage of unskilled workers was 54.5% in 2003, which indicates a moderate decrease since 1996 (68.4%).[47)]

As expected, the share of high school graduates and that of skilled labor show similar trends. Although the percentage of skilled labor is higher compared to that of high school graduates (the difference is greater in 2003 than 1996), their percentage changes showed a similar pattern.

46) However, due to a decrease in population growth rate resulting from gradual low birth rate, the percentage of the young generation has started to decrease. The share of the age group of 15 to 24 was 25.95% in 1996 but decreased to 24.72% in 2003.

47) Nguyen et al. (2005)

Even though school education and occupational skill do not always go together, extending public education such as secondary education (including upper-secondary) can play an important role in producing more skilled workers.

A low level of mental skills, like work discipline, is also a big problem. Frequent absences, high turnovers, and a lack of concentration during work are some of the indicated problems, especially for workers in the rural areas. Liberal and unrestricted lifestyle in the rural areas and people's preference for freedom could be the reasons. Yet, a low education level and low basic social skills (e.g. role playing and adaptation in an organized group) seem to be the main causes of such a problem.

Another weakness, from the worker's perspective, is that the will to work in the industrial sector is not very high; in other words, the average worker does not want to leave the rural sector. This is a somewhat different aspect from work discipline inside the workplace. Even while working in an urban factory and/or urban informal sector, the main goal of many workers is to earn enough seed money to support self-employment back in their rural hometown. However, this may not be an issue of perception. It is likely that the attractiveness of employment in the urban area is not much different from that of the rural area. Compared to other developing countries in the past, the relative attractiveness of urban area against rural area is rather weak in Vietnam. That is, the pull factor and the push factor of migration do not appear large. This might be due to the fact that productivity in the agricultural sector has increased significantly, whereas the urban area suffers from low productivity increase in addition to weak job security. In the past, Japan also experienced this type of phenomenon during their early stage of industrialization. However, the problem was dissolved with the expansion of industrialization and conversion of urban corporations as an attractive place to work.

## 1-3. High Unemployment Rate of Highly-Educated Youth

Unemployment is common in Vietnam's urban areas. Surplus labor in the rural area is not classified as unemployment, but as underemployment. The unemployment rate during 1998-2003 was 6% on average. Although the overall unemployment rate is not considered high, the high unemployment rate of highly educated youth has become a main concern in Vietnam. In the year 2002, the unemployment rate for highly educated youth between the age of 15-24, who graduated from four-year colleges or two-year specialized (technical) colleges, was nearly 10%. Several reasons exist for this phenomenon.

First, considering the fact that demand for labor is a derived demand, lack of sufficient capital investment requiring higher levels of technique or a highly-educated labor was present.

Second, even though the number of college graduates has increased, the quality of education level remains very low.[48] Albeit capital investment involving high-tech is made, companies have been reluctant to hire local college graduates as engineers or managers at the industrial site due to their weak qualifications.

Third, job opportunities in the public sector for highly educated young workers have shrunk. This is mainly because the public sector is not as attractive as before: As the leader of Vietnam's industrial sector, SOEs have not been successful in their business performances. Another contributing factor is that Vietnamese SOEs have been stringent in securing the employment of insiders until their retirement ages of 60 for males and 55 for female workers.

Fourth, although highly-educated youth could lower their expectations and find a low-income occupation, employers find it difficult to hire them, since the minimum wage for college-educated workers is 2.34 times higher than that of average workers.

College graduates under 25 years old are the first generation who received education post-Doi Moi. Their education incorporated to a greater degree the principles of capitalism and market economy, compared to their senior generation. Therefore, an effective strategy is recommended to make the best use of this generation. The GOV should make its best effort to attract more foreign investment, accelerate SOE equitization/privatization and restructuring, and improve the quality of college education. After all, a generation shift in labor market needs to be facilitated.

## 1-4. Deficient Enterprise Reform and Lack of High-Tech Workforce

The privatization of SOEs and the reform in the agricultural sector (land) are the main policy objectives of Doi Moi. The reform in the agricultural sector, which allows land private utilization rights, significantly increased productivity.[49] The privatization of SOEs in the industrial sector is expected to overcome past failures and bring high profit. The government needs to consolidate unsuccessful SOEs and privatize relatively cost-effective SOEs.

However, due to ideological orientation and political consideration of possible conflict with the workers, the speed of SOE restructuring and privatization is relatively slow compared to the reform in the agricultural sector. The government needs to consider possible opposition of the workers to mergers and acquisition, and equitization of SOEs, which could lead to unemployment and loss of employee benefits.

48) Some are arguing that the quality level is not much different from that of high schools. Interviewed government officials in Vietnam are basically of the same opinion. They are suffering from a low quality trap.

49) The land distribution to farmers was almost completed in year 2000 and the average income of farmers increased by 60% during the 1993–98 period).

The GOV is not only controlling the speed of privatization, but is also trying to ease conflict with the workers by sufficient financial compensation for early retirement. The legal base of the government's compensation for firing surplus labor is Decree 41 circular 11. The following are the main contents[50] of this decree:

(1) Target enterprises (six types of enterprises): 100% state-owned SOEs, state-owned limited liability companies, privatized enterprises where the state is still the dominant shareholder, SOEs acquired by other SOEs, bankrupt SOEs, leased SOEs (owned by the state, but operated & managed by private managers)

(2) Three cases of compensation for early retirees:

① Workers with the age of 55-60 years for males and 50-55 years for females who will retire within 5 years and contributed 20 years of social security (national pension)

- Provide rights to receive full payment of pension (70% of average monthly salary before retirement) even though he/she retires early (note that, in the past, pensions were paid after deducting 1% for each year of early retirement).
- For each year between normal retirement and early retirement, 3 months salary of early retirement compensation (bonus) is paid.
- Additional bonus payment of [5.5 months salary] × [tenure – 20 years]

In estimating a male worker who entered a SOE at the age of 25 years and retires early at the age of 55 years, he will receive a total of 70 months early retirement bonus [adding early retirement compensation (=3 months × 5 years=15 months salary) and an additional bonus (5.5 × (30 years – 20 years)=55 months salary)] without losing his pension. This amount is larger than the salary he will receive if he does not retire early and continues to work until he reaches 60 years old (= 5 years × 12 months = 60 months).

② Workers at the age of "less than 55" for males and "less than 50" for females

- Payment for unemployment compensation: One-month salary for each year of continual employment (i.e. tenure)
- Fixed bonus payment for about USD 330
- Additional allowance payment of 6 months salary for job search
- Free 6 month training at a public vocational training school (or center)

③ Near retirement workers at the age of 60 years for males and 55 years for females who have contributed 19 years of social security

- Government to pay one year's (20 years 19 years) social security payment to secure the rights to receive full 70% of average monthly salary as pension.

In order to compensate early retiring surplus labor, THE Redundant Worker Supporting Fund (RWSF) was prepared by Ministry of Finance (MOF). Surplus labor ratio was estimated to be 20%, and the fund was financed by general government budget, ODA and other funds. The size of RWSF is VND 400,000 billion. So far, VND 2,000 billion has spent on subsidy for redundant

50) Information was obtained from an interview with a local expert working for DSI and from CIEM(2004).

labor of SOEs.

The reason for paying "not too much subsidy" until now is the fact that equitization has been concentrated on small and medium sized enterprises and the qualifications for the subsidy were more restricted before than now. If large scale SOEs are privatized in the near future, subsidy payment will increase at an accelerated rate. However, the MOF does not worry much about the size of the fund, since the redundancy ratio is expected to be relatively low (lower than 20%) due to improved business performance.

With adequate compensation for unemployed workers in the restructuring process and the slow speed of equitization, SOEs equitization has progressed with minimal conflict with the workers. According to a survey in 2003, most unemployed workers resulting from SOE privatization process found other jobs within 3 months. The slow process of privatization gave enough time for the private sector to create jobs to absorb people discharged from SOEs. Also, there have been many cases where early-retired workers, who received sufficient compensation, utilized their savings as seed money to enter the upper-tier UIS, where they could secure high earnings.

However, an important issue for enterprise reform is not only in the privatization of SOEs, but how those enterprises transform to operate efficiently and become more competitive to survive intensified competition with other private firms and foreign invested companies. In order to ensure this end, privatized SOEs, other private companies, and foreign invested companies all compete in the same business and legal environment, while the Common Enterprise Law has been drafted and is expected to be implemented soon.

The GOV must realize that enterprise reform is incomplete and the privatization of SOEs is only in the early stage. Particularly, it needs to resolve the following two issues. First, if serious efforts for internal management reform exist, what are the core elements and what assistance is needed from the government Second, if  some companies face a poor prospect of survival, how should they be restructured

As one of the most valuable resources in a company, the quality of human resource should be improved for successful enterprise reform in Vietnam. The main bottlenecks for Vietnam's economic development are the lack of a R&D workforce, who can lead technology development and a top and middle management workforce, who are able to initiate managerial reform with an adequate business mind. Since the Vietnamese economy used to be based on agriculture and socialism, it has not been able to build-up a high-tech workforce.

On the other hand, the GOV should also keep in mind that bureaucratic corporate culture in SOEs had been one of the main bottlenecks to cultivating skilled workers. It is still true that SOEs (as well as the government) are the most attractive workplaces and have many of the first-rated workers of Vietnam. With job security, managers and employees do not have much incentive to develop their job skills.[51] In an environment where not much effort is needed for management improvement, most of the tasks for HRM were misdirected in the past, lacking rationality and fairness.

## 1-5. Ineffective Labor Protection Regulation and Labor Market Rigidity

The legislative system to protect the labor can be divided into: The “right of organization & collective bargaining” and the “government’s direct regulation of the labor contract.” The idea of right of organization and collective bargaining is to complement the labor’s weakness in bargaining power through labor unions, but, not to interfere with the process and contents of the labor contract to be settled between labor and management. However, the government’s direct regulation of the labor contract is to support workers, who are not protected by right of organization and collective bargaining, by setting up a labor standards law for socially acceptable minimum working conditions. The latter has the weakness of inflexibility, and the former has the weakness that it might increase the inequalities of labor income.

Tax-based social insurance system is also an institution to protect workers. Unemployment insurance has not been introduced in Vietnam; however a social insurance system to cover pension, sick and maternity salary, workplace injury and retirement compensation has been created.

Vietnam’s legal system to protect workers was established in 1994 with the Labor Code, which clearly identified the employer and the employee, and provided a basic foundation for the general framework of labor-management relations. It was revised in 2002 towards a stronger protection of labor.

In the current situation of Vietnam, There are some concerns as for the range and effectiveness of protection by the legal institution.

① Enterprise with over 10 employees must have a labor union division attached to the Vietnam General Confederation of Labor (VGCL) before 6 months of its history, and the employers have the duty to help with the workers’ organizing effort.

Yet most the domestic private companies in Vietnam have fewer than 10 employees, or operate in the UIS. As the result, only 10% of Vietnam’s workforce has joined their labor union. On the other hand, 90-95% of SOE workers, 600,000 domestic private companies’ workers (30%), and 350,000 foreign invested companies’ workers joined the labor union in 2002 (data

51) In Korea, many of first-rated workers in the banking industry used to enjoy high pay and job security. In this environment, most of them didn’t have much opportunity or motivation to improve their knowledge and skills to become a real banker. As a result, when they became unemployed in the midst of financial crisis in 1997, they didn’t have qualifications to get another job.

from US embassy in Hanoi).

② Employers, with over 10 employees, and the workers have to pay 15% and 5%, respectively, of the salaries for social insurance.

The system has its limitations, as it does not apply to most of the workers in the rural and urban informal sectors. Among the qualified 9.6 million workers, only 5.4 million workers (56%) have social insurance. Especially, domestic private companies are small and regionally dispersed, so that enforcement of labor inspection is almost impracticable. From the workers' standpoint, current salary barely covers the minimum living expenses, thus causing them to tend avoiding social insurance payments - forced saving for a future retirement fund. With the legislation reform in 2003, enterprises with employees fewer than 10 workers were attempted to be included in the above scheme. However, its practical effectiveness is highly questionable.

③ Total overtime working hours are limited to 200 hours per year (with exceptions for the labor intensive manufacturing sector, such as garment and leather, where the limit is 300 hours per year).

Applying 50 weeks per year, 200 (300) hours of overtime per year amounts to 4 (6) hours per week, which is very restrictive. For employers, overtime work plays as a buffer, easing the burden of hiring regular workers (with a permanent or long-term contract). Thus, it is possible for the employers to avoid hiring workers with a long-term contract. This is not good for workers: Job security as well as the opportunity to learn skills more systematically within the firm are lost. Additionally, from the workers' standpoint, they may desire to work overtime to supplement their low salary, often at below the subsistence level. If this irrational regulation to protect the labor continues to exist or is strengthened, rigidity will increase in the labor market and deteriorate motivation for capital investment. The consequence will be higher unemployment and underemployment, which is likely worsen the situation of workers in absolute poverty.

# 2. Directions and Strategies for Labor Market Reform

## 2-1. Poverty Reduction through Job Creation

The prime national objective of Vietnam should be poverty reduction, which ensures the survival of people - a major responsibility of the state. Any economic development strategy that is not able to alleviate poverty is meaningless. Most economists agree that poverty reduction is more important and should be given higher policy priority than correction of income inequality.

For the past 10 years, Vietnam's economy demonstrated a significant improvement under poverty reduction. Assuming "USD 1/day/person" as the level of absolute poverty, 58% of all citizens were in poverty 10 years ago, but the share decreased to 37% and 29% in 1997 and 2002, respectively.[52] Still 30% of all citizens live in poverty. In the rural sector, the poverty rate is 35.6%, much higher than 6.6% in the urban sector. About 90% of the poor people live in the rural sector.

Therefore, Vietnam's poverty reduction policy should primarily target the labor force in the rural area. Since poverty results from the lack of employment opportunity in this region, the prime strategy should be job creation. Due to fixed land endowment and limited productivity increase, the prospect of job creation in the agricultural sector is not bright. Hence, reliance on the manufacturing and service sectors for a large-scale employment creation needs to be taken.

If government policy places higher priority on protecting the income (salary and employment) of existing workers (i.e. insiders) in the industry and service sectors rather than creating new jobs, both poverty and income inequality might be worsened. Most of the insiders with secure income are no longer in the poverty line. The likely victims from the policy of protecting insiders with its negative impact on investment and job creation - are underemployed poor people in rural area, the outsiders.

Of course, more jobs will be created and wages will increase in the course of sustained economic growth, which will go a long way towards poverty alleviation, and, hopefully will improve income inequality as well. In the early stage of Korea's economic development, many of the poor people lived in rural area. Korea carried forward with two strategies simultaneously: Drastic increase in agricultural productivity (mainly through the New Village Movement) and maximization of job creation in the industrial sector.

One of the main constraints on rapid industrialization (which enables job creation) in Korea was limited investment capital. In order to attract investment capital, the Korean government

52) Nguyen et al. (2005).

made an effort to keep the labor market competitive, taking a non-labor friendly policy, so that wages were determined by the competitive supply and demand conditions in the labor market, rather than through a negotiating body. Low wages certainly encouraged more investment which contributed to job creation. Higher investment activity could be financed through increased domestic savings resulting from larger business profits and a higher income level.

## 2-2. Focus on Large-Scale Manufacturers for Strategic Job Creation

First, the focus of job creation in industrial sector should be on large-scale manufacturers. They are the source for sustained rapid economic growth through market expansion and technology development, with an advantage in capital accumulation and economies of scale. Although traditional services in the UIS have larger employment elasticity, job creation capacity in this field depends largely on sustainable income generation in the industrial sector.

First, the manufacturing industry produces tradables with the potential for penetrating the vast international market, and result in consequent high growth. Thus, the prospect for job creation is high in the manufacturing sector, although its employment elasticity is lower than that of the service sector. Considering the indirect effect of job creation through larger linkage effects of manufacturing, the long-term employment elasticity may not be necessarily low. Finally, labor productivity growth from technology development in the manufacturing industry can facilitate the creation of higher-paying jobs in the long-run.

Second, within the manufacturing industry, a large-scale based development strategy should be pursued. Small and medium scale firms cannot have the advantage of economies of scale in production. Furthermore, this strategy is needed in order to build up corporate brand power, since Vietnamese manufacturing firms have to compete in the international market, especially with Chinese firms.

Third, job creation in the manufacturing sector by FDI is especially critical. Increase in foreign direct investment not only creates more job opportunities, but can also be a dynamic force for sustainable growth through the transfer of advanced technologies and management skills.

It can be a great advantage for Vietnam, with an abundant young labor force, to promote a manufacturing-based job creation strategy. However, to make this strategy effective it is essential to improve worker’s job skills and work discipline. In that sense, the importance of labor-intensive light industry growth should not be underestimated. In the process of light industry growth, basic management skills for production management and cost analysis can be developed as well as work discipline, which are foundations for heavy industry growth.

## 2-3. Resolving Bottlenecks in Job Creation

### 2-3-1. Supply-Side Bottleneck: Unskilled Workforce

As we mentioned in the previous section, Vietnam's advantage is possessing a young labor-force and a low illiteracy rate. However, even with this advantage, skilled workers are in short supply, which presents a major bottleneck in industrialization. In order to break this bottleneck of insufficient skilled workers, there should be effective vocational training programs for unskilled labor.

Although vocational training institutions have continually increased in number, more vocational training centers still need to be established in Vietnam. Especially, if new industrial sites are established in rural areas, the vocational training centers are absolutely needed to supply the necessary workforce. On the qualitatively side, the problem is that training programs are designed mainly with the supply-side considerations in mind, often hardly justifiable from the side of demand. The contents of curriculum, facility, and quality of instruction are largely obsolete in many training centers.

Currently in Vietnam, necessary (low level) skills in small-scale industry (such as garment in the manufacturing industry and motorcycle repair in the simple service industry) can be learned at a reasonably low cost within a short period of time. Thus, demand for training is strong with few financial constraints. Considering the current stage of economic development in Vietnam, the expected benefit of training is greater than the cost for training. Moreover, there will be enough private training centers that provide this type of training service. Low initial investment cost together with the relative ease of mastering the necessary skills make the entry barrier low. Currently, there are many (about 400) private training centers in Vietnam, and trainees are directly paying the costs of training hence the market works.

However, the cost of training is relatively high and the period required is quite long (at least one year) for most skills needed in the heavy industry (machinery, electronics, etc.), information technology, and other high-technology fields. Thus, demand for training is restricted by the limited budget of trainees. Moreover, what are taught are not easy skills, and the training requires a large amount investment, creating a high entry barrier to the high-skilled training service. Thus, training service for this type of skills by private institutions tends to be insufficient.

Eventually, in order to solve the problems of insufficient private training for high-skilled and high-tech workers, the government should be actively involved. The most active model used by the GOV is the direct development and delivery of public training programs at heavily subsidized cost to create enough demand for training.

Theoretically, government intervention is justified for overcoming market failures due to externalities. That is, in the case of the occupation training market, private benefit is smaller than social benefit, leading to underinvestment and undersupply of occupational training. Not enough social demand exists due to low profitability and lack of private market participation. However, in order for this model of government intervention to be efficient, the following three requirements should be fulfilled:

First, government should have the information about the required/demanded skills at the industry or enterprise level as well as the ability to train exact skills. In other words, the government plays the role of technology leader. If private training centers do not have such skills, then the role played by the government is all the more important. Second, the government should actively monitor changes in industrial demand and have enough incentives to provide a high-quality occupational training service. Third, the government should have adequate financial resources for occupational training.

If above requirements are not fulfilled, government involvement may cause serious negative side-effects. It is not easy to evaluate the current situation in Vietnam concerning the above requirements. However, some comments may be made on certain important issues.[53] Private training institutions still do not have much experience and ability (information, knowledge, etc) to provide high-skill occupational training, while the government has information about the general and average level of standard skills in the industry. Currently, occupational training is conducted at public vocational schools (only 34 private schools among 234 vocational schools). The GOV recognizes the inadequate role they play for high-tech skills, especially for skills needed by foreign companies. There are many cases where enterprises train their workers internally for high-tech skills.

The responsible agency for public job training is the Ministry of Labor, and the instruction is conducted completely by government officials. Since the public sector is a relatively attractive place to work, the basic quality of government officials is generally superior to workers in the private sector. However, there are concerns as to the efficiency of service due to organizational rigidity, bureaucratic culture, monopolized service, and the (in)ability to catch up to the fast-pace of industrial demand. According to the GOV's internal evaluation, the training program's curriculum has been far off target from industrial demand. This does not mean that the government is unable to train high-tech skills. Yet even for standardized medium-level skills, the training institutions' curriculum responds rather slowly to new standardized skills. Some argue that the curriculum cannot be improved due to inadequate budget and a deteriorating training facility. However, experiences of other countries show that the fundamental causes of obsolete curriculum and facility are the absence of an updating system for personnel knowledge. The GOV plans to increase the participation of industry people in improving educational training in public vocational schools.

53) General Department of Training (2005)

Educational training has the highest priority in Vietnam's national policy agendas and budget allocation: The educational training budget in 2000 accounted for about 15% of the total budget. However, no separate funding exists, such as the levy for vocational training in Korea, therefore mostly relying on overseas finances, such as the ODA fund. The country lacks adequate and stable finance in this field.

Hence, in Vietnam, the limitations of national job training programs are the inadequate capability to produce high-tech workers, alienation from industrial demand, rigidity of the programs, and failure to secure adequate financial resources.

In order to solve above problems, completely rebuilding a job training system would be better than making supplementary changes to the current system. This view is based on the experiences of other countries including Korea, as well as on new trends in the job training system.[54] Temporarily, in the early phase of economic development, the cost of government failure might be smaller than the benefit from the government's leading role. However, this benefit-cost relationship will be reversed in the process of development and industrialization.

### 2-3-2. Supply Bottleneck: Lack of Work Discipline

This bottleneck of poor work discipline is especially serious for workers with rural background, and often has something to do with their consciousness and social skills.

First, work discipline problem inside of workplace such as frequent absences, high turnover, and lack of concentration during work process is often a signs of an incomplete break away from rural life style and lack of education. The most competitive manufacturing countries like Japan do not have many job training institutions. Workers are trained for their job skills after joining their companies. Hence, the most important decision criteria in recruiting new workers are not job skills, but are basic academic skills (reading and writing and computation, etc.), social skills (loyalty, teamwork, communication, etc.) and learning skills. They strongly emphasize the importance of formal (humanity) education and forming a close relationship and network with top-tier schools to hire their future employees.

Hence, Vietnamese educational institutions have to upgrade their standards of teaching all these skills in the long-term. In the short-term, however, greater attention should be paid to changing the mentality of students. In addition, a personnel management system that differentiates the benefits and compensations for good and bad performance in worker attitudes needs to be introduced. Extra compensation for perfect attendance and continuous work is a simple incentive that can be introduced. Successful cases have been reported in other developing countries by implementing this type of HRM method.

Second, tendencies exist of not staying in the industrial sector for a long period and for a

54) Refer to the details in section 3-3 and 3-4.

preference to return to the rural area. This preference or behavioral pattern may be attributable to a lack of attractiveness for the industrial/urban sector. Since rice can be cultivated three times a year on the same paddy in Vietnam, workers' behavior will change only if earnings from the industrial sector surpass those of the agricultural sector.

As a way of solving this problem, the Japanese vision of life-time employment can be a good example. In the early stage of industrialization in Japan, companies attracted workers away from the rural area. However, they had difficulty in holding them in the industrial sector, since many of them preferred to return to their rural hometown. Since companies directly trained their workers, economic losses ensued in being unable to retrieve training cost when the workers left the companies after being trained. This phenomenon was stopped when Japanese companies adopted a long-term employment strategy.

### 2-3-3. Demand-Side Bottleneck: Labor Protection Regulations

The enactment of the Labor Code has a significant role in the establishment of a legal base for labor-management relation. The question, however, is how much it contributes to the actual protection of workers, and to the national priority of poverty reduction. It may provide limited protection with little impact on workers in the agricultural sector, the UIS, and small-scale businesses. This may be simply because the law is often not observed which, in turn, is due to the fact that the law is far apart from the actual labor market situation. It is very difficult to oversee all the workplaces, and, as Korea experienced, there is possibility of bribery, even if the manager has already been caught for violation. Even though legal protection for SOE workers has actually been given until now, it may not be taken for granted in the future when market competition intensifies and surplus labor keeps flowing into the urban sector.

Labor protection provided by the law may reduce the attractiveness of capital investment and weaken the ability of job creation in the economy. This will have a negative impact on fighting poverty, which is largely a rural problem. Due to difference in working conditions in the urban and rural sectors, labor mobility will slowdown and efficient resource allocation in the labor market cannot be attained.

It is necessary to re-examine all labor protection schemes in Vietnam. Above all, a strategic assessment is necessary to determine the relative dependence on "right of organization and collective bargaining" versus "government's direct regulation of labor contract." Vietnam currently has a legal system that gives seriously considerations to the former. However, in reality, it depends mostly on the government's direct regulation of the labor contract. Collective bargaining fails to be the main device for wage determination. In the case of SOEs, where stable labor union is established, wages have been decided entirely by the Ministry of Labor. Wage level for majority labor has been decided at the minimum wage, or at a slightly higher level.

If excessive dependence on the "government's direct regulation of labor contract" is made, then the level of legal protection tends to be the desirable average level, and not the publicly acceptable minimum condition. It is a general rule that the state should protect the minimum working condition by law, and that, beyond this condition, the state should allow the conditions to be determined through collective bargaining. However, legal protection of promising an average level of working condition cannot be adequately enforced in the realities of Vietnam. In the beginning of industrialization, Korea also depended mostly on the government's direct regulation of the labor contract with the legal protection set at a very high level. As a consequence, it was hardly enforced in reality and had only a minimal effect.

Accordingly, it is necessary to redirect the labor protection policy by reducing its dependency on the government's direct regulation of labor contract, and to recover the negotiation function of collective bargaining. Currently in Vietnam, there are several reasons for labor strikes: Delay in payment of wages including overtime, excess in overtime working hours, failure to pay social security and insurance, ambiguity in the contents (language) of labor contracts, and failure to pay severance pay. All these issues are a violation of the government's direct regulation of the labor contract, implying that collective bargaining does not function as a device for wage determination, and the government's direct regulation of labor contract has limited impact on the current labor situation.

## 2-4. Challenges for Improving Competitiveness

Efforts are needed to improve the ability of job creation in SOEs after privatization/equitization. A key point is whether SOEs are able to reform themselves to be equipped with an efficient management system.

What are the important factors for an enterprise's internal management reform First, it is important to increase in size. Large firms have absolute advantage for technology innovation and price competitiveness. In order to increase the size of enterprises and develop the ability for restructuring old SOEs simultaneously, the GOV needs to foster a market-friendly competitive environment. Firms without competitiveness will be eliminated from the market, and competitive firms may get larger through M&A. In spite of efforts to privatize/equitize SOEs, the state remains as the dominant shareholder in many enterprises. The GOV needs to step up these efforts, if it has strong motivation for reform.

The extent of employee retrenchment may have to be expanded in the course of enterprise restructuring: Exit, M&A, belt-tightening management, equitization and privatization, etc. If the government wants to accomplish smooth downsizing with minimum conflict with workers, it needs to prepare, in advance, the funds to adequately compensate job-losing workers. If necessary, it should consider increasing the current Redundant Worker Supporting Fund (RWSF).

Second, high-tech workers are essential for enhancing the competitiveness of Vietnamese enterprises. They may be distinguished into R&D human resource for technology advancement, and top and middle management, who have a keen business mind capable of leading the enterprises. Since high-tech workers are trained through high education, educational reform is needed for excellence in college education. What is critical is not an improvement of the hardware (i.e. facility), but upgrading the quality of the faculty.

The first task is to improve the personnel management system of the faculty. Even with reform of hardware and institutions, excellence in education cannot be guaranteed without a high quality faculty. Since the faculty cannot be produced domestically, the government should have a program for selecting talented students and supporting their overseas study.

Active utilization of foreign companies should also be pursued as an educational base for supplementing and supporting technical education. The GOV needs to consider the strategy of inducing foreign companies to establish a facility for R&D and engineering education. It is also important to produce a high-tech workforce through a retraining of the existing workers, especially for management ability rather than engineering skills.

A policy effort is needed to prevent a brain drain overseas, by holding and maintaining produced high-tech workers inside Vietnam. The state should become an employer of high skilled workers, retaining them with adequate compensation. This strategy provides talented people with a strong incentive for more educational investment. Moreover, privatized SOEs need to provide incentives in favor of high-tech workers with significant change in corporate culture and HRM.

## 2-5. Revitalization of Labor Market

In order to reduce the surplus labor in the agriculture and the SOE sector, it is important to provide a favorable environment for smooth labor mobility across sectors as well as for creating new jobs. Talented and high-skilled workers should be able to move to more productive sectors. To realize this, wage differentials should reflect differences in productivity among the sectors. That is, wages should play a role as the reliable price in the labor market. Various HRM schemes and practices (i.e. hiring, pay determination, promotion, etc.) should be reformed realistically to fit the market economy. Some flexible wage schemes may be considered, such as contingent pay, productivity-based compensation, and skill (or knowledge)-based pay.

As more opportunities are given to skilled and capable workers, the labor market will be revitalized. It is important to provide more job opportunities for young and highly educated workers (encouraging a generational shift in the labor market). Capital investment requiring high level technology and highly educated workers should be increased. Further SOE restructuring will lead to more employment opportunities for young new entrants to the labor market.

# 3. Reform of the Vocational Training System

## 3-1. Vietnam's Current Situation

There seem to be some problems with the Vietnam's vocational training system. First of all, there are only a small number of vocational training facilities for a large number of unskilled workers. The number should be increased substantially, especially in the rural sector. Second, the training of high-skills required for the development of heavy industry is much more in need, in both quantity and quality, than the training of low skills required in light or service industries. Finally, more often than not the training curriculum is out of touch with industry demand, facilities and training methods are obsolete, and trainers' capabilities are not upgraded. In order to address these problems, the GOV plans to pursue the following political strategies:[55)]

(1) More funds for investment (on facilities, etc.) will be mobilized to strengthen training both quantitatively and qualitatively. Budget for education training has increased from 15% of the total national budget in 2000 to 18% in 2005, and is planned to increase to 20% by 2010. Also, local governments, foreign enterprises, and the donor community will be encouraged to give priority to this area.

(2) More private participation (so called social partnership) will be encouraged in educational training: Encouraging the establishment of more private schools, converting some public schools into private schools, and requiring each industrial complex to establish a job training center.

(3) International cooperation will be strengthened through project-based fund support: Establishing high-tech centers, supporting joint project for research development or education, and strengthening cooperative partnership between international institutes and Vietnamese counterparts for joint-establishment of foreign education institutions - college-level education institutions, vocational training schools, distant learning center, etc.

(4) Stronger efforts will be made to meet industrial demand: Supporting the design of job training based on manpower demand forecast, making training compatible with standardized industrial technologies, enhancing cooperation between industry and education, recruiting industrial personnel as training instructors and/or inducing their participate in the design of training curriculum, and evaluating the level of graduates.

(5) Training methods will be improved: Shifting from the standardized timetable method to the module method, breaking out from the cramming method, and retraining teachers.

(6) Administration reform in education will be pursued: Promoting autonomy and accountability of local governments and educational institutions, making efforts for standardization, and increasing the transferability between vocational education and general education.

55) General Department of Training (2005)

These strategies for Vietnam's vocational training reform are generally sound. However, there is room for improvement in the following issues. Although increased mobilization of funds is undoubtedly essential, strategic considerations seem to be lacking about how to utilize the funds for an efficient vocational training system. The direction still remains in the public sector's lead with an eye to increasing the participation by private institutions. It is questionable whether the public sector in Vietnam is really able to educate high-tech skills and to have enough internal flexibility for efficient management. Most developed countries experienced a failure in this area. Therefore, serious consideration is needed on whether it is desirable to have the GOV as a leading body. Also, there is no blueprint on direct participation of enterprises rather than private education facilities. Experiences in developed countries indicate the possibility of overcoming government failure to some degree with the utilization of private education facilities. However, there was much limitation in private training institutes to meet the rapidly changing industrial demand.

## 3-2. Theoretical Discussion on Vocational Training

### 3-2-1. Characteristics and Types of Skills

Skill cannot be traded or transferred, and can only be accumulated within humans. Training centers provide the necessary skills to trainees, rather than to the enterprises directly. The enterprises receive the supply of skills in the form of labor demand. Even if the training centers provide similar training programs, the effects (skill accumulation) can be different depending on the trainees. Accumulated skills can also be physically depreciated (due to deteriorating physical strength and intellectual power), or obsolete by the advancement of technology as time passes by.

First, base on the specialty (or scope) of the job, the types of skills can be classified as job-general skill and job-specific skill. Vocational training and qualification system are concerned with job-specific skills, while formal schooling, especially elementary and secondary schools, is the educational ground for job-general knowledge.

Job-general knowledge itself can affect productivity if we can assume that the higher the level of general knowledge, the higher the learning ability of professional (job-specific) knowledge. Since it is very difficult to estimate the economic value of general knowledge compared to professional knowledge, it is not easy to fix a price for educational training services.

Second, the type of skill is based on its effectiveness with a specific enterprise. If a skill is effective with a specific firm, it is called as firm-specific skill. It is called (firm) general skill when it is effective with a variety of firms. The main body to support the cost and to supply the vocational training can be decided depending on the degree of the firm-specificity of skills. The trainee bears the cost for firm-general skills, and both the trainee and the enterprise bear the cost for firm-specific skills (due to the existence of a bilateral-monopoly relationship). For firm-specific skills, the employee does not make a separate payment for the training cost. However, since the wages after the training is set lower than the productivity (provided that it is set higher than the opportunity wages or productivity before the training), the employee is in part taking a share of the training cost. Firm-general skill is trained by a professional training center in the training market and firm-specific skills are learned through on the job training (OJT) inside the enterprise.

Firm-specific skills can diversely appear within the 0 ~ 100% spectrum. We may also need to focus on industry-specific skills. In the case of a competitive industry, the industry-specific skills can be the general skills of enterprises within the industry. For instance, an airplane pilot is an industry-specific skill specialized for the airline industry. However, within the industry, it is useful skill for all airlines. In fact, industry-specific skills can be defined as job-specific skills as well as firm-general skills.

<Table 3-1> Types of Skill

| | Job-General | Job-Specific |
|---|---|---|
| Firm-General | General skill (language, computation, cooperation, etc.) | Industry-specific skills |
| Firm-Specific | Multiple skilled (e.g. butler, etc.) | Firm-specific professionals |

In the training market, there exists a high possibility of underinvestment. Due to the existence of a gestation period of training investment, more uncertainty exists compared to other markets, and the market may be vulnerable to a shrink in its size as well. Return on training investment by enterprises may be difficult to recoup if there is a strong tendency of labor mobility. Fast-paced technology development is another reason why firms might have difficulty in recovering the cost of training.

### 3-2-2. Principle of Financial Support for Vocational Training

In the case of vocational training for general skills, it is a general rule that the trainee (student) is fully responsible for the training cost. However, the trainee may have difficulty in paying the training cost due to his/her budget constraint, and, may make inadequate investment on vocational training. If some general skills are considered to be necessary for the welfare of the nation or for each citizen, the government (state) may bear a part (or whole) of the cost.

In the case of firm-specific skills (for which enterprises train current or potential employees to meet their own needs), enterprise and employee share the cost. If more active vocational training investment needs to be promoted, forced savings of budget for training investment through a social insurance system can be one of the possible strategies. In the case of Korea, the

Employment Insurance (one of the four Social Insurances, the other three insurances being the National Pension, Medical Insurance, and Worker's Compensation) includes forced savings for vocational training cost for current workers (i.e. the insured) as well as premium for unemployment benefit. This scheme solves the problem of budget constraints and consequent underinvestment in training. In addition, an income redistribution effect can be expected by utilizing social insurance, as enterprises in economic hardship can receive insurance (financial support) in a greater amount than that which they have paid.

In the case of industry-specific skills, the incentive to bear the cost by employees could decrease considerably, if there is no guarantee that it leads to employment in the corresponding industry. Enterprises may also avoid investment in the skills of high firm-generality due to uncertainty about recovering their investment (i.e. the risk of being poached). So, in addition to the strategy of financial support for mutual liability in enterprises' investment risk, it is important to make the trainees bear the cost by increasing the chance of participating trainees' getting a related job after training.

### 3-2-3. Importance of Vocational Training Initiated by Enterprises

The higher the firm-generality of the skills (the more socially demanded industry-specific skills), the more active role the government should play to secure a sufficient level of education investment. The government's role is necessary not only to cope with enterprises' reluctance to invest, but also to support the less fortunate class, who has the most difficulty in finding a job and getting training. However, even in this case, it is more effective to support the government budget to the "most capable institutions" (regardless of whether it is private or public), instead of the public sector being directly involved and establishing training programs as it did in the past. It is also necessary to carefully evaluate the direct involvement of the enterprises.

When enterprises are directly involved, the problem of training institutions' not knowing about the necessary skills required by the enterprises (i.e. incomplete information on the details of demanded skill) can be resolved. The training tends to be more appropriate. In the case of training for skill-upgrading, enterprises have the most information for the currently employed, and also know much about job-losers' training need for subsequent reemployment.

The main objective of trainees for training is employment rather than learning itself. Therefore, when the labor (skill) demanding enterprises are involved as the main body for training, there will be a higher level of response by workers (i.e. a higher training demand).[56] Participating enterprises may also be involved in selecting the trainees, which can increase the possibilities of linking the training (internship) process to employment. However, evaluation of private training institutions seems to be rather imperfect, even if the index of trainees' success

56) Then, the size of training program will be larger and trainees will be more willing to shoulder the training cost, reducing the net cost of training delivery .

in employment is used as the criteria (as verified in England). Furthermore, even though we assume that perfect evaluation is possible, the time lag involved and the fast-paced advancement of technology will make the evaluation very challenging.

Firm-specificity of a particular enterprise can be expressed as its dominant position regarding technology and market share within the industry. It may be actively involved in training of even firm-general skills. Due to the fact that its wage rate is higher than other enterprises within the same industry, and/or the technology levels of other enterprises are inferior, the possibility of poaching by other enterprises may be low. For example, Korea's POSCO established a specialized vocational high school to train its own workers.

However, in industries where the small and medium scale enterprises are dominating in a highly competitive environment, the possibility of an enterprise's own training investment can be hardly expected. Thus, it is necessary to promote a "joint training strategy at the industry level" to train industry-specific skills. First, due to the risk of being poached by other enterprises, enterprises hesitate to invest in their own training. All enterprises might be interested in poaching skilled workers from other enterprises, so the "joint training strategy" can be a solution, sharing both required capital and the risk. Second, if the enterprises' network for training becomes a potential "workplaces (employment promotion) network," workers will probably join the training more actively. Third, economies of scale in training will reduce the training cost and lower the burden for individual small and medium scale enterprises, which leads to participation of more enterprises.

For skills that are not easily trainable by small and medium scale enterprises themselves, transfer of skills to these enterprises can be accomplished under the guidance of large scale enterprises. It would be much more efficient than a public training system. Although it is possible that the public sector can acquire standardized industrial technology ahead of enterprises, it may be the case only in the early phase of industrial development. It is almost impossible for the public sector to constantly catch-up with the fast-changing industrial technology ahead of private enterprises. In addition to their limitation on capability, the public sector does not have adequate incentive to respond as fast as the enterprises.

## 3-3. Korea's Experience of Public Training System

Korea basically followed the Japanese strategy for training technical skills to workers, partially mixing it with the German strategy. Due to fast transition from an agricultural economy to industrialization, Korea followed Japan's "Training within Enterprise" strategy, usually through OJT. Enterprises directly trained non-skilled workers from the rural area to suit their needs. Given the shallow industrialization experience, a social (and external) labor training scheme based on the apprentice system in Europe was not feasible.

Consequently, enterprises needed to focus their training on firm-specific skills. As a way of strengthening the motives of enterprises and employees for this training, a permanent employment system was established. Enterprises bore the cost of training firm-specific skills. In order to recover the cost, they needed a guarantee that their employees would not move to other enterprises after the training. On the employees' side, in order to motivate them to learn skills that are not very useful in other enterprises, they also needed the guarantee of long-term employment.

In order to overcome an "employment's numerical rigidity" problem in permanent employment, Japan established other personnel management practices. A contingent pay system of group incentive, such as bonus, was introduced to secure the wage's numerical flexibility. Another example is formation of multi-skills through job rotation to improve the "employment's functional flexibility." Korea, however, experienced difficulty in the latter practice because of its labor unions' opposition. Meanwhile, a competitive relationship between seniors and juniors was intercepted through the introduction of a seniority-based pay plan. This vitalized OJT, and successfully established the intra-firm training system for firm-specific skills.

This kind of enterprise training system is usually established in large-scale enterprises. Small and medium scale enterprises didn't have any organized training system for workers. In any case, the level of skills required in small and medium scale enterprises was rather low in the light industry-based development stage. However, at the end of the 1970's, demand increased significantly for training the skills required for a heavy manufacturing industry, such as standardized industrial skills like lathe, milling, welding, electric circuit, etc. During this period, large-scale enterprises were serious about training their workers in house on necessary skills. Small and medium-sized firms that could not afford their own training programs also had a need to train their workers. Nevertheless, it was difficult for private training institutions to survive. In addition to the inadequate capabilities of these private institutions, uncertain profitability due to expensive training costs prevented them from playing any meaningful role.

Therefore, the Korean government led and expanded vocational training by directly establishing public training facilities. It was a handy solution, given that it would take much time for enterprises or private training institutions to get ready for the needed training due to lack of ability or immature market. Public provision of training was also appropriate since (the most needed) standardized industrial skill was firm-general skills. Additional significance of the public vocational training was that it provided income earning opportunities for the youth who could not graduate from a high school due to their poor economic status.

The government has adopted a vocational training levy system to secure the necessary training budget. Large-scale enterprises (with the ability to provide knowledge, facility, and finance) are obliged to provide vocational training by themselves. If they do not fulfill this requirement, a levy is imposed for public training. The logic behind the levy is that they will benefit indirectly from the system. If workers are trained at a public training center and get employed at large scale enterprises, then, the enterprises save their training cost. Even if the workers are employed at small and medium scale enterprises, they are likely to be the subcontractors of large-scale enterprises. As the government is the provider of public training, there is no concern of being “poached.” However, this levy scheme is subject to criticism that the levy payment and the benefit of public training do not match tightly.

In order to increase the quality level of public training, efforts are made to attract talented people as the teachers of vocational training by paying relatively higher salaries. Also, a national college for technology education was established, which contributed greatly to producing many capable instructors.

However, over time, government failure caused by the principal-agent problem started to show. For instance, it is very difficult to layoff teachers. Even if there is little demand for some courses, they are continually offered for the sake of the teachers, rather than the trainees. Sometimes, the schools are very reluctant to set up new courses, only because these would give them a new burden. Vocational training programs are often very rigid, fail to meet industry demand, and show the tendency of excessive investment simply for the expansion of the organization. For instance, although the role of public training should be shifted more towards facilitating the employment of the disadvantaged class, they have made little progress in this direction. Due to the difficulty in restructuring the training facilities and the teachers, they still insist on maintaining the former system.

At present, the range of demanded specialty becomes narrower and requires more advanced knowledge reflecting the general trend of greater technical complexity for necessary skills. the timeliness of training on some skills is very important given the fast speed of technology development and shortening of time for recovering the cost of training investment. When provision of training is delayed, the involved technology and skills might soon become obsolete.

The skill characteristic of most workers in Korea has the tendency to be higher in job-specificity and lower in firm-specificity. This means that the labor market is segmented by occupational classification (along with job-specificity of skill) and with a higher possibility of labor mobility among enterprises (due to lower firm-specificity of skill). Actually, after the economic crisis in 1997, labor mobility across enterprises has accelerated. The implication is that enterprises shift their strategy from internal labor development (directly producing workers, the so called “make” strategy) to “scouting” workers (so called “buy” strategy) who have already accumulated necessary skills from other enterprises. This fact is reflected in the current trend of hiring experienced workers instead of new-entrants into the labor market. Higher firm-generality of skill makes enterprises more worry about being poached with internally developed workers. Also, in the case of fast-advancing technologies, the “buy” strategy would be much more effective than the “make” strategy.

## 3-4. Transition of Vocational Training in Major Advanced Countries: Lifelong Education and Role of the Private Sector

### 3-4-1. United States

Education in the US is mostly through formal schooling. Specific skills required to perform a job after the employment is trained by each enterprise. Formal schooling is generally based on humanity education, and its main objective is to develop job-general skills. Since the society is highly educated, with more than half of high-school-graduates entering colleges, the rest of the graduates employed in simple service or blue collar work at manufacturing plants are rarely expected to develop sophisticated skills. Consequently, "training by enterprise" is to cultivate traditional type workers having a low level of job-specific skills to perform a simple job (i.e. Taylorism).

Eventually, vocational training in the US is not promoted under the active labor market policies for skill formation for higher productivity and higher wages. Instead, the strategy remains in the passive labor market policies of "depending on machinery-based technology evolution" and "machinery operation worker based simple skill training and low wages." This type of strategy may not have problems for a massive production system (Fordism) during the industrial era, but may not able to overcome the "weakness of labor quality" problem in the post-Fordist era.

As a result, the US competitiveness in labor-intensive assembly industry is weaker than Japan, Germany, and even Asia's semi-developed countries. This caused greater wage disparities in the labor market due to the skill disparity among workers. In order to get employed, non-skilled workers have no choice but to accept lower wages. Meanwhile, as the wage disparities are increased by knowledge level (educational attainment), demand for college education is also increased in the education market.

The new paradigm of US vocational education started in January 1999 at a conference (in Washington DC) led by then Vice President Al Gore, with the subject of "21st Century Skills for 21st Century Jobs." The main theme of this conference was "how to provide high-skilled and high-wage jobs for the Americans." That is, given the duality of the US labor market (divided into professionals and non-skilled), the market needed to be reorganized towards expanding the portion of workforce with intermediate-level skills. This new direction not only helped improve competitiveness by establishing a knowledge supply system to meet industrial demand, but also contributed to social integration countering the "deterioration of income distribution by knowledge disparity," sometimes expressed as a digital divide.

One noticeable strategy for enterprises is to develop their own training facilities and programs to promote active human resource development. Competitiveness of the enterprises will be enhanced through this strategy called "Work to Work Program." Until the mid-1990's, the

“School to Work” programs by industry-university collaboration tried to raise the connectivity between enterprise employment and university education. The two strategies are distinguished by the main body of education - school or enterprise.

A representative example is the establishment of a university within an enterprise. Motorola University & GMU (General Motors University, renowned for satellite education) are the examples. In case of NTU (National Technological University, renowned for cyber education), each of the six companies of Digital Equipment, Eastman Kodak, GE, Hewlett-Packard, IBM, and NCR invested US D 1 million in 1984 to establish a higher educational institution to provide distance learning in high-technology.

Second, as interests in vocational training by labor unions as well as by management increase, joint training projects based on collective agreements are promoted. Collaborative effort is made between labor and management to promote a training fund. With the support of the fund, workers’ competitiveness can be improved through firm-general skill training, which enterprises normally shun for fear of being poached.

Third, Community Colleges (CCs) go beyond their original function of educating general adults to become a vital center for technical training for non-college entrant youth labor for improvement training (i.e. for skill upgrading and updating) for current employees in local area as well as reemployment training for the unemployed. Since high school education is based on humanity and the knowledge level of non-college-entrants is not high, it is unavoidable for them to end up in a non-skilled position. CCs became an institution to connect non-college-entrant youth who wants a position paying a decent wage level and enterprises demanding field workers with a higher level of practical skills. CCs have certain advantages compared to universities: Affordable cost, easy accessibility in location, flexible curriculum, and field experience (through enterprise’s participation).

Fourth, a lifetime learning account system is introduced with the model of England’s Individual Learning Account (ILA). Bringing it all together - the worker’s and the enterprise’s contributions and the government support - ensures a fixed amount of budget for vocational training.

### 3-4-2. England

England bears the weakness of the European continent’s traditional unionized and apprentice system, coupled with a strong background in liberalism like the US Thus, an extreme duality of skills has noticeably emerged. A small number of enterprises with high levels of technology is able to maintain and secure highly skilled labor through their own training. However, a majority of enterprises without such levels of technology depend on price competition for employing low skilled labor.

Under these circumstances, the British government introduced national level strategies to reduce the problem of deficient technology and to share training expenses. The shared training expense system support funds only HR-developing (training) enterprises, and not scouting (without training) enterprises. However, such financial support system faced strong opposition by small and medium scale enterprises, since they could not benefit much from the system. This caused lack of enthusiasm among enterprises to participate in educational training.

Government budget was increased to support private training institutions. However, some unexpected negative effects were observed: Since the financial support is based on policy performance index (i.e. employment rate), training institutions tended to focus on some easy-to-be employed occupations in the short run based mainly on low skills. Consequently, it was difficult to achieve their original objective to improve the skills of industrial labor force. In addition, since the support is based on unit training cost, there was a tendency to fall into the trap of “low cost training low quality of skill formation.”

Starting from the year 2000, England established an industry-based enterprise-initiated training system with both industrial and regional characteristics, which promoted a matching-fund system between the central government and enterprises to financially support job training projects conducted by enterprises.

### 3-4-3. Germany

The German education system, so-called dual education system, is characterized by early vocational education, apprentice system, and multi-class certification system. Each individual decides early his/her specialty. Within a limited range of selected job-specific skills, enterprises actively participate in this training process through an apprentice system. Continual accretion through a certification system has the role of signals and incentives for getting higher level skills.

This vocational training system is based on the European continent’s traditional apprentice system. This socially active vocational education training system was introduced earlier than any other countries in the world. Moreover, since the apprentice system pushes enterprises for full participation in the training process, carrying out vocational training to meet the features and levels of industrial demand was not difficult.

Meanwhile, in order to induce active participation of enterprises in the vocational training process through the apprentice system, the cost borne by firms for OJT of firm-general skills needs to be resolved. This problem is addressed by obligating the workers to accept lower wages than productivity during the period of apprenticeship. In Germany, labor demand is usually under collective monophony by the cell (mix) of region and industry. Within a pair of specific region and specific industry, collective bargaining between labor union and management minimizes the possibility of poaching as well as wage disparities among the enterprises. Also, the government bears all the costs of formal education and other Off-Its, providing a perfect inducement for enterprises’ active participation in vocational training. On the other hand, in order to induce workers to participate in training, the expected benefit of training should be sufficiently large. This is ensured by guaranteeing substantial wage disparities between skilled workers and non-skilled workers (i.e. sufficiently high wage premium for skill).

However, the German dual system is currently facing challenges, even though a new system has not been established yet. First of all, occupationally segregated labor market (resulting from excessively job-specific occupation) makes any restructuring process in the labor market very slow. When changes in industrial and occupational labor demand are fast (as is the case in a knowledge economy than in an industrial society), this training system is poorly prepared to produce new workers in demand. On the worker's side, wage loss incurred by shifting their job is very large, so that workers are reluctant to change to a new occupation even though they know that jobs in their occupation are vanishing resulting in a very slow restructuring process in the labor market.

Although the system works well for minimizing youth unemployment through enterprise-participated high-quality training, it may not be good for re-employment of the unemployed. Current unemployment policy regarding training has progressed towards upgrading the level of existing skills of the unemployed. However, this would not be effective in increasing the chance of re-employment because unemployment, to begin with, was caused most likely by changes in occupational demand rather than by demand for higher skills in the current occupation.

Decentralization of collective bargaining after the mid-1980's in Germany has caused larger wage disparities among enterprises. This might have reduced enterprises' interest in participating in vocational training. Also, by hiring immigrants from the East European Bloc for non-permanent positions (i.e. increase of labor supply), there has been growing pressure for lower wages for skilled German workers. This development is expected to reduce worker's incentive for training.

Over all, a key to success in establishing a new training system in Germany is to consider the possibility to expand the range of occupation and promote the functional flexibility of worker's skills. Also important is to devise adequate incentives for the enterprises and the workers to actively participate in training.

### 3-4-4. Implications

First, the range of enterprises' participation as a supplier of vocational training has significantly increased. There has been growing direct participation of enterprises apart from academic-industrial collaboration. One of the representative examples is the US "Conversion from School to Work to Work to Work." Before, enterprises played the role of main provider of firm-specific skill training. However, the recent increase in enterprises' participation is in firm-general skill training. In this case, the trained skills are mostly job-specific skills, even though training on job-general skills is also provided occasionally (e.g. enterprises carrying out training on deficient basic academic and social skills for US workers).

Second, in order to stimulate enterprises to provide training on general skills, clear and strong incentives are needed for both enterprises and employees. If enterprises are to share training cost, the possibility of employees' moving to other enterprises (poaching) should be minimized until the shared cost is fully recouped. On the other hand, in order to induce workers' participation, it is necessary to offer, after the training, adequate and reliable compensation matching with their enhanced productivity.

In the case of Germany, the possibility of poaching is minimized by minimal wage differences among workers in the same occupation, and by the collective bargaining within a pair of specific region and specific industry. On the other hand, there is significant wage difference between skilled and unskilled workers so that worker's motivation to join training is high.

Third, Germans focus on the mix of industry and region, which is the base for specialty and innovation. Region-based network without an industrial specialization concept is a strategy without a goal. Industrial specialization strategy without region-based management (a central administration approach) is inefficient. In the case of England and Canada, the key element of vocational training activity is to organize a network by the cell of connecting a specific industry with a specific district.

Fourth, the government's financial support to private training institutes, combined with the adoption of misleading evaluation criteria, often lead to poor training performance, defeating the original intention. In the case of England, such evaluation criteria as short-term success rate in employment and program development with unit training cost as an important consideration resulted in poor training.

## 3-5. Vietnam's Policy Challenge

Vietnam's vocational training system is a model led by public training directly controlled by the government. Public training, which played a leading role in many other developing countries, has shown reasonable success in producing immediate effects. But, it generally did a poor job at meeting changing demand of the market. A key question is then how to overcome the limitation of public sector in its ability and motivation.

Korea basically followed the Japanese system of "directly training necessary workers by the enterprises." Public training has played only a supplementary role, helping to mitigate temporary shortage in basic industrial skills. The training has been conducted by government-supported public institutions rather than the government itself. Germany's public training actually utilized enterprises' sites for most of the skill training through academic-industrial collaboration and apprenticeship. In Vietnam, however, the government is directly in charge, causing concerns of lacking specialty and organizational rigidity. Additional constraints are the lack of business mind and political interference in government organizations. Most of the large scale manufacturing enterprises are SOEs, which tend to heavily depend on the public training system for their workers' skill formation.

### 3-5-1. Making Clear the Role of Public Training

Under the premise of "public training limited to the most needed sector," public vocational training programs may be pursued where all the following conditions are met:

(a) Even though the industrial skills are already standardized, private training facilities are not ready to carry out the training due to inadequate capability and/or expected poor profitability of the training

(b) Enterprises are concerned about poaching, making them reluctant to provide the training to their workers directly, and

(c) The skills and technologies are general in broad industrial demand (such as lathe, milling, welding, and electric circuit most commonly required for the development of heavy industries).

Even though the necessary territory for public training exists, considerations should be given to the strategy of supporting or motivating the private sector, rather than conducting the training directly by the government or a public institution. The vocational training levy system adopted in Korea is a strategy forcefully mandating large scale enterprises to provide vocational training. A strategy of supporting some of the most competent private vocational training facilities can also be introduced (e.g. Certified private vocational training centers in Korea).

### 3-5-2. Gradually Establishing the Enterprise-Based Training System

Large scale domestic and foreign enterprises may be mandated to train their employees (together with the introduction of a vocational training levy system). Currently, the most competent training organizations in Vietnam are large scale private (especially foreign) enterprises. Training provided by these enterprises using their existing facilities should better be open to workers from outside.

Training may be most effective when industrial and regional policies are linked with human resource development policy. Training by industrial and regional sector is recommended. Since small and medium scale enterprises are usually operating in a competitive environment and incapable of investing in training their workers, establishing a joint training center in each industrial sector to train industry-specific skills can be a good strategy. Vietnam is constructing industrial complexes based on each region's comparative advantage. It will be a good idea to establish and manage a training facility within an industrial complex to train industry-specific skills. In this connection, it may be necessary to re-evaluate and redesign the blueprints of Vietnam's industrial complex construction so as to maximize the synergy effects from the optimal geographical distribution of industries.

Vietnam may induce globally competitive enterprises in Vietnam to establish "enterprise-initiated university of technology," where enterprises directly design education programs and enterprise personnel serve as the faculty. The university should train not only the enterprises' workforce, but also general students. In view of the large potential gains from such a university, the global enterprises may be given generous government support including significant tax incentives and subsidization of university expenditure.

# 4. Reforms for Increasing the Competitiveness of Labor Market

## 4-1. Education for High-Tech Workforce

### 4-1-1. Reform Strategies for Excellence of College Education

In this area, Vietnam needs to benchmark China's university reform model. The key point of the Chinese model is to induce colleges to reform HRM of the faculty with a full financial support from the government.

The starting point of higher education reform should be based on personnel management of the faculty. Professors are the principal players in knowledge creation and specialization. Most essential is to establish a fair and reasonable evaluation system for faculty members' ability in research and teaching, on which their tenure, salary and promotions should be based. Also, universities need to be encouraged to actively hire well-qualified professors from overseas by giving them attractive compensation packages.

In addition to reorganization and reform of the faculty, the government should financially support a selected number of universities to foster them as world-class universities. Financial ability is the most important factor for the quality of college education. Nationally selected and supported universities should focus on elite education by recruiting and nurturing the most talented students (although it may be general public education at elementary through high school levels). Other universities are to be operated on a competitive basis. Also, universities need to consider introducing a credit bank system, where a student's tuition is determined by the number of credits regardless of the institutions from which the student gets the credits. It would lessen the burden of student's tuition and encourage competition among universities to recruit more talented students by offering high-quality and specialized curricula.

### 4-1-2. Expansion and Improvement for Nationally Funded Students Sent Abroad

If it is difficult to train and educate top level scientific technology within the country; highly qualified and talented students should be sent to first-rate universities overseas. Since this program involves national support to the selected individuals and requires a large budget, a strategy that can provide more efficient program management should be considered.

First, from a strategic perspective at the national level, some industrial sectors or academic subjects should be chosen, on which domestic experts are in urgent demand. Consequently, national support should be prioritized, so that top-quality elites who want to study these selected subjects are given full financial support until they successfully finish their study (conditional on their academic performance).

Second, maximizing the effects of financial support on technology attainment should be considered. For some industries, it might be more advantageous to send their students to semi-developed countries, like Korea, instead of world-class universities in advanced countries. Korea has more technologies and skills, than the US, that are quickly applicable in Vietnam. Also, tuition in Korea is much cheaper than in the US. Korean firms also have great interest in engineering workers from overseas (especially from developing countries), since Korean students tend to shun majoring in science and engineering as of recent years.

### 4-1-3. Prevention of Brain Drain

It is not enough to educate talented students to become high-tech workers. Vietnam should also provide opportunities and conditions for them to return to or stay in Vietnam, contributing to the country's economic development.

In the case students supported by the national budget, the government may require them an obligation to serve in Vietnam for certain period of time after they finish their studies overseas. However, there are many cases, in other countries, of not fulfilling such a requirement. Still more prevalent is moving to other countries after the obligation period.

In order to minimize these phenomena, adequate opportunities and compensation to stay in Vietnam and make best use of what has been learned overseas should be provided. If necessary, the government should consider directly hiring the candidates. In the case of Korea, during the early stage of economic development, government-supported public institutes like KDI (Korea Development Institute), KIST (Korea Institute of Science and Technology) and KAIST (Korea Advanced Institute of Science and Technology), actively hired elite economists and scientists or engineers mostly trained at reputable universities abroad. Providing excellent compensation and work environment, these institutes were successful in keeping these well-educated human resources. However, during the economic crisis of 1997, Korea witnessed a brain drain phenomenon as the result of reduction in R&D budget in both the government and business enterprises. Domestic scientists and engineers moved to other countries, especially Silicon Valley in the US, in large numbers. What is worse, more talented or capable scientists were the first to move out of the country during the period (an adverse-selection problem).

## 4-2. Improvements in Labor Protection Regulation

### 4-2-1. Deregulation of Labor Standards

The rules most in need of re-evaluation are that of limiting total overtime working hours to 200 hours per year (300 hours per year in labor-intensive manufacturing enterprises). Overtime work is an absolutely necessary practice to buffer permanent employment for regular workers. Restrictive regulation to control overtime work may create additional jobs through work-sharing. However, it may create worse side-effects, such as more reliance on non-regular workers and neglecting training investments. Additionally, stable employment of regular workers may be the most effective way of stopping the tendency for Vietnamese workers to return to rural areas.

### 4-2-2. Experimentation of New System

There have been many cases in other countries where implementing a new system takes a long period of time or is forfeited in the middle of the process. Introducing a new system inevitably causes changes in interests and invites opposition from the groups who lose vested interests. The conflicts of interests tend to be particularly stronger in labor issues, which might be even more so given the socialist orientation.

In order to effectively introduce a new system, experimentation is necessary in certain selected regions. Depending on the result of the experiment, the system may be extended more widely. This kind of experiment might promote competition among institutions and minimize trial and error. For example, a set of new rules and regulations related to labor protection may first be applied to free trade zones on an experimental basis.

## 4-3. Securing More Funds for SOE Reforms

Continuous restructuring of SOEs should be high on the national reform agenda. In order to facilitate this process, it is necessary to secure enough funds in advance for supporting smooth employment adjustment, i.e. financial compensation for the displaced. Considering the significant social benefits expected from SOE privatization/equitization or restructuring, it is reasonable to collect public funds to facilitate this process. SOEs are likely to need funds from other sources as well, since they have to be continuously restructured even after an ownership change. It is fair and reasonable to ask burden sharing by those who will benefit the most from the sacrifices of jobs due to restructuring.

Who, then, should receive such benefits The answer is the “shareholders” and “survivors at SOEs under restructuring.” More specifically, the GOV might consider letting the shareholders “grant stock options to job-losers,” and the survivors “contribute a fraction of their salary as additional rewards for the unemployed.” In the latter case, enterprises may accumulate such funds from a long-term perspective, even if the enterprise is not in an immediate need of restructuring. This may function as a kind of private unemployment insurance, signifying thoughtful consideration to the unemployed by the survivors, while also serving as a “preparation against recession by saving during prosperous times.”

## References


Central Institute for Economic Management (2005), *Vietnam's Economy in 2004*, Science andTechnics Publishing House

Central Institute for Economic Management (2004), "Accelerating State-Owned Enterprises Reform to Meet the Requirements of National Development and WTO-Accession", *CIEM-FES Working Paper 01/2004*

General Department of Training (2005), *Vocational Training Vietnam*

www.koliaf.org, Labor Information : *Vietnam*

Ministry of Education and Training (2004), *Education and Training Vietnam.*

Ministry of Education and Training (2000), *The Education Development Strategic Plan: For 2001-2010*, Education Publishing House

Nguyen, Binh T., Loi, Cu Chi, and Nguyen Chien Thang (2005), "Labor Markets, Growth and Poverty Reduction in Vietnam", mimeo

Rhee, Chonghoon, and Sejong Kim (2005), *Human Resource Development Policy for Knowledge & Information Society (written in Korean)*, Korea Information Strategy Development Institute

Rhee, Chonghoon, Sejong Kim (2004), *Vocational Training System with Consortium of Small and Medium Enterprises (written in Korean)*, Korean Research Institute for Vocational Education and Training

Rhee, Chonghoon (2004) *175*, Myongji University Press

Rhee, Chonghoon, and Jeonghyn Lee (2004), " The Effects of Labor Unions on Employment (written in Korean)", Presented at 2004 Winter Conference, Korea Labor Economics Association.

Chapter 4

# Macroeconomic Stabilization of Vietnam

Chapter 4

# Macroeconomic Stabilization of Vietnam

*Ehung Gi Baek*
*Sangmyung University*

## Executive Summary

The objective of this paper is to search for macroeconomic stabilization policies of Vietnam to support a sustainable growth in the long run. This paper attempts to basically make policy suggestions based on the Korean growth and stabilization experience.

### *Vietnam's Five-Year Socio-Economic Development Plan*

Vietnam's major achievements in economic activities in the past five years are as follows. First, the economy maintained its rapid growth rate. Since 2000, Vietnam's economy has recovered and returned to rapid growth. During the period, the economy grew at a faster pace each year. Second, fundamental economic restructuring toward industrialization and modernization has occurred. The manufacturing and services industries have been effectively restructured, contributing to economic development. Third, the macro-economy is stable; balances among the major macroeconomic variables have been adjusted to maintain development. The saving and spending balance has improved. Fourth, there have been improvements in external economic activities. Recent years have seen a difficult international context of complicated changes, increasingly competitive markets and reduced investment capital flows. However, domestic political and social stability and the implementation of well-tailored policy measures have enabled Vietnam to achieve its planned objectives.

Despite the above achievements, drawbacks and problems exist in the socio-economic situation. Four drawbacks are pointed out. First, the quality of growth is unsatisfactory and the competitiveness of the economy is still slow to improve. Second, economic restructuring is proceeding at a slower pace than scheduled. Restructuring serves as a critical source of progress toward industrialization and modernization. Third, the use of resources is not efficient. National financial resources have not been mobilized and efficiently used for socio-economic development. Moreover national assets, public finance and corporate finance have not been managed properly and efficiently. Fourth, there have been difficulties in external economic activities.

Macroeconomic goals of the next Five-year plan (2006-2010) are to maintain high and sustainable economic growth with an emphasis on growth quality and efficiency and competitiveness of the economy so as to lift the country step-by-step out of its underdeveloped, low income state. Other goals are as follows: Speed up the development of science and technology and considerably improve the technological level of the economy; create the best conditions for deeper integration into the world and region; accelerate the establishment of a complete socialist-oriented market mechanism; associate social and cultural development with economic development; enhance the quality of education and training and human resource development; improve Vietnam's living standards; protect and improve the environment; ensure political stability and social security; preserve national independence, sovereignty; etc.

## *Trends of Vietnam's Macroeconomic Variables*

While GDP growth rate accelerated since 1999, per capita GDP growth rate started to pick up speed only after 2002. Inflation demonstrated negative rates in 2000 and 2001, but inflationary pressure accumulated since 2002. The exchange rate depreciated rapidly between 1986 and 1992, but has slowed down since. The ratio of the current account deficit to GDP was approximately 4% in 2004, a theoretically sustainable figure. The fact that beginning from 2002, imports amounted to more than exports produced a negative trade balance during the same period. Unrequited transfer as a major credit source of current account is around 5% of GDP and is increasing. Meanwhile direct investment as a major source of capital inflow hovers at around 4% of GDP. Total external debt as a percentage of GDP has shown a decreasing trend: While it amounted to 329% of GDP in 1989, in 2004 the figure tumbled to 36.4%. The level of total external debt seems to be sustainable in the long run. An international reserve to average monthly imports is about 2 months, as compared to the safe level of the international reserve of some country, usually 3 months. Current fiscal deficit records about 4% of GDP, a figure narrowly within the tolerable range.

We suspect that there are potential macroeconomic imbalances in some sectors. The question is, then, how to identify these imbalances. Several sources exist: High economic growth and low inflation rate; rapid money and credit growth and low nominal interest rate; rapid money growth and low inflation rate; accumulating current account deficit and slow exchange rate depreciation; continuing overall fiscal deficit due to fast growing expenditure and slow-growing revenue. The Vietnamese economy is exposed to some macro imbalances such as rapid money growth vs. low inflation, and accumulating current account deficit vs. slow exchange rate depreciation. In the coming years, it seems possible that these balances will be corrected, resulting in an acceleration of inflation and a depreciation of the domestic currency.

## *Korea's Five-Year Economic and Social Development Plan*

Korea carried out seven successful economic development plans. Some of the contributing factors were high quality education and human resources, unrestricted foreign capital inflow, strong corporate incentives, active SOC investment and low wage, a favorable international environment, etc. Even though its plans were compressed growths driven by the government-led planning strategy, the Korean economy has contained several shortcomings and problems that emerged from these growth paths: Resource misallocation from preferential credit and tax incentives, government failure, lack of transparency in economic policymaking, and poor corporate governance in family-controlled business groups.

The natural relationship between government and firm during the planning years is discretion rather than rule. The government became too ambitious to achieve its given economic targets, and the result was much market distortion: For instance, credit rationing was undertaken to provide investment funds. Compressed growth generated high inflation, while sacrificing equity and efficiency. Intervention in interest rate determination and credit allocation impeded the development of the financial industry. Allocation of resources according to governmental decisions tended to promote a monopolistic or oligopolistic market structure. The Korean government no longer proceeds with economic development plans, the result of several reasons. Above all, the Korean private sector grew too big to be controlled through government plans. Government intervention was effective when the private sector was small and weak. However, the private sector in Korea now possesses better and greater information than the government. Moreover, it has more investment ability than the government, resulting in governmental planning becoming truly inefficient.

## *Trends of Macroeconomic Variables in Korea*

While per capital GDI showed rapid growth from 1986 to 1996, negative growth rates have been recorded in 1997 and 1998. Brisk fixed investments and exports were major contributions to rapid growth. As for the production structure, the services sector has increased, while the agriculture, forestry, and fishery sectors have decreased substantially. The manufacturing sector also gained, but its share has been generally stable since 1989. Composition of the industrial sector has also undergone change continuously. The weight of the HCI went up while that of the LI diminished. Saving rates overtook investment rates in size since 1998. Private saving rates decreased from 1998 to 2002, but increased from 2003 to 2004. Government saving rates became greater in 2004 than in 1998. After the Asian financial crisis, the Korean growth rate showed a strong downward trend, beginning in 1999. Inflation rate as an increasing rate of GDP deflator has become quite stable after the crisis. Trends of monetary growth rate of M2, M3 and market interest rate (calculated as yield on corporate bond) have been decreasing since 1991.

## *Macroeconomic Stabilization in Korea*

Stabilization as an objective of Korean policy has ebbed and flowed over the years, partly due to the need to compete with the more urgent feeling of the need to promote rapid economic development. Only when stabilization was so severely compromised as to threaten economic growth itself did political leaders treat it as a high priority goal. Only when inflation was getting out of hand as in the end of the 1970s or when the balance of payments deficit seemed beyond the country's ability to finance it did stabilization become a truly salient issue. One might argue that this was true because neither internal nor external balance was ever seriously out of control in Korea. Except during wartime, Korea never experienced hyperinflation, as in Indonesia during the early 1960s or Latin America on several occasions. Similarly, the current account deficit as a share of GDP of Korea never approached the double-digit levels of several developing countries.

The successful economic stabilization in the early 1980s enabled Korea to prepare for another major economic takeoff in the mid-1980s. During the latter half of the 1980s, Korea was able to achieve strong economic growth with a brisk increase in exports due to the so-called "three lows."[57] The current account recorded an unprecedented surplus while inflation remained at a very stable level. In addition, the economy became self-sufficient in terms of resource requirements to finance its domestic investment, and hence has been able to reduce its exposure to foreign debt since 1986.

The financial crisis that hit Korea in the second half of 1997 had a devastating impact on the Korean economy, causing Korea's worst recession in the postwar era. Real GDP growth fell from levels that had been running in the positive 6.1% to 9.2% range before the crisis (1993-1996) to a negative 6.9% in 1998.[58] In the aftermath of the crisis, unemployment rose from pre-crisis levels of 2% to 6.8% in 1998 and 8.1% in March 1999. The financial crisis in 1997 was not only the biggest shock to Korea's economy since the early 1960s, but also embodied some macroeconomic causes, albeit structural factors were more accountable. Regarding macroeconomic factors responsible for the crisis in Korea, inadequate preparation for the capital market opening as a conduct of financial liberalization in the 1990s is probably the main focus. Korea was not ready to deal with the increased risk at that time. Another macroeconomic cause of the Korean financial crisis was the maintenance of a strong Korean won (KRW) in the presence of sizable current account deficit. Even though current account deficits were 1.0-4.1% between 1993 and 1996, before the crisis, the foreign exchange authority tried to keep the KRW/US Dollar (USD) exchange rate within a certain boundary. For instance, while the exchange rate was 802.8 KRW per USD on overage in 1993, it was 805.1 KRW per USD in 1996. Such tendency continued before the crisis, resulting in a near exhaustion of the foreign

57) "Three lows" means low oil price, low interest rates and low Korean exchange rate (weak dollar).

58) GDP growth rate recorded 4.7% in 1997.

reserve at the BOK before the crisis. To overcome the crisis, various reform policies in the financial sector, corporate sector and labor market were driven by the government. However, these policies are beyond the scope of this paper.

### *Korean Macroeconomic Policies*

Koreans achieved industrialization by allocating cheap credit to large industrialists, forcing them to build industries and to increase their exports, and threatening to withdraw credit if they did not perform. What contributed most to the effectiveness of these government interventions seems to be good economic management characterized by effective monitoring and sensible performance criteria, as well as a competitive business environment. Other factors were also determinants of success, but nonetheless are largely linked to these two factors.

Monetary policy has been influenced by major economic developments during the last several decades. Monetary expansion during the periods of post-war reconstruction and the periods of rapid economic development has typically been followed by monetary contraction in order to check ensuing inflationary development. In addition, monetary policy has been significantly affected by external shocks such as the world oil shocks and the rapid appreciation of the Japanese yen. Thus monetary policy in the past was not successful in smoothing out business cycles as its stance may well be characterized as pro-cyclical rather than counter-cyclical. In order to assess the role of fiscal policy in the business cycle management, it is more appropriate to examine the full-employment budget balance that excludes the cyclical component from the actual budget balance. This is particularly so because tax revenues are sensitive to the phase of the business cycle.

Despite substantial fluctuations on several occasions, the REER has been relatively stable compared to those of other countries. One major factor behind infrequent but large fluctuations was that exchange rate management placed too much weight on the stability of the bilateral exchange rate between the KRW and the USD, to accurately reflect changes in the exchange rates of other major currencies vis-à-vis the USD. Changes in the exchange rates of major currencies were usually reflected in the KRW/USD exchange rate with roughly a one-year lag.

### *Policy Recommendations for Stabilizing Vietnam's Economy*

The government needs to keep the fiscal deficit at the appropriate level for fiscal sustainability. There can be disagreement about the level. However, many macroeconomists suggest that fiscal deficit larger than 5% of GDP is unsustainable. Tight fiscal policy is desirable when inflation continues to be a serious economic problem. In this case the government should reduce government expenditures and collect more revenues at the same time. When reducing expenditures, current expenditure reduction is more desirable than capital expenditure reduction. Canceling or deferring inefficient public investment projects is necessary.

The goals of Vietnam's monetary policy are stabilizing the economy, boosting the economy in recession and maintaining security of the monetary sector. Open market operation and reserve requirement are major indirect policy instruments. The SBV regulates money growth rate based on market conditions. Current monetary target is M2, but no close relationship is found between money growth and inflation, propelling the monetary authority to control short-term business cycles.

Price policy was heavily used as an instrument for macroeconomic stabilization in Vietnam. Before 1992, the government set the price of manufacturing goods and services. However, the government utilized indirect intervention to adjust supply and demand after 1992. After 2002, prices are no longer set by the government. The fact that there is no way to restrain inflationary pressure by controlling individual price directly is well known. To control inflation, the government needs to establish a cooperation system with the monetary authorities. A policy mix of monetary policy and fiscal policy is much more effective to control inflation. To control inflation indirectly, some forecasting models are required.

Exchange rate has not been used as an active policy instrument for macroeconomic stabilization. REER is an important concept for controlling external balance. If the foreign exchange authorities maintain the REER at an appropriate level, the external imbalance problem is alleviated. A floating exchange rate, which is determined in the foreign exchange market, also helps authorities stabilize the external sector. To control the inflation resulting from substantial exchange rate depreciation, cooperation with the monetary authorities is important.

# 1. Introduction

As the title of this study is “macroeconomic stabilization of Vietnam,” the objective is to search for macroeconomic stabilization policies of Vietnam to support a sustainable growth in the long run. The focus is thus to basically make policy suggestions based upon the Korean growth and stabilization experience. Limitations from environmental differences between the two countries should be considered when policy suggestions are made for Vietnam.

Korea has achieved compressed economic growth in the last four decades. Since official GDP data are available from 1970 onwards, Korean national income data is viewed under analogous circumstances. Korean per capita GDP was only USD 254 in 1970, which grew to USD12,197 in 1996. Immediately after the Asian financial crisis, the figure dropped down to USD 7,355 in 1998, however the Korean economy recovered from the economic meltdown within a few years, and the Korean per capita GDP recorded USD 14,162 in 2004.[59)] Even though Korea recorded surprising growth, some side effects emerged from the rapid progress. For instance, forepart from a few years, Korea suffered from high inflation until the early 1990s. Moreover, current account deficit was a continuous issue of concern until before the financial crisis, a development from high investment exceeding domestic savings. These two phenomena, high inflation and current account deficit, invariably led to macroeconomic imbalance or instability.

The Korean government enforced a series of reform policies after the financial crisis. Major attention was given to corporate and financial restructuring with a focus on improving corporate governance, strengthening risk management, and enhancing transparency and disclosure. Had Korea reformed its economic structure earlier, crisis could have been avoided. This study follows an approach of applying the Korean experience to Vietnam, focusing specifically on the recent stability question.

This report consists of eight Chapters. Chapter 2 explains the current Vietnamese Five-year socio-economic development plan. Chapter 3 demonstrates the trends of major macroeconomic variables in Vietnam. Korea also maintained Five-year economic development plans until 1997. Korean Five-year plans are reviewed in Chapter 4. Similar to Chapter 3, trends of macroeconomic variables are shown in Chapter 5. Chapter 6 reviews some Korean macroeconomic imbalances and stabilization efforts during the period from the 1970s to the 1990s. Korea has implemented various macroeconomic policies to boost up the economy or to restrain severe inflationary pressure. Along this line, a series of macroeconomic policies such as credit policy, monetary policy, fiscal policy, exchange rate policy and wage policy are discussed in Chapter 7. The domestic saving rate is a very important source of funds for investment projects. Based on Korean experiences regarding this matter, a packet of macroeconomic policy recommendations centering on monetary policy, fiscal policy, price policy and exchange rate

59) Compressed growth means rapid as well as sustained growth.

policy for future stabilization is presented in Chapter 8. Some final remarks are also made in that Chapter.

## 2. Vietnam's Five-Year Socio-Economic Development Plan

During the recovery period after war in 1945, the northern Vietnamese economy grew quickly through a recovery of agriculture and transportation. Since 1958, the North pursued a socialist transformation of the economy, subsequently establishing a centralized-economic development model and nationalizing all means of production. The state carried out a production distributing system by norm payments and budget subsidies through coupons. With the first Five-year plan (1961-1965), the North moved into a construction period. The state paid close attention to developing education, health care and many public works. The new mechanism's preeminence was brought into full play; preliminary heavy industry facilities were formed to mainly solve food shortages. The economic system began, however, to expose its shortcomings. Meanwhile, the economy of South Vietnam took the market economy route, the main target being to serve the war.

After the liberation of South of Vietnam in 1975, the Socialist Republic of Vietnam carried out the second Five-year plan (1976-1980). The majority of the targets in the plan were impossible to meet. Production was stagnant, keeping the annual growth rate at a mere 0.4%, while population growth exceeded 2.3% per year. Budget deficit remained high and prices rose by 20% annually. Moreover investment for the economy left many plans unfinished. Due to the excessive aims posed by the third Five-year plan (1981-1985), the economy took on many imbalances and sank into a serious crisis. Stagnant production was manifest in all aspects. Inflation rose rapidly from 30-50% annually in the early 1980s to 587% in 1985 and 775% in 1986. Facing this dire situation, the Communist Party of Vietnam created and led the "Doi Moi" process.

The main driving force behind the fourth Five-year plan (1986-1990) was no longer to boost investment as before but to renovate the administration mechanism. The government and ruling party issued many resolutions and decisions in an attempt to improve economic management, and monetary and agricultural policies. The fact that the old mechanism did not yet disappear and the new one did not prominently emerge made reform ineffective. GDP increased by 3.9% on average in these five years. The Sixth Congress of the Communist Party of Vietnam worked out the strategy "stabilizing and developing the socio-economic situation to the year 2000," putting forth the orientation and tasks for the fifth Five-year plan (1991-1995). The major obstacle then was the long-lasting economic embargo together with economic blockade imposed by the United States while Eastern Europe and the former Soviet Union were jammed in serious crises. The total foreign trade turnover from Vietnam to ruble areas sharply decreased. However, to Vietnam's great advantage, renovation started to have effectiveness. Economic units were gradually adapted to the new management mechanism.

The medium term objectives for the sixth Five-year plan period (1996-2000) were to achieve stronger, more sustainable and stable economic growth, to resolve critical social issues, to ensure national defense and security, to lift the country from backwardness and poverty, to improve the living standards of people, to increase national savings, and to establish the foundations to move to a higher stage in the development process during the 21st century. In order to realize these objectives, the GDP growth target for the sixth Five-year plan was 9-10% per annum. As for the improvement of national fiscal performance, the targets were to increase state tax revenue and to reduce fiscal deficit.

The overall objective of the seventh Five-year socio-economic development plan (2001-2005) approved by the National Assembly is:

- Rapid and sustainable economic growth;
- Dramatically restructuring economic and labor structures toward promoting industrialization and modernization;
- Remarkably improving the efficiency and competitiveness of the economy;
- Expanding foreign trade and investment links;
- Making reforms in education, training, science and technology, and using human resources to the fullest extent;
- Creating a large number of jobs;
- Basically eradicating famine, and significantly reducing the number of poor households;
- Eliminating social evils;
- Continuing to strengthen socio-economic infrastructure;
- Making progress in developing a market regime with a socialist orientation;
- Maintaining political stability, social order and safety;
- Firmly defending national independence, sovereignty, territorial integrity and security.

Major achievements in economic activities in the past five years are as follows.[60)] First, the economy maintained its rapid growth rate. Since 2000, Vietnam's economy has recovered and returned to rapid growth. During the period, the economy grew at a faster rate each year. The average GDP growth rate for the Five-year period (2001-2005) is forecast to be 7.4% per annum, higher than that of the previous five years. Agriculture, forestry and fishery are projected to have grown at 3.4% per annum, industry and construction at 10.2% and services at 6.9% per annum. The aggregate growth rate of production value in agriculture, forestry and fishery should reach a projected average of about 5.1% per annum, exceeding the planned target. The average growth rate of industry production value for the Five-year period is estimated at 15.4%, 2.3% points higher than the target set. The value of production of the service sector is projected to have increased by about 7.5% per year on average, nearly reaching the planned targets.

60) Main reference of the socio-economic plan (2001-2005) and the next plan (2006-2010) is "Vietnam's Socio Economic Development" by Vietnam Institute of Economics (2004).

Second, fundamental economic restructuring toward industrialization and modernization has occurred. The manufacturing and services industries have been effectively restructured, contributing to economic development. The proportion of agriculture in GDP was continuously curtailed from 24.5% in 2000 to 20.4% in 2004, and is estimated at 19% in 2005. The planned target is 20-21%. The proportion of industry and construction increased constantly from 36.7% in 2000 to an estimated 42% in 2005. The planned target is 38-39%. The proportion of service industries reached a level of about 39%, while the planned target is 41-42%.

Third, the macro economy is stable; that is, major balances in the economy have been adjusted to maintain development. The saving and spending balance has improved. Total spending maintained a honorable increase oft about 6.2% a year on average (the estimated target is 5.5%), while consumption per capita increased nearly 6% per year on average. As a result, people's living standards have improved considerably. Savings continued to increase, ensuring sufficient capital for development investing. The CPI increased by 0.8% in 2001, 4% in 2002, 3% in 2003, a probable 9.5% in 2004 and an estimated 5% in 2005. The estimated average annual increase in the CPI for the five years is 4.5%. The balance of capital investment for development continued to improve year by year. The ratio of capital mobilization in GDP was 34% in 2001, increasing to 36.5% in 2005. Total capital invested in the economy in the five years of 2001-2005, as calculated at the 2000 price, exceeded the target by about 16%.

Fourth, there have been improvements in external economic activities. Recent years have seen a difficult international context of complicated changes, increasingly competitive markets and reduced investment capital flows. However, domestic political and social stability and the implementation of well-tailored policy measures have enabled Vietnam to achieve its planned objectives. International economic relations have been strengthened and expanded, ASEAN commitments implemented, negotiations for WTO accession conducted, and the implementation of bilateral and multilateral commitments promoted. Import and export activities continued to maintain fairly good growth rates.

Despite the above achievements, drawbacks and problems exist in the socio-economic situation. Five drawbacks in particular are pointed out. First, the quality of growth is not highly satisfactory and the competitiveness of the economy is still slow to improve. The growth rates during the past years are largely attributed to extensive development factors. Traditional industries and products maintained low technology and high rates of material consumption. The competitiveness of the economy is low since the government's macroeconomic policy does not stabilize the economy successfully. Production costs of many manufacturing and agricultural products and services are still high, while labor productivity is low and labor quality remains inadequate.

Second, economic restructuring is proceeding at a slower pace than scheduled. Restructuring serves as a measure of progress toward industrialization and modernization. The government's policy orientation was clear, but few specific measures have been taken. Due to such problems, the economic structure is still far from being modern and failed to meet the demand for intensive development to raise the quality of growth.

Third, resource utilization  is not optimally efficient. National financial resources have not been mobilized and efficiently used for socio-economic development. Moreover, national assets, public finances and corporate finances have not been managed properly and efficiently. Government revenue is unstable, and budget expenditures continue to increase at a high rate, as compared to the economic growth rate. Direct subsidies from the state budget are hastily growing. Hence, there is much waste and loss in capital construction.

Fourth, there have been difficulties in external economic activities.  Abrupt challenges with regard to competition and markets have not been overcome. There have been difficulties in importing and exporting, in particular that exports are less competitive. The proportion of raw materials with low value-added is high, while the percentage of exports via intermediate goods is also high and the forecasting of export prices is not optimal. Finally, serious problems still exist in some social aspects.  The quality of education and training is low and activities in science and technology have not yet met the requirements. Corruption and social evils have not been reduced by much. Many people face difficult living conditions and receive unsatisfactory incomes in the rural areas.

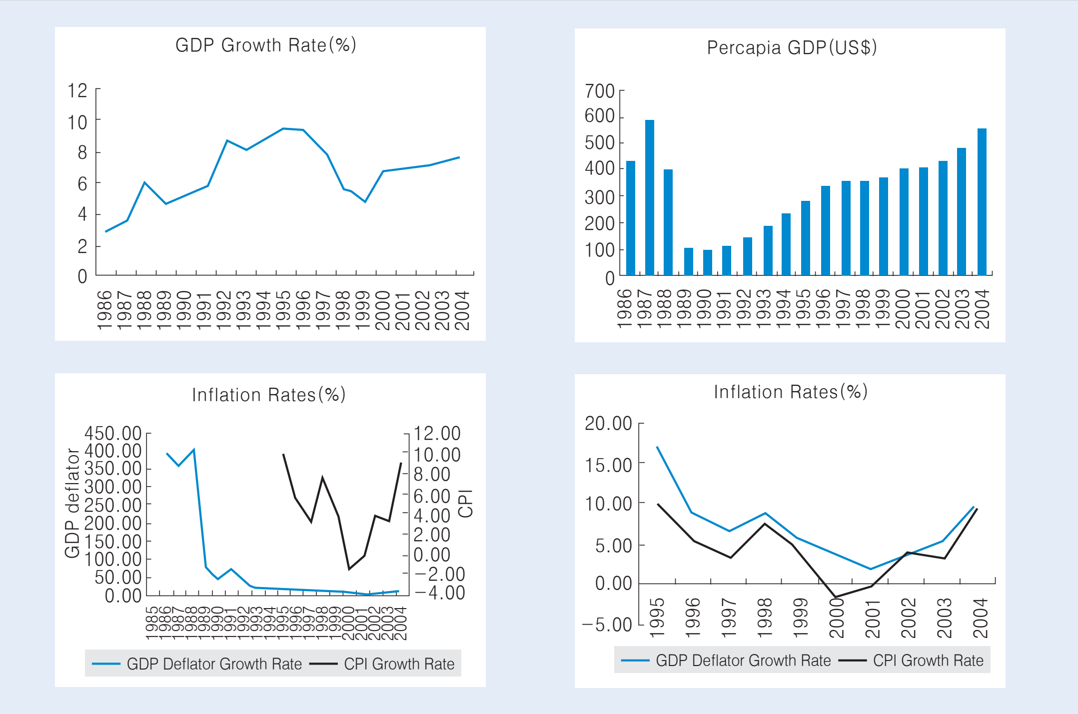
Macroeconomic goals of the next Five-year plan (2006-2010) are to maintain a high and sustainable economic growth, with an emphasis on growth quality and efficiency and the competitiveness of the economy, so as to lift the country out of its underdeveloped, low income state in a piecemeal manner. Other goals are as follows: Speed up science and technology development and considerably improve the technological level of the economy. Create the best conditions for deeper integration into the world and region. Speed up the establishment of a complete socialist-oriented market mechanism. Associate social and cultural development with economic development. Enhance the quality of education and training and human resource development. Improve people's living standards. Protect and improve the environment. Ensure political stability and social security, and preserve national independence, sovereignty etc.

There are necessary conditions for the success of the next Five-year socio-economic plan. The government needs policies to accelerate resource mobilization. In the next five years, production and business activities are expected to receive a boost, ensuring a higher level of economic development and a larger-scale economy. Changes should be made in state budget expenditure towards subsidy elimination and better capital mobilization from the public to ensure the maximum utilization of all resources. Second, the economic infrastructure should be reinforced for sustainable growth and poverty reduction. Vietnam's economic infrastructure is still very poor, and is in need for further investment in infrastructure construction and upgrading, more so for large-scale infrastructure projects. Third, the society needs to develop and considerably improve the quality of human resources and enhance scientific and technological capacity. Fourth, the government should improve the mechanism of a market economy with a socialist orientation, create a fair and highly competitive business environment, strongly accelerate economic integration and cooperation, and improve the effectiveness of the state machinery.

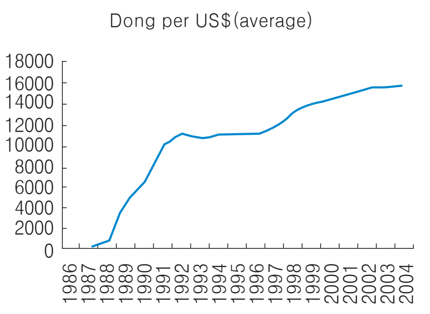
## 3. Trends of Vietnam's Macroeconomic Variables

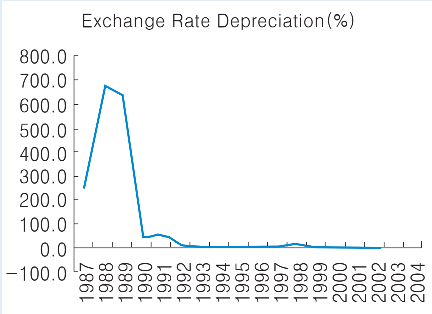
Figure 4-1 shows recent trends of Vietnam's major macroeconomic variables (Sources are available in the final page of this paper). While GDP growth rate accelerated since 1999, per capita GDP growth rate started to accelerate after 2002.[61] Inflation demonstrated negative rates in 2000 and 2001, but inflationary pressure accumulated since 2002. The exchange rate depreciated rapidly between 1986 and 1992, but has slow down in speed since then. The ratio of current account deficit to GDP is about 4% in 2004, a theoretically sustainable figure. The fact that imports have outweighed exports since 2002 produces a negative trade balance during the same period. Unrequited transfer as a major credit source of current account is around 5% of GDP, with an increasing trend. Meanwhile direct investment as a major source of capital inflow is around 4% of GDP, while total external debt has shown a decreasing trend (329% of GDP in 1989 to 36.4% in 2004). The level of total external debt seems to be sustainable in the long run. An international reserve to average monthly imports is approximately 2 months. The safe level of an international reserve of some country is usually 3 months imports. Current fiscal deficit recorded near 4% of GDP, in line with the recommended figure of less that 5%.

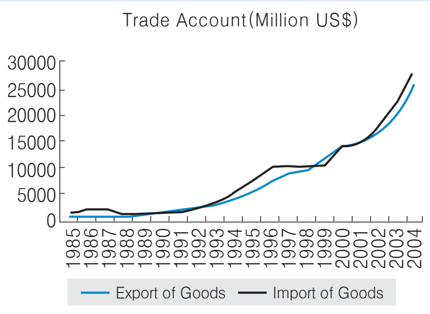
<Figure 4-1> Trends of Vietnam's Macroeconomic Variables

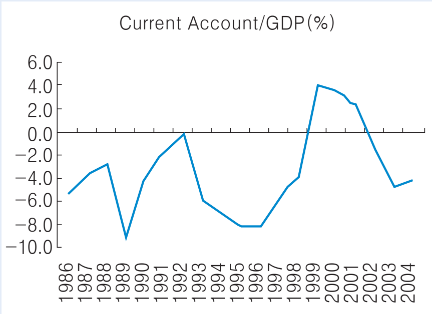


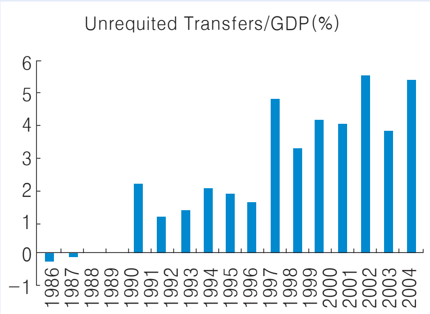

61) GDP per capita for 1986-1988 needs to be explained because of their unreasonably high amounts. It is due to unrealistically overvalued exchange rates before 1989

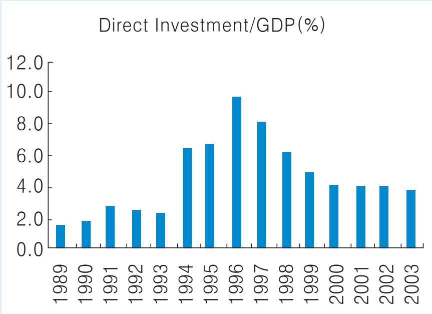

Dong per US$(average)
18000
16000
14000
12000
10000
8000
6000
4000
2000
0
1986 1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004

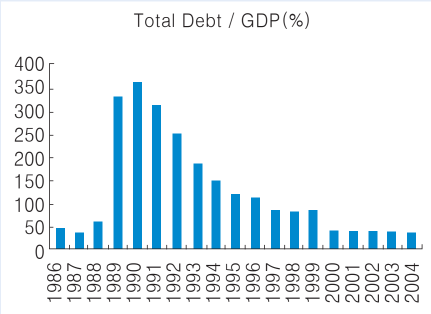

Exchange Rate Depreciation(%)
800.0
700.0
600.0
500.0
400.0
300.0
200.0
100.0
0.0
−100.0
1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004

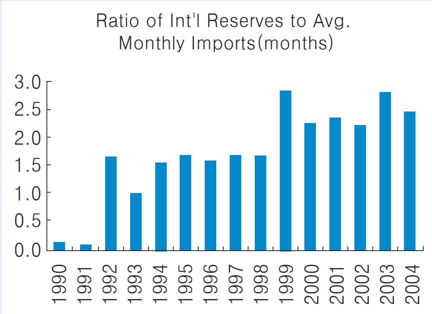

Trade Account(Million US$)
30000
25000
20000
15000
10000
5000
0
1985 1986 1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004
Export of Goods
Import of Goods

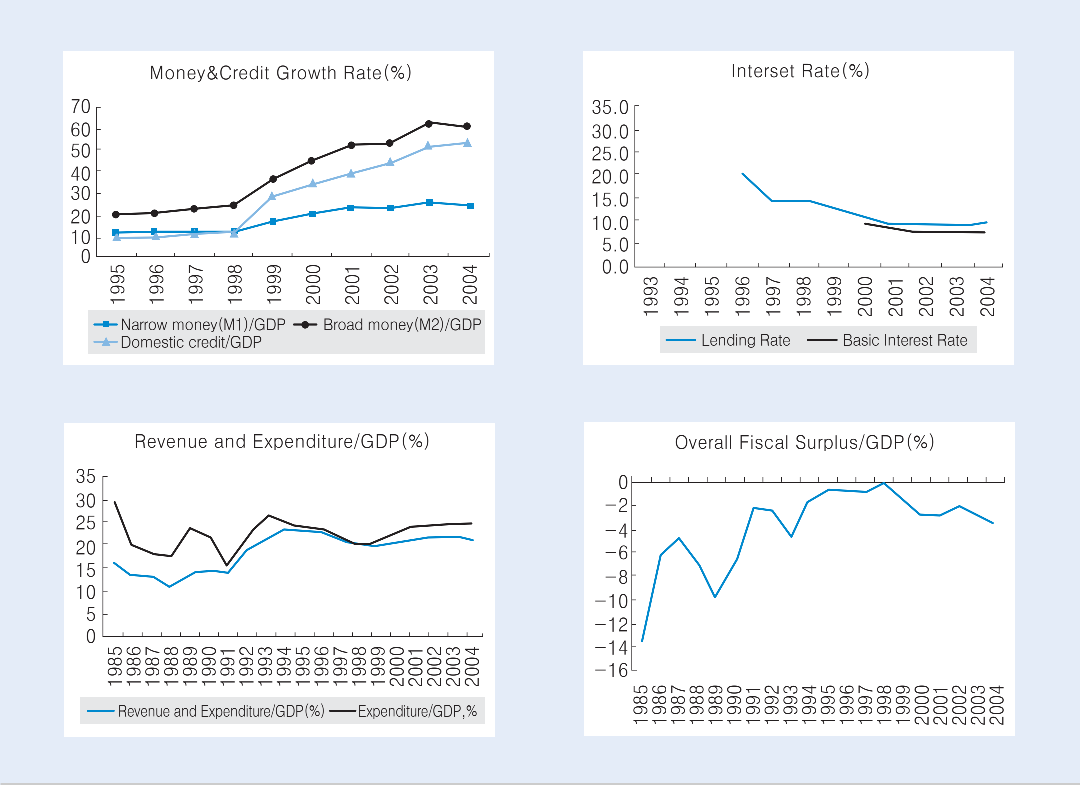

Current Account/GDP(%)
6.0
4.0
2.0
0.0
−2.0
−4.0
−6.0
−8.0
−10.0
1986 1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004


Unrequited Transfers/GDP(%)
6
5
4
3
2
1
0
−1
1986 1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004


Direct Investment/GDP(%)
12.0
10.0
8.0
6.0
4.0
2.0
0.0
1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003


Total Debt / GDP(%)
400
350
300
250
200
150
100
50
0
1986 1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004


Ratio of Int'l Reserves to Avg.
Monthly Imports(months)
3.0
2.5
2.0
1.5
1.0
0.5
0.0
1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004




The above data gives ground for suspicion that potential macroeconomic imbalances exist in some sectors. The question, then, is how can these imbalances be identified There answer lies in several sources: High economic growth and low inflation rate; rapid money and credit growth and low nominal interest rate; rapid money growth and low inflation rate; accumulating current account deficit and slow exchange rate depreciation; continuing overall fiscal deficit due to fast growing expenditure and slow growing revenue. The Vietnamese economy is exposed to some macro imbalance such as rapid money growth vs. low inflation and accumulating current account deficit vs. slow exchange rate depreciation. Settling these imbalances inflation and exchange rate depreciation are expected to accelerate in the next few years.

## 4. Korea's Five-Year Economic and Social Development Plan

The 1960s carry a special meaning for the Korean economic history of the past half-century. To specify, this decade marked the beginning of a national effort to launch an economic takeoff by way of a series of Five-year economic development plans, the first of which was launched in 1962 under the auspices of a newly established government. One of the characteristics of the Korean economic development plan was that it was a rolling plan, implying that the government prepare alternative policies should it face major unforeseen changes outside of the domestic environment.

Furthermore, the government can modify the plan and defer it by one year if necessary. The plan was also an indicative plan, allowing the government to induce the private sector to follow the plan. Kang (2000) reviews the Korean economic development plans.

The first Five-year economic development plan (1962-66) consisted of initial steps toward the building of a self-sufficient industrial structure. Thus the economy was neither consumption-oriented nor over-dependent on oil. Such areas like electric power, fertilizer, oil refining, synthetic fibers, and cement were emphasized. The second Five-year plan (1967-71) stressed modernizing the industrial structure and rapidly building import-substitution industries, including steel, machinery and chemical industries.

The third Five-year plan (1972-76) achieved rapid progress in building an export-oriented structure by promoting heavy and chemical industries (HCIs). Industries receiving particular attention included iron and steel, transport machinery, household electronics, shipbuilding, and petrochemicals. The developers of HCIs sought to build these industries as future export industries as well as substituting imports of intermediate goods and capital goods and to reduce or even eliminate dependence on foreign capital. New and critical industries were to be constructed in the southern part of Korea, thus encouraging economic development and industrialization outside of Seoul and providing new employment opportunities for residents of the less developed areas.

The fourth Five-year plan (1977-81) fostered the development of industries designed to compete effectively in the world's industrial export markets. These major strategic industries consisted of technology-intensive and skilled labor-intensive industries such as machinery, electronics, and shipbuilding. The plan stressed large HCIs, such as iron and steel, petrochemicals, and nonferrous metal. As a result, the ratio of HCIs to the entire industrial production reached to 58.5% in 1981. These developments can be ascribed to a favorable turn in the export performance of iron, steel, and shipbuilding, which occurred because high-quality, low-cost products could be produced in Korea. By contrast, the HCIs of advanced countries slumped during the late 1970s. In the machinery industries, investments were doubled in electric power generation, integrated machinery, diesel engines, and heavy construction equipment; the increase clearly showed that the industries benefited from the government's generous financial assistance program and tax incentives as well as import protection.

The late 1970s, however, witnessed worldwide recession, rising oil prices, and growing inflation. Korea's industrial structure became somewhat imbalanced sometimes experiencing acute shortage of some daily necessities or building materials. Many companies in the HCI suffered from heavy debt burden while their capacity utilization rate was very low due to inadequate demand. The financial sector also suffered, being severely "repressed" through the 1970s, since the government used bank credit as an industrial policy tool providing policy loans at subsidized interest and resorting to other credit rationing. Banks were further burdened with snowballing NPLs. Rapid credit expansion for the financing of the HCI, as well as the two oil shocks, also generated acute inflationary pressure and rampant real estate speculation. Also of concern was the growing disparity of income/wealth and concentration of economic power towards large business groups, the then main beneficiaries of the HCI drive. It was clear that Korea's growth potential was severely threatened.

With this lesson from the 1970s, the emphasis of the fifth Five-year economic and social development plan (1982-86) was placed on macroeconomic stabilization and liberalization: Financial liberalization, external liberalization and fair and freer competition in the market. It sought to shift the emphasis away from HCIs to technology-intensive industries, such as precision machinery, electronics (televisions, videocassette recorders, and semiconductor-related products), and information. More attention was to be devoted to building high-technology products in greater demand on the world market.

The sixth Five-year plan (1987-91) to a large extent continued to emphasize the goals of the previous plan. The government intended to accelerate import liberalization and to remove

<Table 4-1> Achievements of the Korean Five-year plans

| | 1st 1962-1966 | 2nd 1967-1971 | 3rd 1972-1976 | 4th 1977-1981 | 5th 1982-1986 | 6th 1987-1991 | New 1993-1997 |
|---|---|---|---|---|---|---|---|
| Growth rate, % | 7.8 | 9.6 | 8.0 | 6.2 | 8.7 | 9.4 | 7.1 |
| (Target), % | (7.1) | (7.0) | (8.6) | (9.2) | (7.6) | (8.2) | (7.0) |
| Inflation rate, % | 16.3 | 12.7 | 16.0 | 18.6 | 3.6 | 6.8 | 5.0 |
| Current account, | -3.2 | -26.5 | -49.0 | -151.9 | -14.5 | 194.8 | -432.8 |
| USD100 million | | | | | | | |
| [CA/GDP],% | [ • ] | [ • ] | [-5.2] | [-4.7] | [-0.6] | [2.7] | [-1.6] |

Source: BOK DB, IFS CD-ROM, Lee (2002)

Note 1: Growth rate is the average GDP growth rate during the given period; Inflation rate is the average increasing rate of the

CPI; Current account is the accumulated balance over the given period.

Note 2: Target growth rates are in parentheses.

Note 3: Current account balance/GDP ratios are in brackets.

various types of restrictions and non-tariff barriers on imports. These moves were designed to mitigate such adverse effects as monetary expansion (due to improved balance of payments) and delays in industrial structural adjustment. The government pledged to continue phasing out direct assistance to specific industries and instead to expand manpower training and research and development in all industries, especially the small and medium-sized firms that had not received much government attention previously. The government hoped to accelerate the development of science and technology by raising the ratio of research and development investment from 2.4% of the GDP to over 3% by 1991.

The goal of the seventh Five-year plan (1992-96), formulated in 1989, was to develop high-technology fields, such as microelectronics, new materials, fine chemicals, bioengineering, optics, and aerospace. The government and industry would work together to build high technology facilitates in seven provincial cities to better balance the geographic distribution of industry throughout Korea. The seventh plan was replaced by the Five-year plan for the new economy (1993-97) by the Kim Young-Sam administration to better reflect the economic policies of the new government.

The Five-year plan for the new economy (1993-97) stressed relaxing business activity regulations and changing the attitudes of government officials toward public service. It anticipated lowering entry barriers and removing other restrictions on competition in traditionally over-protected industries like alcoholic beverages, oil refining, transport, construction and finance. However, these efforts failed to deal with vested interests, including those of bureaucrats, so were largely unsuccessful in enhancing market competition.

What are the major contributing factors for the successful macroeconomic performance of the Korean Five-year plans High quality education and human resources, unrestricted foreign capital inflow, strong corporate incentives, active SOC investment and low wage, favorable international environment etc. Even though the plans were compressed growth driven by a government-led planning strategy, the Korean economy nonetheless contained several shortcomings, and subsequent problems emerged from the growth path: Resource misallocation from overly ambitious industrial policy, government failure, lack of transparency of economic policy decision, failure to put sound corporate governance in place, and poor preparation for financial market opening.

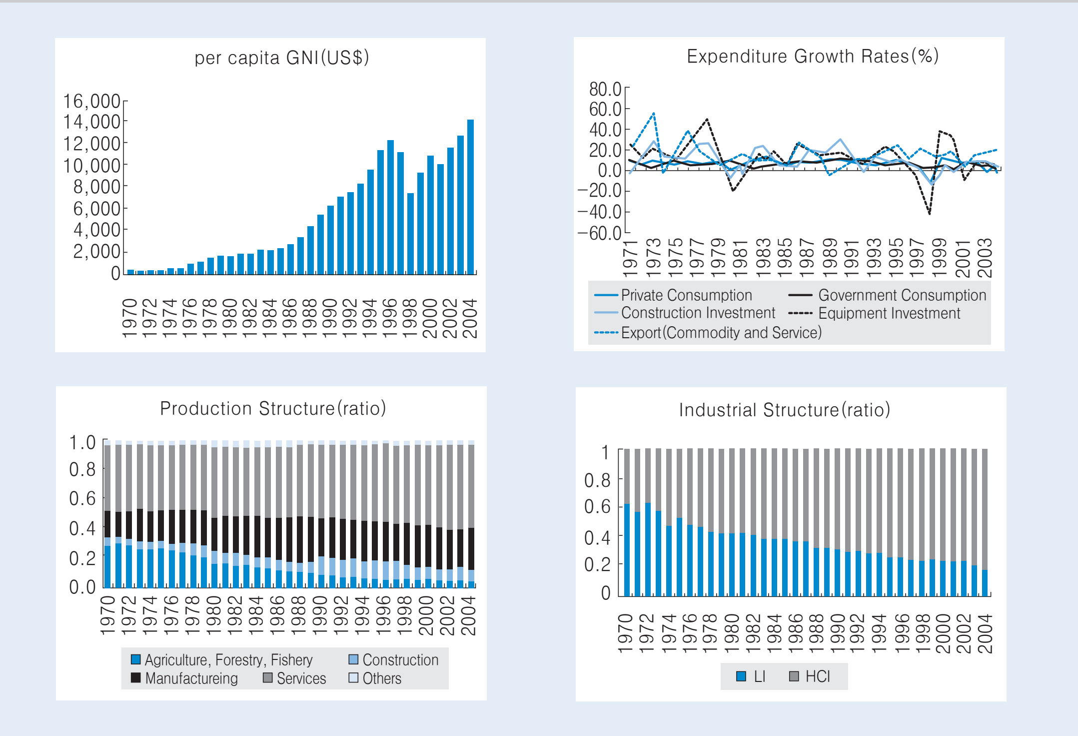
The government required concrete investment plans to fulfill the Five-year development plans. The government has selected specific industries, which backed up the growth targets. Moreover it set up investment projects and their financing plans. After evaluating the Five-year plans, many investment plans were proved to be inefficient or failures. Various causes of the investment plan failure present a mixed picture, but some commonalities are nonetheless found. The primary cause of the failed investment plans is lack of realism. Inaccuracy, irrationality and inefficiency are additional causes of the failed investment plans. Deeper evaluation of the Five-year development plans reveals both positive and negative sides. On the positive, the Korean government heavily utilized exports as an engine of rapid growth. This decision proved the right direction to achieve high growth performance for a developing country during that period of history. The plans also encouraged investment by reducing uncertainty, while developing social structure by building institutions and laws, thus expanding the supplementary function of the market. On the negative side, the plans overly emphasized production, investment and savings, prompting people to sacrifice consumption and welfare. Such strategy generated many insolvent enterprises, causing many companies to depend on government rather than the market.

The natural relationship between the government and firms in this environment is discretion rather than rule. The government became too ambitious in achieving the given targets, leading to much market distortion, for instance credit rationing to provide investment fund. Compressed growth generated high inflation, while it sacrificed equity and efficiency. Intervention in interest rate determination and credit allocation impeded the development of the financial industry, and the allocation of resources according to governmental decisions promoted a monopolistic or oligopolistic market structure. The Korean government has ceased with any economic development plans, based upon several reasons. Above all, Korean private sector grew too big to be planned, and government intervention was effective only when private sector was small and weak. Currently the private sector in Korea has more and better quality information than the government. In addition, it possesses greater investment ability than the government, leading to government-led planning becoming inefficient.

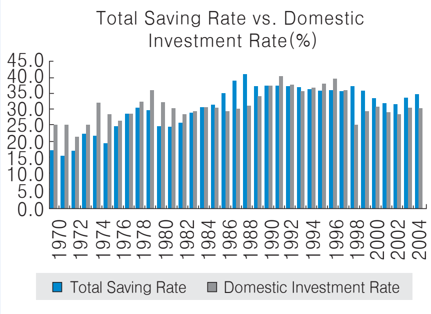
# 5. Trends of Korea's Macroeconomic Variables

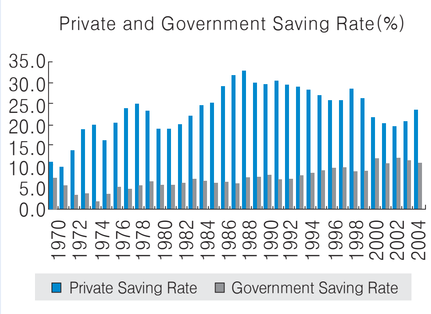
While per capita GDI showed rapid growth from 1986 to 1996, negative growth rates have been recorded in 1997 and 1998. Brisk fixed investment and export were major contributors to the rapid growth. For the ratio of change in the production structure, the service sector showed increased, while agriculture, forestry, and fishery sector decreased. The share of the manufacturing sector has been rather stable since 1989. The composition of industry has also changed continuously. The weight of HCI grew while that of LI diminished. Saving rate became greater than investment rate since 1998, while private saving rate decreased from 1998 to 2002, but increased from 2003 to 2004. The government savings rate in 2004 reached a figure higher than that in 1998. After the financial crisis, Korean growth rate showed a strong downward trend since 1999. Inflation rate as an increase rate of GDP deflator is quite stable after the crisis. Trends of monetary growth rate of M2, M3 and market interest rate (here calculated as yield on corporate bond) have been decreasing since 1991.[62]

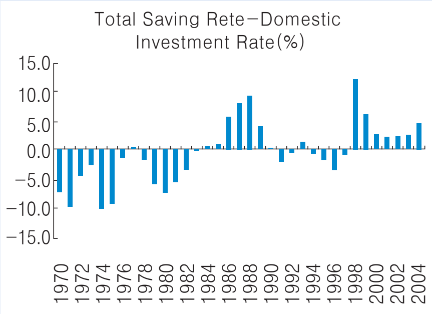
<Figure 4-2> Trends of Korean Macroeconomic Variables

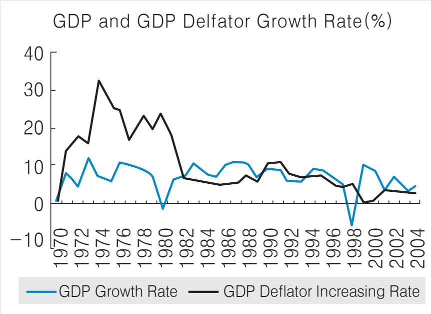


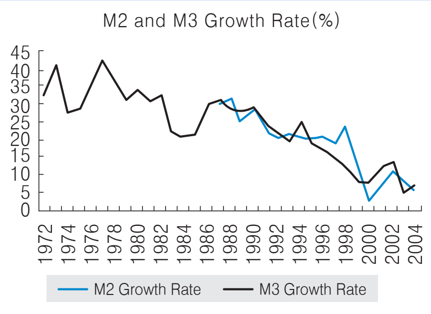

62) Most of the Korean macroeconomic data are easily obtained from websites of the Bank of Korea (www.bok.or.kr) and the National Statistical Office (www.nso.go.kr).

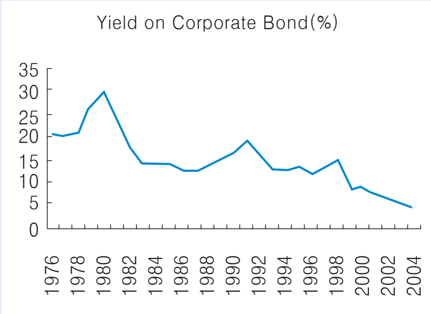

Total Saving Rate vs. Domestic Investment Rate(%)
Total Saving Rate
Domestic Investment Rate


Private and Government Saving Rate(%)
Private Saving Rate
Government Saving Rate


Total Saving Rete–Domestic Investment Rate(%)


GDP and GDP Delfator Growth Rate(%)
GDP Growth Rate
GDP Deflator Increasing Rate


M2 and M3 Growth Rate(%)
M2 Growth Rate
M3 Growth Rate


Yield on Corporate Bond(%)

# 6. Macroeconomic Stabilization in Korea

Stabilization as an objective of Korean policy has ebbed and flowed over the years. It had to compete with the more urgently felt need to promote rapid economic development. Only when stabilization was so severely compromised as to threaten economic growth itself did political leaders treat it as a high priority goal. It was only when inflation was getting out of hand, as in the end of the 1970s, or when the balance of payments deficit seemed beyond the country's ability to finance it that stabilization became a truly salient issue. One might argue that this was true because neither internal nor external balance was ever seriously out of control in Korea. Apart from wartime, Korea has never experienced hyper-inflation like in Indonesia in the early 1960s or Latin America on several occasions. Similarly, the current account deficit as a share of GDP of Korea never approached the double-digit levels of several developing countries.

The judgment of whether a stabilization problem exists is difficult to make, since it does not depend on current numbers alone.[63] Stability implies that the situation is sustainable without extraordinary government policy or without requiring a change of policy. Two kinds of difficulties are involved. First, the sustainability of some variables such as inflation depends on the society's willingness to accept it, something that is not easily observed. Moreover, society's tolerance changes over time and its willingness to accept inflation tends to decline as financial assets become more widely held. Second, some variables such as the exchange rate have a delayed impact on the economy, requiring some judgment as to what would have happened if the exchange rate had been frozen at the existing value. Furthermore, the problem with inflation with its high variation is that it distorts other macroeconomic variables, particularly when those variables are managed by the government. In a situation of high and unstable inflation, it is difficult for the government to manage real interest rates or real (effective) exchange rate stability which is likely to result in distorting effects to investment and trade activity.

## 6-1. Macroeconomic Imbalances

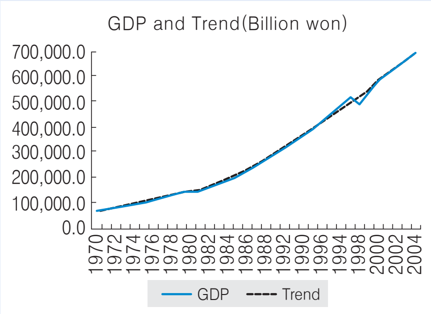
In the 1970s, the Korean economy grew at an average annual rate of 8.3% in real terms, despite the first oil shock.[64] However, this rapid growth was accompanied by serious macroeconomic imbalances. In particular, the first and second oil shocks dealt a fatal blow to the oil import-dependent economy, accelerating inflation and considerably deteriorating the balance of payments. In addition, massive investment in HCIs, participation in the Middle-East construction boom, and an increased budgetary deficit arising from the subsidization of grain prices all led to increasing excess demand pressure in the second half of the 1970s. In fact,

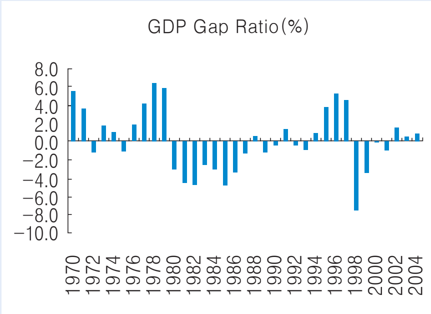
63) We understand that stabilization problem does not matter as long as equilibrium prevails.

64) Base year of the national income statistics is 2000.

producer's prices rose by 23.6% annually from 1974-1979, and the real GDP for the same period was estimated to have exceeded the potential GDP.[65] Figure 4-3 shows the Korean GDP, potential GDP and GDP gap ratio. According to the graphs, the excess demand pressure disappeared at the outset of the second oil crisis in 1980 until the late 1980s. Another big excess demand pressure reappeared in the first half of the 1990s and continued until Korea was hit by the Asian financial crisis. The scale of the excess demand formed between -6% and 6% of total GDP, except for the crisis period. Such scale is not too trivial to cruise, but evaluated to be managed by the dynamic potential of the Korean economy.

<Figure 4-3> Korean GDP, Potential GDP and GDP Gap Ratio




In the case of internal balance, a close look at Table 4-2 yields the impression that price stability was not introduced into Korea until 1982. The only two years before 1982 that inflation rate was under 10% were 1973 and 1977. Hence, one is forced to reach the judgment that there was no period of internal equilibrium before 1982. To be sure, the years from 1970 to 1973 were better from a stabilization point of view than those that followed the first oil shock in 1973, but the differences were only in the degree of how bad the inflation was, not whether inflation existed. Price stability was simply not a high priority of the government, which believed that it could manage the consequences of inflation, even desiring fallout from inflation, such as the transfer of wealth from lenders to borrowers. Inflation might not have worsened the income distribution too severely since there were few fixed-income earners in Korea. On the other hand, it probably did benefit the owners of land and real estate which skewed the distribution of wealth severely.

Price stability was introduced and was maintained from 1982 through 1987, but was upset again by the wage explosion of 1988 to 1991 in the wake of progress toward political democratization and the consequent increase in labor disputes. What has followed from 1992 to 1997 is an ambiguous situation. The CPI inflation rate hovered between 4 to 6%. Compared to

65) Potential GDP in Figure 4-3 is calculated using Hodrick-Prescott filtering.

most previous years, this represents a modest inflation, something Koreans might well have been willing to tolerate. On the other hand, Korea rapidly underwent change, with a growing middle class that is impacted badly by inflation. For instance, the rising prices of medical services, education, restaurant meals, and real estate severely impacted the middle class. As a result, Koreans blamed the government for not doing a better job.

In terms of external balance, the criteria for judging Korea's external balance over time had to be adjusted. External balance is defined as any target value for the balance of current account, balance on capital account, or balance of payments. In this study, the current balance and overall balance is taken as the criteria (refer to Table 4-3). The volatility of the external balance increased sharply in the 1970s because of the HCI program, the first oil shock, and the Korean adjustment. One year of large overall deficit in 1974 was followed by two years of large surpluses (1976-1977). As the full brunt of the HCI impacted on the economy in the late 1970s and early 1980s, the economy returned into a significant current account deficit position. Keeping the nominal exchange rate stable vis-à-vis the USD, while the USD was substantially weakening against other major currencies, resulted in undervaluation of the currency, which ultimately led to a non-sustainable surplus in 1987 and 1988. Due to the financial crisis in 1998 with its sharp reduction in domestic demand as well as a sharp depreciation of the currency - Korea recorded a huge external surplus.

It is difficult to set criteria for internal balance. However, it is possible to use CPI and PPI as indicators of the criteria. If increase rates of the both indexes are smaller than 4%, it is generally regarded as internal balance. Consequently, the eight years, 1983-1987, 1999-2003 (except for 2001), maintained internal balances (refer to Figure 4-4). Similarly if ratios of current balance and overall balance to GDP are smaller than 2%, it can be regarded as a status of external balance. According to this criterion, the nine years, 1983-1985, 1990-1995 (except 1991), and 2001, established an external balance (refer to Figure 4-5). Considering these internal and external balance simultaneously, it appears that only three years can be considered in balance for 1983, 1984 and 1985.

<Table 4-2> The Growth Rate of CPI, PPI, GDP and GNI (Unit: %)

| Year | CPI | PPI | GDP | GNI |
|---|---|---|---|---|
| 1970 | 17.5 | 9.1 | 8.8 | 7.6 |
| 1971 | 13.5 | 8.6 | 8.2 | 7.5 |
| 1972 | 10.7 | 14.0 | 4.5 | 4.2 |
| 1973 | 3.2 | 6.9 | 12.0 | 12.1 |
| 1974 | 25.0 | 42.1 | 7.2 | 6.7 |
| 1975 | 25.0 | 26.5 | 5.9 | 4.1 |

| | | | | |
|---|---|---|---|---|
| 1976 | 15.3 | 12.1 | 10.6 | 12.4 |
| 1977 | 9.8 | 9.0 | 10.0 | 10.8 |
| 1978 | 14.7 | 11.7 | 9.3 | 10.4 |
| 1979 | 18.3 | 18.7 | 6.8 | 6.1 |
| 1980 | 28.7 | 39.0 | -1.5 | -4.2 |
| 1981 | 21.4 | 20.4 | 6.2 | 5.2 |
| 1982 | 7.2 | 4.7 | 7.3 | 8.0 |
| 1983 | 3.5 | 0.2 | 10.8 | 11.2 |
| 1984 | 2.2 | 0.7 | 8.1 | 8.2 |
| 1985 | 2.4 | 0.9 | 6.8 | 6.3 |
| 1986 | 2.8 | -1.5 | 10.6 | 12.5 |
| 1987 | 3.1 | 0.5 | 11.1 | 13.1 |
| 1988 | 7.1 | 2.7 | 10.6 | 12.1 |
| 1989 | 5.6 | 1.5 | 6.7 | 8.4 |
| 1990 | 8.6 | 4.2 | 9.2 | 8.9 |
| 1991 | 9.4 | 4.8 | 9.4 | 9.8 |
| 1992 | 6.3 | 2.1 | 5.9 | 5.8 |
| 1993 | 4.8 | 1.6 | 6.1 | 6.3 |
| 1994 | 6.2 | 2.7 | 8.5 | 9.2 |
| 1995 | 4.4 | 4.7 | 9.2 | 9.5 |
| 1996 | 5.0 | 3.2 | 7.0 | 5.6 |
| 1997 | 4.4 | 3.8 | 4.7 | 2.7 |
| 1998 | 7.5 | 12.2 | -6.9 | -8.3 |
| 1999 | 0.8 | -2.1 | 9.5 | 9.4 |
| 2000 | 2.2 | 2.0 | 8.5 | 5.5 |
| 2001 | 4.1 | -0.5 | 3.8 | 2.8 |
| 2002 | 2.7 | -0.3 | 7.0 | 7.0 |
| 2003 | 3.6 | 2.2 | 3.1 | 1.9 |
| 2004 | 3.6 | 6.1 | 4.6 | 3.8 |

Note: The 1970 data of GNI column is GNP because it is not available.

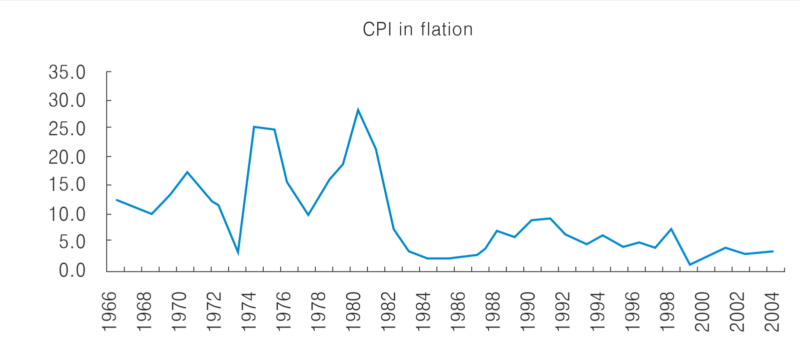
<Table 4-3> Balance of Payments (Unit: million US dollars)

| Year | Export(FOB) | Import (FOB) | Trade Balance | CB/GDP | OB/GDP |
|---|---|---|---|---|---|
| 1970 | 882.2 | 1,804.2 | -922.0 | -7.7 | -0.1 |
| 1971 | 1,132.3 | 2,178.2 | -1,045.9 | -8.9 | -2.0 |
| 1972 | 1,676.5 | 2,250.4 | -573.9 | -3.5 | 1.5 |
| 1973 | 3,271.3 | 3,837.3 | -566.0 | -2.3 | 3.4 |
| 1974 | 4,515.1 | 6,451.9 | -1,936.8 | -10.5 | -5.7 |
| 1975 | 5,003.0 | 6,674.4 | -1,671.4 | -8.8 | -0.7 |
| 1976 | 7,814.6 | 8,405.1 | -590.5 | -1.1 | 4.0 |
| 1977 | 10,046.5 | 10,523.1 | -476.6 | 0.0 | 3.5 |
| 1978 | 12,710.6 | 14,491.4 | -1,780.8 | -2.0 | -0.8 |
| 1979 | 14,704.5 | 19,100.0 | -4,395.5 | -6.6 | -1.5 |
| 1980 | 17,245.3 | 21,858.5 | -4,613.2 | -8.3 | 1.3 |
| 1981 | 20,747.3 | 24,596.1 | -3,848.8 | -6.5 | 0.4 |
| 1982 | 20,934.4 | 23,761.6 | -2,827.2 | -3.3 | 0.1 |
| 1983 | 23,271.6 | 25,120.1 | -1,848.5 | -1.8 | -0.1 |
| 1984 | 26,486.1 | 27,575.2 | -1,089.1 | -1.4 | 0.9 |
| 1985 | 26,632.6 | 26,652.8 | -20.2 | -0.8 | 0.0 |
| 1986 | 34,128.3 | 29,829.2 | 4,299.1 | 4.2 | 0.0 |
| 1987 | 46,559.9 | 39,030.5 | 7,529.4 | 7.2 | 0.6 |
| 1988 | 59,973.0 | 48,689.7 | 11,283.3 | 7.7 | 4.7 |
| 1989 | 61,832.0 | 57,486.7 | 4,345.3 | 2.3 | 1.4 |
| 1990 | 63,659.7 | 66,121.0 | -2,461.3 | -0.8 | -0.4 |
| 1991 | 70,546.4 | 77,450.0 | -6,903.6 | -2.7 | -0.4 |
| 1992 | 76,209.5 | 78,116.5 | -1,907.0 | -1.2 | 1.1 |
| 1993 | 82,097.8 | 79,947.7 | 2,150.1 | 0.2 | 0.8 |
| 1994 | 94,982.5 | 97,999.7 | -3,017.2 | -1.0 | 1.1 |
| 1995 | 124,933.6 | 129,298.2 | -4,364.6 | -1.7 | 1.4 |
| 1996 | 130,037.6 | 145,114.7 | -15,077.1 | -4.1 | 0.2 |
| 1997 | 138,730.7 | 141,986.4 | -3,255.7 | -1.6 | -2.3 |

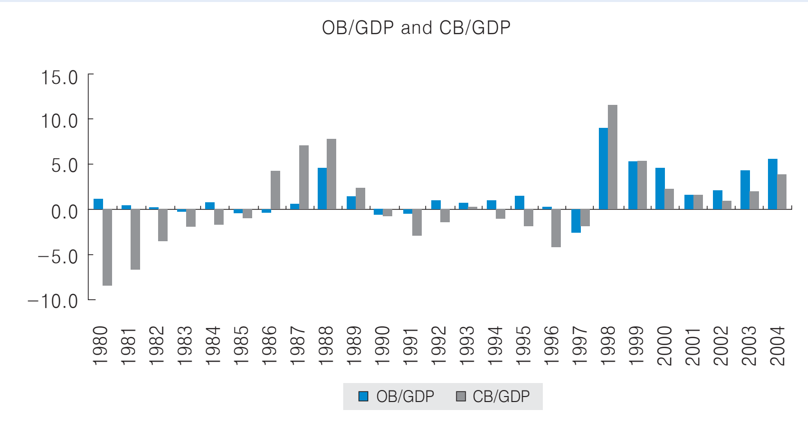
| | | | | | |
|---|---|---|---|---|---|
| 1998 | 132,251.2 | 90,586.2 | 41,665.0 | 11.7 | 8.9 |
| 1999 | 145,375.4 | 116,912.4 | 28,463.0 | 5.5 | 5.2 |
| 2000 | 176,220.5 | 159,266.9 | 16,953.6 | 2.4 | 4.6 |
| 2001 | 151,478.3 | 137,990.3 | 13,488.0 | 1.7 | 1.6 |
| 2002 | 163,414.0 | 148,636.6 | 14,777.4 | 1.0 | 2.2 |
| 2003 | 197,289.2 | 175,337.2 | 21,952.0 | 2.0 | 4.3 |
| 2004 | 257,745.0 | 219,584.3 | 38,160.7 | 4.1 | 5.7 |

Note: Updated BOP data of the BOK are available from 1980.
Previous issues of balance of payments were used for the data before 1980.

<Figure 4-4> Korean Inflation (Unit: %)




<Figure 4-5> Korean Overall & Current Balance Ratio (Unit: %)



## 6-2. Stabilization Efforts in the 1980s

The rapid growth and high inflation in the Korean development stage resulted in soaring wages. Between 1976 and 1979, real wages in the manufacturing sector ballooned to 18% annually, 2.2 times higher than the increase in labor productivity. This was mainly due to the strong demand for higher-educated, skilled workers by large business groups in the process of the HCI drive. Together with the rapid rise in wages, the over-valued exchange rate eroded the competitiveness of Korean exports.[66] Consequently, exports in real terms recorded negative growth in 1979, the first decline since the nation adopted the export-oriented industrialization strategy in the early 1960s. Thus faced with both high inflation and a widening deficit in the balance of payments, attention was called to the need for conservative fiscal and monetary management as well as an exchange rate adjustment.

Priority in fiscal policy was given to stabilizing prices by cutting expenditures and deferring some public investment projects. Following a zero-based budgeting principle, the general account budget was prepared to produce a sizable surplus to finance deficits in some public funds. In the 1982 budget, the government's purchase price of grain was kept low to reduce the deficits incurred by the grain-price support program. As a result of fiscal austerity, the consolidated budget deficit was reduced from an average of 3.1% of GDP in 1976-1982 to 1 % in 1983-1986. The annual growth rate of the broad money supply (M2) also decreased from 30% in 1976-1982 to 15% in 1983-1986. In addition, bank interest rates were adjusted slightly upward to make them relatively attractive for depositors compared with non-bank rates.

The stabilization efforts exerted in the early 1980s proved very successful. CPI inflation, which ran at an average annual rate of 25% in 1980-1981, decelerated to 7.2% in 1982 and to 2.2-3.5% during 1983-1987. Real wage increases in the manufacturing sector also subsided to 4.7% in 1980-1987, lower than the 6.7% increase in labor productivity during the corresponding period. However, fiscal austerity, which was directed at achieving economic stability by restricting the expansion of public investment projects, gave rise to a shortage of social overhead facilities, creating a major bottleneck to economic growth during the late 1980s.

The success in curbing inflation during the first half of the 1980s led to a turning point in the Korean economy. Thanks to rapid export growth, GDP grew by over 11% annually and recorded a sizeable current account surplus during 1986-1988 for the first time in its modern history. Economic success was due in large part to the favorable external conditions appreciation of the Japanese yen, low international interest rates and oil prices. The economy became self-sufficient in terms of resource requirements to finance its domestic investment, and hence was able to reduce its exposure to foreign debt since 1986. Without price stability, however, Korean firms could not capitalize on the external environment which was favorable to

66) The exchange rate is fixed to the USD in 1975-1979 despite the nation's high inflation.

expanding exports.

The brisk increase in exports was largely attributed to significant depreciation of the real effective exchange rate. In fact, the real effective exchange rate depreciated by about 35% between 1982 and 1987 not only because of the nominal depreciation of the KRW/ USD rate by more than 20% during the same period, but also because of strong appreciation of the Japanese yen from an average of 238 yen per USD in 1982 to 128 yen in 1988. As a result, exports increased by 31% annually in USD terms between 1986 and 1988. This surplus added about 15 trillion KRW to the domestic money supply during the 1986 to 1988 period, accounting for 73% of the total increase in M2 supply during the period.[67)]

The restrictive monetary stance from the early 1980s began to be shaken due to the large current account surplus, which was resulting in a rapid increase in net foreign assets. In 1988, the growth rate of M2 again exceeded 30%. The KRW had to be appreciated in view of the current account surplus. Wages also started to accelerate after the declaration of democratization in June 1987. Consequently, exports and GDP growth began to slow down considerably by the late 1980s. To stimulate the sluggish economy, the government launched a massive housing construction program building 2 million housing units. By and large, these measures were successful in promoting economic growth as the economy recorded a 9% growth annually between 1990 and 1991. High economic growth was accompanied by rapid expansion of service industries in accordance with a booming asset market as well as an increase in demand for leisure after the 1988 Summer Olympics in Seoul. Since 1991, the government has resumed the economic stabilization policy, which thus far had promoted robust economic growth with relatively stable prices.

## 6-3. Economic Stabilization in the Early 1990s

Economic growth propelled by the expansion in consumption and service production, however, resulted in a serious macroeconomic imbalance with rising inflation and a large trade deficit. Faced with growing external and internal imbalances, the government switched its economic policy stance to economic stabilization in 1991. It announced comprehensive stabilization policy measures, and introduced a new set of regulations designed to manage construction activities at a proper level and to tighten restrictions on commercial building construction. In the second half of 1992, the government partially lifted restrictive measures imposed on construction.

Given these stabilization efforts, inflationary pressures were eased and the external balance

67 ) The BOK issued MSBs (Monetary Stabilizing Bonds) to absorb excess liquidity injected by the monetary expansion in the foreign sector. Because the interest rate on MSBs was regulated at below the market level, financial institutions were in fact to purchase MSBs, and hence their asset management was significantly

was improved at the expense of sluggish economic growth, 6.0% on an average in 1992 and 1993. However, the economy soon regained its growth momentum to achieve 8.5% and 9.2% growth over the period of 1994 to 1995, thanks to the rapid expansion of facility investment and exports along with the appreciation of the Japanese yen.

## 6-4 Financial Crisis in 1997

The financial crisis that hit Korea in the second half of 1997 had a devastating impact on the Korean economy, causing Korea's worst recession in the postwar era. Real GDP growth fell from levels which had been running in the positive 6.1% to 9.2% range before the crisis (1993-1996) to a negative 6.9% in 1998.[68] In the aftermath of the crisis, unemployment rose from pre-crisis levels of 2% to 6.8% in 1998 and 8.1% in March 1999. The financial crisis in 1997 was not only the biggest shock to the Korea's economy since the early 1960s, but also were the result of some macroeconomic causes, even if structural factors might have greater responsibility.[69] Hahm and Mishkin (2000) used an asymmetric information framework to understand the causes of the Korean financial crisis. Four factors were pointed out as potentially leading to increases in asymmetric information problems and thus to financial instability: Deterioration of financial sector balance sheets, increases in interest rates, increases in uncertainty, and deterioration of non-financial sector balance sheets due to changes in asset prices.

Black and Black (1999) claimed that the Korean financial crisis arose because of government failure in the two major policy areas: Exchange rate policy and industry policy. Collectively, these government failures had adverse repercussions for the Korean economy. The exchange rate policy failure arose from the government's attempt to peg the KRW to the USD. When the USD appreciated, so too did the KRW, which in 1997 was judged by financial markets to be significantly overvalued. The government's implicit guarantee to maintain the fixed exchange rate misled businesses into believing that foreign exchange risk did not exist. Thus business did not consider the potential increase in the domestic cost of foreign debt, which occurred when the KRW eventually devalued. As the KRW lost value it became increasingly difficult to repay foreign debt, which resulted in Korea banks and businesses defaulting on loan obligations. Similarly, the government's industry policy, whereby financial institutions and business firms collectively made investment decisions on political rather than economic grounds, resulted in much investment being unprofitable. Therefore the Korean financial crisis was caused by the overvalued KRW encouraging excessive foreign borrowing and the crony capitalism industry policy, investing the loans for uneconomic purposes.

68) GDP growth rate recorded 4.7% in 1997.

69) Structural factors include the extensive government intervention in the economy which brought about moral hazard for big businesses and banks, corruptive symbiotic relations between politicians and big businesses, poor corporate governance in family-controlled business groups (Chaebols), the weak banking sectors, etc.

Regarding macroeconomic factors responsible for the crisis in Korea, inadequate preparation for the capital market opening as a conduct of financial liberalization in the 1990's should be focused on. Korea was not ready to deal with the increased risk at that time. Wyplosz (2001) examined a topic of "whether financial liberalization is hazardous." He studied the experience with liberalization in a sample of 27 developing and developed economies, attempting to detect whether exchange rate instability, possibility culminating into full-blown currency crises, is a standard outcome. He concluded that liberalization may be desirable, if only because it increases competition and reduces monopoly powers, not just in the financial markets. Yet liberalization is a risky step, one on which our knowledge remains rudimentary. He emphasized that there is no urgency to undertake liberalization, even though that step should clearly be taken somewhere down the road.

Another macroeconomic cause of the Korean financial crisis was the maintenance of the strong KRW in the presence of sizable current account deficit. Even though current account deficits were 1.0-4.1% between 1993 and 1996, before the crisis, the foreign exchange authority tried to keep the KRW/USD exchange rate within a certain boundary. For instance, while the exchange rate was 802.8 KRW per USD on overage in 1993, it was 805.1 KRW per USD in 1996. Such tendency continued before the crisis. Therefore the foreign reserve at BOK was almost exhausted before the crisis. To overcome the crisis, various reform policies in financial sector, corporate sector and labor market were driven by the government. However these policies are beyond the scope of this paper.

# 7. Korean Macroeconomic Policies

## 7-1. Credit Policy

In Korea, the government owned, or otherwise heavily intervened in, the banking institutions, setting their interest rates, and directing a substantial portion of their loans until the 1990s. Most economists view this strategy a policy of financial repression as an ineffective way to achieve high economic growth. This policy stance indeed caused many problems in Korea. That is, at times a large amount of credit was being allocated to unsuccessful ventures, forcing the government to bail out firms and banks with monetary expansion. It also inhibited the development of an efficient banking system, and fostered economic concentration.

Koreans, desiring industrialization, were able to achieve it by allocating cheap credit to large industrialists, forcing them to build industries and to increase their exports, and threatening to withdraw credit should they fail to perform. Depositors were rewarded, after all, as wage earnings with the expansion of job opportunities and an increase in real wages. Rapid income increase contributed to the accumulation of domestic savings and the subsequent expansion of the financial market. The question, then is, what made this approach work in Korea, albeit at some cost, while similar policy initiatives led to unsuccessful developmental experiences elsewhere?

No clear answer has been found yet in the literature. However the government can play a critical role in promoting economic development, and credit policies can be used as an effective instrument for doing so. Cho and Kim (1997) surveyed the evolution of the financial sector policies and directed credit programs in Korea. Many aspects, however, were left unstudied, such as which aspects of credit policies contributed most to the growth of industries; what constituted the optimal level of government intervention; whether alternative approaches could have worked better etc. The Korean economy is still in the process of development, and the costs of this strategy might have not yet been fully realized. Therefore various research issues including the ones above should be further evaluated in the near future.

In Korea, what contributed most to the apparent effectiveness of credit policies seems to be effective monitoring and sensible performance criteria and competitive business environment. Effective monitoring was possible thanks to political leadership with vision and commitment to economic development and a strong bureaucracy capable of carrying out the mission. Provision of strong incentives (for instance preferential credit and tax treatment) and effective monitoring are moot without sound and clear performance criteria. In Korea, the major criterion was success in exports, an ultimate test of efficiency and competitiveness. Other factors were also determinants of success, but they are linked to these two factors. For example, Korea faced a favorable international environment, but how fully it could seize upon these opportunities depended on the type of management exercised at both the government and the firm level. Korean credit policy has adjusted to the changes in the focus of industrial policy over time. Clearly focused industrial goals and a macroeconomic environment that was conducive to the effective operation of credit policies also owed to good economic management. In Korea, close consultation between the government and businesses, and the government risk partnership with businesses, made what could have been a distorted interventionist approach a quite effective development strategy.

It was not specifically directed credit programs that helped overcome market imperfections and spur industrial growth in Korea. More broadly, it was government surveillance over the banking system and how it was used as an industrial policy instrument to effect corporate governance that contributed to rapid industrialization and growth. By controlling financing, the government became an effective risk partner of business firms and their monitor. The directed credit programs were adjusted continuously in the process of close government-business consultation. The government did not simply provide these programs; it ensured that the programs worked to help exporters and industrial producers. When it was deemed that additional policy measures were necessary to help them succeed, the government took such measures correcting exchange rates, building the infrastructure, extending tax exemptions, and sometimes taking extraordinary measures, such as the August 1972 Emergency Decree. In this way, the government responded with vigor to market imperfections.

The Korean financial and development experience suggests that government can play an important role in laying the groundwork for rapid industrialization in the early stages of economic development. If government intervention in credit allocation is predicated on close consultation with industry, and if it is implemented with effective monitoring and sensible performance criteria within a competitive business environment, it can be reasonably successful at overcoming financial market imperfections, thereby contributing to rapid industrialization. When the risky capital market was poorly developed, the Korean government affected a close relationship between banks and industry by exerting control over bank management, thereby becoming an effective risk partner of industry. The implicit co-insurance scheme among government, industries, and banks allowed the credit-based economy and the highly leveraged corporate firms to explore risky investment opportunities and to operate without a major financial crisis.[70)]

However the Korean experience also suggests that the cost of this approach can be substantial, and can be exacerbated as economic development advances. The Korean policy strategy fueled rapid industrialization, but also dampened efforts to develop an efficient banking system. The government's risk partnership with industrial firms placed a heavy burden on the banking system, loading it with large non-performing loans, and raised social equity issues. Extensive government intervention in financing, especially low interest rate ceilings, slowed the growth of

70) Refer to Coe and Kim (2002) and Hahm and Mishkin (2000).

financial savings. Korea was able to overcome this negative impact of government intervention by relying heavily on foreign borrowing, banking on its special relationship with the United States and Japan for access to foreign borrowing.

Furthermore, the perpetuation of strong government intervention in credit allocation when the industrial sector was well established and when economic organizations had become sophisticated placed Korea at greater risk of distorting the allocation of financial resources. The co-insurance scheme among the government, industries, and banks fostered a moral hazard for banks and firms, despite contributing to the development of entrepreneurship and the expansion of industrial investment. The moral hazard, together with changes in the domestic political scene that necessitated the mobilization of political donations and support, provided a fertile soil for developing a collusive, corruptive symbiosis between politicians and big businesses. The government became increasingly ineffective as the monitor, and the big businesses were busy trying to maximize their family interests at the expense of minority shareholders as well as the survival of their businesses. However, the government failed to impose sound corporate governance on business groups as well as workable corporate exit mechanisms. On the eve of the 1997 crisis, business groups in serious financial distress must have believed that they were too big for the government and banks not to come to the rescue, while the government and banks painfully realized that the needed rescue operation was beyond their capacity.[71)]

The overall lesson from the Korean experience is that governments can intervene productively and effectively in the early stages of economic development. The balance between the role of government and market forces should reflect the financial market, industrial organization, market structure, and political and international environment that face a country. As economic development advances, the role and scope of government intervention must be re-appraised with a view toward fostering greater reliance on market forces.

## 7-2. Monetary Policy

Korea was caught in a state of virtual hyperinflation after its liberation from Japanese colonial rule in 1945 mainly because of the massive increase in currency circulation shortly before the end of World War II. However, it was not until 1957 that the government took a major step toward economic stabilization, resulting from the country’s division into the North and South. The Korean War (1950-1953) further aggravated the already dismal economic condition.

Economic stabilization after 1957 involved monetary tightening as a major apparatus for

71) Refer to Nam (2001) for the evolution of the relationship between the government and big businesses: how the effective development partnership degenerated into a corruptive symbiosis ultimately leading to the financial crisis of 1997.

inflation control. The central bank raised its lending rates while the government prioritized the allocation of financial credit across industries and imposed a credit ceiling for each bank loan. Accordingly, inflation subsided significantly by the early 1960s. In the early phase of the first Five-year economic development plan, the money supply rapidly rose and inflation began to pick up. Rising inflation led to a re-tightening of monetary policy in 1963 and 1964. However, the large upward adjustment of interest rates in September 1965 brought a sharp rise in bank deposits; consequently, the annual M2 growth rate surpassed 60% in the 1965 to 1969 period. Although the money growth rate fell in tandem with steadily declining interest rates thereafter, M2 growth remained at higher than 30% per annum during the period of 1972 to 1973 and 1976 to 1978 because of the August 3 emergency measure in 1972 and investment boom in the course of HCI development, respectively.

Suffering from the high cost of inflation that prevailed in the 1970s, the government adopted an extensive economic stabilization package with a particular emphasis on monetary tightening that began in the late 1970s. The economy fell into a deep recession from 1979 to 1981 due not only to disinflation policies but also to the adverse impact of the second oil shock in 1979, and the political and social unrest in 1980. However, inflation control was very successful as inflation stabilized remarkably to remain at less than 3% during the period of 1983 to 1987. Such price stability enabled the monetary authority to maintain M2 growth at less than 20% per annum during that period as well.[72)]

Financial deepening, measured as the ratio of the monetary aggregates to nominal GDP, showed substantial progress in the course of economic development except in the 1970s. The ratio of M2 to nominal GDP rose rapidly from less than 9% at the end of 1964 to about 33% at the end of 1969 largely due to the drastic upward adjustment of deposit interest rates in 1965. But the process of financial deepening was impeded by inflationary development in the mid-1970s. In fact, the M2/GDP ratio remained effectively the same at about 37% until 1981. Since the early 1980s, however, firm price stability helped the M2/GDP ratio begin to rise, reaching 88% in 1994 even with a rather low money growth compared with the previous decades. The ratio reached 132% in 1998, but fell to 121% in 2004.

Although the rising pattern of the M2/GDP ratio was not uniform across decades, its long-run trend was rather stable, reflecting increasing demand for money in accordance with economic development. For instance, the average M2 growth was higher than the nominal GDP growth by 5.6% per annum over the two decades since 1985. The ratio of M3 to GDP, another indicator of financial development, rose at an even more rapid pace from 42-46% in the late 1970s to about 100% by the end of 1989, and further to 165% by the end of 2004. Such a rapid rise in the ratio was mainly fueled by the expansion of the non-bank financial sector. In the first half of the 1970s, non-bank financial institutions were newly established in order to integrate the unorganized financial market into the organized financial system. They were less tightly

72) Refer to BOK (2003) for the detailed review of Korean monetary policy tools, framework and operations.

controlled than banks in setting interest rates, and their scope of business has expanded since the early 1980s. In addition, trust accounts and certificates of deposit (CDs) of banking institutions excluded from the M2 category have increased markedly. All these developments have translated into a sharp rise in the ratio of M3 to GDP.

After the end of the Korean War, the interest rates for banking institutions remained largely negative in real terms because of the rigidity of nominal rates in the face of high inflation. However, as a result of the financial stabilization program introduced in 1957 and the ensuing price stability, the bank interest rates remained higher than the rate of inflation from 1958 to 1962. With a drastic increase in bank deposit interest rates in 1965, time deposits of one-year maturity carried a real rate of return of more than 10%, which exceeded lending rates for some types of deposits.

During the late 1960s through the 1970s, however, real interest rates stayed at very low levels, sometimes even plunging into negative levels, thus rendering bank deposits highly unattractive to savers. Low or negative real interest rates were mainly caused by a declining trend in nominal rates since the late 1960s, and also by the sharp rise in inflation triggered by two world oil shocks in the 1970s. In contrast, real interest rates were significantly positive between 1984 and 1987 when inflation was low despite the fact that nominal interest rates were regulated rigidly at a relatively low level.

One the other hand, corporate bond yield showed a steady downward trend in real terms; the real rate of return on corporate bond declined to 5-9% in 1993-1994, down from 11-12% between 1983 and 1985. However, corporate bond yield did not show any close relation with the free market rate when the government managed to control the yield during the early stage of economic development. With the interest rate liberalization, the corporate bond yield represented the market rate fairly well after 1996. The real corporate bond yield moved over the range of 10-18% from December 1997 to March 1998 due to the financial crisis, stabilizing at 2.8% in October 1998. Even though it has fluctuated according the economic environment, it has settled at around 1-2% recently.

In order to assess the impact of monetary policy on aggregate demand, it is useful to examine the changing pattern of real money growth. Highlights of changes in the money growth trend during the past five decades can be summarized as follows:

- Monetary expansion during the periods of post-Korean War economic reconstruction (1954), the first full-fledged economic development phase (1961), and the development of the HCI phase (1977);
- Monetary contraction during the periods of disinflation policy (1955 to 1957, 1960, and 1963 to 1964);
- High real money growth during the periods of price stability (1958 to 1959 and 1982);
- Sharp increases in financial savings following interest rate reforms (1965 to 1969);
- Bank credit expansion due to the August 3 emergency measures, which was designed to

stimulate the economy and improve the debt structure of firms (1972 to 1973);

- Monetary contraction due to an increased current account deficit during the oil shock periods (1974 to 1975 and 1979 to 1980);
- Rapid monetary expansion fueled by a large current account surplus (1986 to 1989);
- Expanding money supply to overcome the financial crisis in the second half of 1998 (1998);
- Monetary expansion due to household credit increase (2002);
- Tight monetary policy to hold down a household credit boom (2003 to 2004).

As indicated above, monetary policy has been influenced by major economic developments during the last several decades. Monetary expansion during the periods of post-war reconstruction and the periods of rapid economic development has typically been followed by monetary contraction in order to check ensuing inflationary development. In addition, monetary policy has been significantly affected by external shocks such as the world oil shocks and the rapid appreciation of the Japanese yen. Thus monetary policy in the past was not successful in smoothing out business cycles, as its stance may well be characterized as pro-cyclical rather than counter-cyclical.

## 7-3. Fiscal Policy

In 1966, the government established the National Tax Administration Office to strengthen tax administration on an institutional basis, and raised tax rates on the consumption of luxury goods and on high income brackets. Consequently, the tax burden ratio, or the ratio of tax revenue to GDP, rose from a mere 8.6% in 1965 to over 14% by 1970. However, the ratio actually declined during the 1972 to 1974 period, as a result of increased tax benefits granted to promote industrial restructuring and facility investment. This decline in the tax burden ratio was soon reversed to reach around 19% in the period of 1982 to 1983. The primary factors for the rise were economic recovery, the introduction of a defense surtax and a VAT in the latter half of the 1970s, and reduced tax benefits and exemptions in the early 1980s. Since then, the ratio dropped slightly to 17% and remained at that level due to budgetary restraints, before rising again to more than 19% later.

Tax revenue as a percentage of central government expenditure was less than 20% prior to the Korean War, and remained at slightly higher than 30% during the post-war period from 1953 to 1958. However, it continued to rise to about 70% by the end of the 1960s, and further to 80% from 1974 to 1982 and 85% from 1983 to 1991. In 1995, tax revenue covered 90% of central government expenditure. However, this ratio fell to 85% in 2000 and to 69% in 2003 because of rapid increase in non-tax revenue.

There have been five different periods of intensive fiscal tightening in the past five decades. They are:

- The fiscal expenditure freeze (general account of the central government) in 1959 and 1960, as a part of the Fiscal Stabilization Plan for post-war inflation control;
- The fiscal expenditure cut in 1963 and 1964 in an effort to alleviate inflationary pressures in the early stages of economic development. The ratio of fiscal expenditure (general account of the central government) to GDP declined to about 11% during 1964 and 1965, the lowest level reached during the last four decades;
- Downsizing the budget in 1973 to correct the large fiscal deficit incurred in the previous year;
- Suppressing fiscal expenditure growth below nominal GDP growth between 1983 and 1988, in line with overall stabilization policies. The ratio of fiscal expenditure to GDP fell from 17.5% in 1982 to 13.7% in 1988;
- According to the consolidated budget, total fiscal expenditure increased by 8.1% and 7.0% in 2000 and 2002 which were lower than the growth rates of nominal GDP in these years. The ratio of fiscal expenditure went up to 19.1% in 1999, but fell down to 18.9% in 2000. After restoring 20.4% in 2001, it declined to 19.8% in 2002. The ratio moved up to 22.9% in 2003. Tight fiscal policy was implemented in these years since the Korean government made an effort to make up sizable fiscal deficits due to the financial crisis in the three consecutive years.[73)]

Conversely, the periods with relatively rapid fiscal expansion are as follows:

- A large increase in fiscal expenditure in 1961 and 1962 to finance investment (as prescribed in the first Five-year economic development plan) after a two-year budgetary freeze;
- An expansion of fiscal outlays based on increased tax revenue from 1966 to 1969, which was intended to finance increased public investment in social infrastructure. The ratio of fiscal expenditure (general accounts) to GDP rose from 11% during 1964-65 to 17% in 1969;
- A fiscal expansion during two oil shock periods (1974 to 1975 and 1979 to 1980), which was an attempt to counteract the recessionary impact of the oil crises by expanding public works projects;
- A budget expansion in 1989 and 1990 to restore normal fiscal operations that had been largely suppressed from the early 1980s for economic stabilization;
- As pointed out above, an expansionary fiscal policy was indispensable to overcome the financial crisis. Owing to the three-year deficits, the unemployment rate fell down from 8.8% in February 1999 to 3.6% in June 2000, and the economy began to recover from the crisis.

The budget balance registered a large deficit in 1972 as fiscal spending increased to counteract economic recession. Although the deficit dropped significantly in 1973 due to fiscal

73) The ratios of fiscal deficit to GDP are 1.4%, 3.9% and 2.5% from 1997 to 1999.

tightening, the first oil shock and the ensuing economic stagnation called for an expansionary fiscal policy, causing a consolidated budget deficit of more than 4% of GDP in 1974 and 1975. The fiscal balance improved in the late 1970s owing to economic recovery, but worsened again with a deficit of 4% of GDP from 1980 to 1982 as budget spending increased in response to economic slowdown after the second oil shock.

In subsequent years, the consolidated budget balance improved steadily due to tight fiscal management. It recorded surpluses for the first time during 1987 to 1988, whose magnitude was about 1.3% of GDP. Entering the 1990s, however, the government expanded its expenditures rapidly to revitalize the sagging economy as well as to improve the social infrastructure, the shortage of which had eroded the economy's growth potential. As a result, the consolidated budget balance ran a deficit in 1991 and 1992, but reverted to a surplus from 1993 onward.

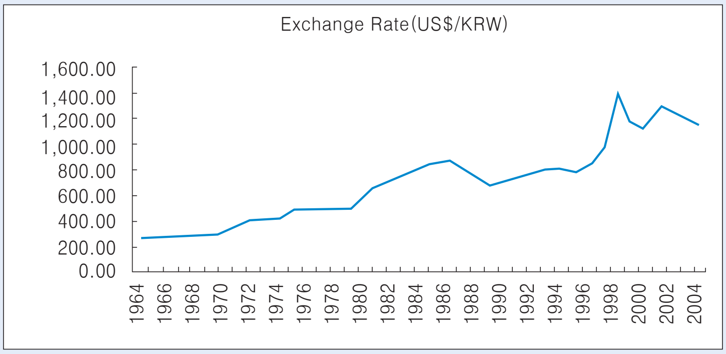
In order to assess the role of fiscal policy in business cycle management, it is more appropriate to examine the full-employment budget balance that excludes the cyclical component from the actual budget balance. This is particularly so because tax revenues are sensitive to the phase of the business cycle. For instance, despite the fact that the actual consolidated budget balance deteriorated significantly into a deficit of 3.2% in 1980, the full-employment budget balance for the same year improved in comparison with the previous year.

In fact, changes in the full-employment budget balance of the 1970s and 1980s were negatively correlated with real GDP growth, thus suggesting a counter-cyclical pattern in fiscal policy. In this context, the 1979 to 1981 period was an exceptional period in which, despite the drastic economic downturn, the full-employment budget balance shifted to a contractionary stance, in line with the overall economic stabilization efforts at the time. In 1981, fiscal policy was reoriented towards an expansionary stance in reaction to the previous tightening, even though the economy was already in a stage of mild recovery. On the other hand, fiscal policy of the 1990s turned out to be much less conforming to business cycle management. Evidence in the 1990s points to the unsatisfactory performance of fiscal policy as an instrument for cyclical management. For instance, the consolidated budget balance deteriorated during the 1990-91 period of cyclical upswing while it improved over the period of economic downturn of 1992-93.

## 7-4. Exchange Rate Policy

The nominal exchange rate was devalued by a factor of 9 from 0.05 KRW per USD to 0.45 KRW per USD between 1945 and 1948, and then further devalued by a factor of 40 to 18 KRW per USD by 1953, while wholesale prices soared by a factor of 37 between 1948 and 1953. Similarly, the KRW/USD exchange rate showed a 7.2-fold rise between 1953 and 1962, while wholesale prices more than quadrupled. In sum, the KRW/USD exchange rate was devalued even more rapidly than the rate of inflation between 1945 and 1957, thus preventing the overvaluation of domestic currency.

<Figure 4-6> Korean won Exchange Rate




The exchange rate began to float superficially under the unitary exchange rate system from 1965. However, since the early 1980s, when the multi-currency basket system was introduced, the exchange rate remained under the control of the monetary authority to a large degree. Since the adoption of the "market average" exchange rate system in 1991, market forces began to play an increasingly important role in the determination of the exchange rate as the allowance for daily fluctuations in the exchange rate was increased.

The official exchange rate was devalued from 130 KRW to 255 KRW per USD in May 1964, and was made flexible within a certain range upon the adoption of a unitary floating exchange rate system in 1965 (refer to Figure 4-6). From then, the KRW/USD nominal rate remained generally stable through 1969. However, the REER index (1985-1986=100) appreciated from 89 in 1965 to around 77 during 1968-69, largely because of higher domestic inflation relative to major trading partners. In the following years, the nominal exchange rate depreciated steadily due to high domestic inflation while the Japanese yen remained strong against the USD. As a result, the REER depreciated up to 106 in 1973, before it declined to 91 in 1974.

Although the nominal KRW/USD exchange rate remained fixed at 484 KRW per USD and the domestic inflation rate stayed at a fairly high level between 1975 and 1979, the REER index showed only a mild appreciation from 92 to 82 as the Japanese yen continued to gain strength against the USD. In January 1980, the KRW/USD exchange rate was devalued by 20%, and the exchange rate system shifted back to a floating regime under the multi-currency basket system. Despite high inflation resulting from the second oil shock, the REER remained relatively stable during the 1979 to 1982 period because of the steady rising trend in the nominal KRW/USD exchange rate.

However, the REER index depreciated rather sharply from 81 in 1982 to 108-109 in 1986 and 1987. Such depreciation in the REER resulted mainly from the continued depreciation of the nominal exchange rate through 1986, coupled with the remarkable domestic price stability achieved through economic stabilization in the early 1980s, as well as the sharp appreciation of the Japanese yen during the period from 1987 to 1988.

Since 1986, a massive current account surplus, particularly a large trade surplus against the US, has caused mounting international pressure to appreciate the domestic currency. Subsequently, the nominal KRW/USD exchange rate recorded an unprecedented appreciation from 881 KRW in 1986 to 671 KRW in 1989; thereby, the REER index also appreciated to 91 KRW by 1989. After that year, the deteriorating current account balance brought the rising trend back to the nominal exchange rate and the Japanese yen strengthened against the USD until 1991. Consequently, despite the relatively higher rate of domestic inflation, the REER index rose around 109 during 1993-94, the same level it had been during 1986-87. Right after the financial crisis, the nominal KRW/USD exchange rate skyrocketed over 1,700 on average until 1998. It did not fall below 1,200 until January 1999, and it currently fluctuates at around 1,030 in September 2005.

Despite substantial fluctuations on several occasions, the REER has been relatively stable compared to those of other countries. One major factor behind the infrequent but large fluctuations was that exchange rate management placed too much weight on the stability of the bilateral exchange rate between the KRW and the USD, to accurately reflect changes in the foreign exchange rates of other major currencies vis-à-vis the USD. Changes in the exchange rates of major currencies were usually reflected in the KRW/USD rate with roughly a one-year lag. Thus, the depreciation of the REER during both the 1972-73 and the 1986-87 periods were largely attributed to the appreciation of the Japanese yen against the USD.

On the other hand, inflation differentials between home and abroad were more quickly reflected in the nominal KRW/USD exchange rate. This may have been the result of an effort to retain the price competitiveness of exports in the face of high domestic inflation. In addition, the exchange rate was affected by domestic macroeconomic conditions. The nominal exchange rate tended to appreciate ceteris paribus to maintain price stability during high inflation periods, while it appeared to depreciate in response to the decrease in foreign exchange reserves compared to import bills. Also, the nominal exchange rate tended to be depreciated to promote exports during periods of sluggish economic growth, although such tendency has little statistical significance.

## 7-5. Wage Policy

From the late 1950s to 1967, the first year of the second Five-year economic development plan, manufacturing wages remained effectively unchanged at about USD 20 per month despite the sizable increase in nominal wages. This was because the domestic currency depreciated vis-à-vis the USD at an almost equal speed. Since the beginning of full-fledged economic development, the inflation-adjusted real wage has considerably increased over three different periods:

- Real wages rose at a steep rate between 1967 and 1969 along with rapid growth of the manufacturing and construction industries. Real wage growth was fueled by active imports of foreign capital, increased bank liquidity after the drastic interest rate hike, and the world economic boom in the late 1960s.
- Real wages increased at an annual rate of nearly 20% during the 1976-78 due to an increased demand for construction workers and skilled labor in the course of intensive HCI development and the overseas construction boom of the late 1970s.
- Real wages rose somewhat rapidly from 1988 to 1990, not only because of strong economic expansion, but also because of nominal wage hikes in the wake of political democratization in the late 1980s.

The monthly manufacturing wage, which exceeded USD 100 for the first time in 1976, quickly surged to USD200 in 1978. Then it showed a gradual rise until it settled at USD 330 in 1986. However, it shot up to USD 1,270 by 1994 because of various factors including the appreciation of the KRW/USD exchange rate, a labor shortage due to continued economic growth, and the active labor union movement since the declaration of democratization in 1987.

The rise in real wages in tandem with labor productivity growth would not disturb the economy, as neither labor's income share nor inflationary pressure would be affected. In fact, labor productivity growth has shown considerable differences across industries, particularly between manufacturing and non-manufacturing industries. Between 1964 and 1994, labor productivity measured as value added per worker increased at an annual rate of 7% in the manufacturing sector, far exceeding the all-industry average productivity growth of 4.2% per annum. In contrast, the rate of wage increases has been similar across different sectors, implying that the growth of real wages per efficiency unit has been higher in other industrial sectors than in the manufacturing sector. Between 1997 and 2004 the productivity of the manufacturing sector exceeded that of the all-industry, while such a phenomenon was reversed between 1994 and 1996.

The real wage rose for the manufacturing sector in excess of productivity growth during the periods of 1967-69 and 1976-78. But such excessive real wage growth was usually corrected over subsequent years. In contrast, the wage-productivity gap developed during 1988-89 persisted until 1994. This may well be attributed to wage inflexibility in the face of worsening labor shortages and the increased influence of labor unions in wage determination. Real wage growth rate was faster than productivity growth from 1995 to 2004, except for a few years such as 1997, 1998 and 2001 in all industries, while real wage growth rate was slower than productivity growth for the manufacturing sector except 2002. Such a phenomenon is due to rapid real wage growth in the service sector in comparison to the manufacturing sector.

An increase in unit labor cost, defined as the ratio of nominal wage to labor productivity, may be partially absorbed by squeezed profit margins in the short run, but will be eventually channeled into inflationary pressure in the long run. It is well known that there exists both backward and forward links between wage and price changes; a current rise in nominal wages is linked to past inflation, but at the same time affects current and future prices. Thus, wage stability may be an important ingredient of price stability.

It is on these grounds that the government, albeit informally, suggested that wage guidelines should be a part of the economic stabilization package in the early 1980s. The government utilized the government sector's wage growth, grain-purchase price, and the minimum wage after 1988 as a reference guideline for the private sector's wage increases. Notwithstanding doubts raised about the effectiveness of such wage guidelines, the government's effort to stabilize wage growth in the early 1980s was helpful in achieving price stability. In fact, average real wage growth of the manufacturing sector was far lower than labor productivity growth by 11% points from 1980 to 1987. In addition, the unit labor cost rose by only 3% per annum between 1983 and 1987, thus, considerably contributing to price stability with average inflation of 2.8% over the same period.[74] However, the unit labor cost did not change much between 1994 and 2004 while average inflation rate recorded 4.1% for the same period.

74) Refer to Nam and Kim(197) for further details.

# 8. Policy Recommendations for Stabilizing the Vietnamese Economy

The concept of macroeconomic stability should be defined in a broad sense. It includes balance of payments, external debt, and real estate price, as well as inflation. Until the mid-1980s inflation was a serious problem in Vietnam, skyrocketing to several hundred percent. However, a series of reform policies brought it down to 35%. Disinflation rather was the trend until 2003, and inflation began to accelerate in 2004, going up to 9.5%. Many people are concerned about the recurring high inflation, expected to be a little over 5% this year. In this Chapter, macroeconomic policy recommendations such as fiscal policy, monetary policy, price policy and exchange rate policy are suggested.[75)]

## 8-1. Fiscal Policy

Vietnam's budgetary revenues are heavily dependent on three sources: (1) oil sector taxes, (2) taxes on international trade, (3) other taxes collected through State Owned Enterprises (SOEs). With each of these revenue sources likely to contract relative to GDP over the medium term, and demands for budgetary resources likely to increase, the government needs to develop alternative sources of revenue in ways that are non-distortional and conducive to growth. Important steps have been taken to develop the revenue base, including the introduction of a VAT in 1999, and to modernize tax administration, but further reforms will be needed in the near future.

Vietnam started, in 2005, preparation for the third phase of comprehensive tax reform, which is to be completed by 2010. New tax laws and ordinances are planned to be in effect from 2006 for import-export taxes, and from 2008 for personal income tax, VAT and special consumption tax, for instance. Priorities in tax reform might be given to broadening the tax base for personal income tax, reducing items of exemptions and lower tax rates for VAT, and simplification of corporate income tax. Currently, personal income tax revenue accounts for a little over 2% of total tax revenue, effectively being a tax on high level wage income without any effective tax on capital income and self-employed business income.

The government needs to keep the fiscal deficit at the appropriate level for fiscal sustainability. Disagreement about the appropriate level is possible, but many macroeconomists suggest that a fiscal deficit of 5% or above of GDP is unsustainable. Tight fiscal policy is desirable when inflation continues to be a serious economic problem. In this case the

75) Unteroberdoerster et al. (2003) and IMF (2005) contain recent selected issues.

government should reduce government expenditures and collect more revenues at the same time. When reducing expenditures, current expenditure reduction is more desirable than capital expenditure reduction. Canceling or deferring inefficient public investment projects is necessary. How can inefficient investment projects be identified Introduction of a project pre-evaluation system for public investment may be one possible solution. Moreover ideas for collecting more tax revenues are important, since the budget scale takes on a large size in order to keep pace with new investment plans for socio-economic development. A priority should be given to broadening of the tax base in order to collect more tax revenues.

## 8-2. Monetary Policy

Goals of Vietnam's monetary policy are stabilizing the economy, boosting the economy in recession and maintaining the security of the monetary sector. Open market operation and reserve requirement are major indirect policy instruments. The SBV regulates money growth rate based on market conditions. Current monetary target is M2, but there is no close relationship found between money growth and inflation, forcing the monetary authority to control the short-term business cycles. For example, M2 growth was high for the period of 1998-2001 while disinflation was proceeding. Deepening dollarization and global low inflation might be partial reasons. Moreover, the ratio of deposits of foreign currency to total M2 reaches 20%, making it difficult to estimate inflation solely based on M2. In other words, economic structural change during this transitional period disturbed the tight relationship between money supply and inflation. It seems that over the last few years, confidence in the Vietnamese currency has improved due to success in controlling inflation and maintaining a stable exchange rate. For example, since 2001, the ratio of currency deposit to M2 has declined substantially (partly due to a relatively unattractive interest rate on foreign currency deposit). To the extent that this trend can be taken as an indicator of de-dollarization or dishoarding of USD and gold, we can expect reasonably high growth of money without adding to inflationary pressure.

In addition, weight of food and foodstuff in CPI is around 48%, which means that supply also affected the inflation, to a degree no lesser than demand. In spite of this point, the monetary authority should make an effort to measure the basic statistics, M2 and the inflation index. If M2 does not take a useful role as a target, the monetary authority needs to develop another target. Meanwhile, another kind of inflationary index such as core inflation would be helpful to control money supply, since it excludes the supply side impact on the inflation rate. In actuality, , the IMF seems to be monitoring credit growth rate, and the credit growth rate is currently too high and is likely to lead to deterioration of loan quality and increase in NPLs at banks in addition to inflationary pressure.

With respect to the role of interest rate policy, it does not seem to be an active tool. Even though Vietnamese Dong interest rates were liberalized, they were highly inelastic to market conditions. Monetary authorities seem to prefer maintaining low and stable interest rates to keep growth momentum, to avoid weakening the balance sheets of heavily indebted SOEs, and possibly to keep foreign banks out of the domestic loan market. However, this policy might end up with poor loan quality, delay in banking reform, and loss of important indicator in the financial market.

## 8-3. Price policy

Price policy was heavily used as an instrument for macroeconomic stabilization in Vietnam. Before 1992, the government set the price of manufactured goods and services. However, the government utilized indirect intervention to adjust supply and demand after 1992. The price is no longer set by the government after 2002. The fact that there is no way to restrain inflationary pressure by controlling the individual price directly is well known. Vietnam seems to be willing to use a tool of price subsidy as a way of fighting inflation. For instance, recently, import tariffs on petroleum and steel products were cut to mitigate the impact of increased international prices of these goods on domestic prices. Though such measures might be justifiable as a temporary policy response, they should be used only temporarily and selectively. To control the inflation, the government needs to establish a cooperation or consultative mechanism with the monetary authorities. Policy-mix of monetary policy and fiscal policy is much more effective to control inflation. To control the inflation indirectly, some forecasting models are required. If the government equips with a macroeconomic model and a time series model for expected inflation, it will find it easier to prepare preemptive policy to stabilize the economy.

## 8-4. Exchange rate policy

Exchange rate has not been used as an active policy instrument for macroeconomic stabilization. The REER is an important concept for controlling external balance. If the foreign exchange authorities maintain the REER at an appropriate level, the external imbalance problem is alleviated. Also, a floating exchange rate, determined in the foreign exchange market, helps the authorities to stabilize the external sector. REER calculated by IMF indicates that the Vietnamese Dong has shown a trend of moderate depreciation in terms of REER, although it appreciated a bit in 2004. Though there seems to be no indication that the current exchange rate is causing deterioration of Vietnam's export competitiveness, Vietnam may adopt a policy further away from the current de facto pegged exchange rate management. As seen from the Asian financial crisis, a de facto fixed exchange rate regime induces financial intermediaries and enterprises fail to be prepared for potential exchange rate risk, thus posing as a source of systemic financial risk. Vietnam seems to have restored people's confidence in their currency through the stable management of the Vietnamese Dong since the early 1990s as well as keeping inflation under control. Thus, the need to have "fixed" exchange rate for the purpose of anchoring inflationary expectation seems to have been weakened significantly. To control the inflation resulting from the exchange rate depreciation, cooperation with the monetary authorities is important.

## 8-5. Remarks

Rapid growth bestows favor on national economies in terms of welfare. However it simultaneously incurs costs. Pushing the growth rate up to a higher level usually is correlated with a growing domestic demand. It also brings about instability, causing a tradeoff between growth and stabilization in the short to medium-run. To support rapid economic growth, the economy requires credits from either the private sector or the public sector. Credit supply induces inflation and sometimes contributes to form real estate bubbles. Higher economic growth expands current account deficit due to larger aggregate demand. It also deteriorates fiscal balance. Therefore it is important to maintain sustainable growth without losing internal and external balances. Sustainable growth can be calculated from a potential growth rate.

Current capital mobilization for investment in Vietnam is 36% of GDP, an extremely high figure compared to the domestic saving rate. Vietnam's investment rate has been persistently higher than its saving rate over a long period, which leads to internal and external imbalance chronically. Even though current external debt is not high, sustainability of the external sector will be threatened in the long run if such a trend continues. Productivity improvement is more important than capital mobilization for sustainable growth. Constructing a system which is conformable with the market economy is necessary. Vietnam is a transitional economy, and thus the country needs to reform many institutions, including laws, regulations and traditions to make the market function properly on its own.

Five-year socio-economic plans take on an important role for Vietnam to advance its economy. However, too much dependence to the given targets may distort operation of the economy. If the economic environment changes much during the planning period, the government should adjust its targets to implement the initial goal. Setting up an internal government organization exclusively to perform such a task will bring about desirable results.

## References


Black, T. and S. Black, The Korean Financial Crisis Causes, Effects and Solutions, *Policy*, Autumn, 42-47, 1999.

BOK, Data Base www.bok.or.kr, 2005.

BOK, *Monetary Policy in Korea, 2003*.

CIEM, *Vietnam's Economy in 2004, Science and Technics Publishing House,* 2005.

Cho, Y.J. and J.K. Kim, *Credit Policies and the Industrialization of Korea*, Korea Development Institute, 1997.

Coe, D.T. and Se-Jik Kim, *Korean Crisis and Recovery*, 2002, IMF.

GSO, *Statistical Handbook*, 2004.

GSO, *Statistical Yearbook*, 2003.

Hahm, J.H. and F. Mishkin, "Causes of the Korean Financial Crisis: Lessons for Policy," *Emerging Market Review*, Vol. 1. No. 1, 21-52, 2000.

IMF, Country Report, No. 05/148 (Staff Report for 2004 Article IV Consultation), 2005.

Kang, K.H., *5-Year Economic Development Plan: Target and Evaluation of Its Implementation,* Seoul National University Press, 2000.

Lee, J.W., *Korean Economy*, Seoul, Yulgok Publication, 2002. (in Korean)

Nam, S.W., "Family-Based Business Groups: Degeneration of Quasi-Internal Organizations and Internal Markets in Korea," ADBI Research Paper 28, 2001.

Nam, S.W. and J. Kim, "Macroeconomic Policies and Evolution" in *The Korean Economy 1945-1995: Performance and Visions for the 21st Century,* eds. D. Cha, K.S. Kim and D.H. Perins, 1997, KDI.

National Statistical Office, Data Base www.nso.go.kr, 2005.

Unteroberdoerster, O. and R. Al-Mashat, S. J. Peiris, Q. Wang, E. Lueth, *Vietnam: Selected Issues,* IMF, 2003.

Vietnam Institute of Economics, *Vietnam's Socio-Economic Development: A Social Science Review,* No. 40, Winter 2004.

Wyplosz, C., "How Risky is Financial Liberalization in the Developing Countries?," in J. Kim ed., *Conference Proceedings: The Financial Crisis and Beyond,* Korea Deposit Insurance Corporation, 2001.

### Sources of Vietnamese Data in Chapter 3

Population: Asian Development Bank

GDP (current dong): Asian Development Bank

Exchange Rate: International Monetary Fund

GDP Deflator: Asian Development Bank

CPI: Asian Development Bank

Trade Account: Asian Development Bank and International Monetary Fund

Current Account: Asian Development Bank and International Monetary Fund

Unrequited Transfer: Asian Development Bank and International Monetary Fund

Direct Investment: Asian Development Bank and International Monetary Fund

Imports: Asian Development Bank and International Monetary Fund

International Reserves: Asian Development Bank and International Monetary Fund

Total Debt: Asian Development Bank

M1 and M2: International Monetary Fund

Domestic Credit: International Monetary Fund

Lending Interest Rate: International Monetary Fund

Basic Interest Rate: State Bank of Vietnam

Government Revenue: Asian Development Bank and International Monetary Fund

Government Expenditure: Asian Development Bank and International Monetary Fund

Overall Fiscal Surplus: Asian Development Bank and International Monetary Fund

Chapter 5

# Foreign Capital Mobilization in Vietnam: With a Focus on Foreign Direct Investment

Chapter 5

# Foreign Capital Mobilization in Vietnam: With a Focus on Foreign Direct Investment

*Seung-ho Sohn*
*Korea Eximbank*

## Executive Summary

Ever since the adoption of the Doi Moi policy at the 6th Communist Convention in 1986, Vietnam has promoted various reform policies, which resulted in, among others, the establishment of FDI laws, and economic and financial reforms. As a result, the nation has been enjoying price stability, government debt reduction and FDI expansion, to name a few, while maintaining sustained economic growth. Particularly noteworthy is the fact that Vietnam has reached an average annual economic growth rate of over 7% in the last decade, recording a US$ 53.8 billion GDP in 2004.

A vast amount of investment capital was needed to achieve such economic growth, and as a nation lacking domestic investment capital, Vietnam took active measures to raise funds by attracting FDI. Indeed, FDI has played a vital role in the nation's economic growth, as can be seen from the fact that investment funds raised through FDI have reached as much as 30.5% of the total investment in Vietnam.

Countries that need foreign capital secure it in the forms of aid, loans and FDI. Major developing countries in Asia have sought different methods to raise foreign capital, depending on their economic conditions. As for Korea, up until the 1950s, it was heavily dependent on overseas aid in the aftermath of the Korean War. Since the 1960s, the nation started to actively pursue economic development, seeking foreign capital mostly in the form of loans. In contrast, FDI was utilized as the main source of foreign capital in Taiwan, Singapore and Hong Kong.

Vietnam has also pushed forward with its FDI attraction policy as a way of securing capital for its economic development. Nonetheless, records show that the actual effect of FDI on Vietnam's GDP, industrial output, exports, financial earnings, employment, technological transfers, etc. has not always been satisfactory.

This paper looks into the current status of FDI in Vietnam and evaluates the impact of FDI on different economic sectors to see how big a role FDI has played in the sustained economic development of the nation. Also, by introducing Korea's FDI policy, the paper attempts to make some recommendations on Vietnam's FDI policy.

## *The Current Status of FDI in Vietnam*

Between 1988 (the year from which statistics are available) and 1994, FDI in Vietnam was concentrated in the petroleum and gas sectors. In 1994, FDI started expanding to various sectors including real estate and manufacturing, as many East Asian countries greatly enlarged their foreign investment in low-wage nations before the Asian financial crisis of 1997.

The Asian financial crisis resulted in a drastic contraction of FDI in Vietnam after 1997, notably in the real estate sector. Another factor that caused the reduction of FDI was the domestic political environment in Vietnam: conservatives in the Vietnamese political circles started raising their voices to express concerns on the various side-effects of fast-paced reform. This development slowed down the pace of economic reform, which discouraged many prospective foreign investors.

As the inflow of FDI continued to decline, the nation changed its policy stance on the occasion of the 9th Communist Convention in 2001. Since then, various reform policies have been vigorously pursued, including the adoption of new corporate laws, revision of foreign investment-related laws and privatization/equitization of state-owned companies. As a result, Vietnam has recently witnessed an increase in the FDI inflow.

## *The Economic Impact of FDI*

Overall, FDI has played a vital role in Vietnam's economic growth since the implementation of the market opening policy. Most of all, FDI has accounted for a considerable portion of total investment in the nation, which is the main driving force for the nation's economic growth. It has also contributed to increased access of Vietnamese products to the global market through the expansion of exports.

The share of FDI's contribution to Vietnam's GDP growth more than doubled from 6.3% in 1995 to 13.3% in 2000, and its contribution to exports has reached as much as 23.2%. Despite such significant contributions made by FDI, the number of workers at foreign-invested companies accounted for only 2% of Vietnam's total workforce, as of 2000. This is because foreign-invested firms tend to be concentrated in capital-intensive sectors and the labor productivity of their workers is much higher than other Vietnamese firms.

Also, evidence shows that technology transfers have fallen short of expectation in spite of the emphasis placed on increases in local contents. This result may be attributable to the fact that Vietnamese companies are not yet equipped with a system for introducing advanced technologies and management know-how from foreign-invested firms. These firms, however, have made moderate contributions to introducing new ideas and manufacturing technologies to Vietnamese enterprises and helping them develop their technologies and know-how.

Notably, 74% of the FDI in Vietnam is concentrated in five major cities, where only 15% of the nation's total population resides. Consequently, the remaining 56 regions with 85% of the total population have received only 26% of total FDI. Such geographical concentration may be explained by the fact that foreign investors, except for those interested in resources development and tourism, favor large cities as their investment destinations, obviously due to the potential markets and relatively better social infrastructure.

## *Korea's Foreign Capital Procurement Policy*

Up until the late 1950s, Korea was dependent on a vast amount of overseas aid. The nation was in a chaotic situation in the initial years after its independence from the Japanese colonial rule, followed by the devastating Korean War, which virtually wiped out major productive facilities. The foreign aid that sustained the economy, however, started phasing out since the 1960s. This is when the Korean government embarked upon an ambitious economic development plan with the strategy of export-oriented industrialization. In order to finance necessary investment beyond the constraint of limited domestic savings, Korea began to induce foreign capital - mainly in the form of loans.

The international financial market was relatively stable and the cost of foreign capital was low until the early 1970s, which provided a favorable environment for industrialization based on foreign debt, to a large extent. In the wake of the two major oil shocks in the 1970s, however, this policy of relying on foreign debt for industrialization encountered some problems in the early 1980s, due to the snowballing foreign debt arising from large trade deficits and surging debt service burdens.

Korea's policy towards the mobilization of foreign capital since the 1960s can be characterized as follows. First, due to the lack of policy consistency and long-term strategy, necessary adjustments were made only after problems had already arisen. This was true even though the government was capable of taking preventive measures by reflecting expected changes in overall economic trends and conditions in the rolling five-year socio-economic plans.

Second, the basic objectives of foreign capital mobilization policy and related laws were not successfully fulfilled. This is not to say that government officials and/or entrepreneurs violated the laws, but that they were, for example, not prudent enough to restrict reliance on commercial loans with unfavorable terms and conditions, which eventually turned out to be a heavy burden for those companies that had used these loans.

Third, throughout the development process from the 1960s to the 1970s, the nation was preoccupied with securing foreign capital itself without thoroughly reviewing loan conditions and establishing an adequate system for overall management of foreign capital.

Particularly, when the private sector wanted to raise foreign funds, the government was supposed to comprehensively review all relevant factors associated with the loan before deciding whether or not to grant approval. These factors include the conditions attached to the loan, the borrower's repayment capability, and the loan's effect on the balance of international payments, employment creation and technological transfers. The government, however, did not have much choice when the conditions of the international financial market were unfavorable and the nation suffered from deteriorating balance of payments.

Korea's FDI policy had gone through three different phases before the currency crisis of the late 1990s. At the beginning of the industrialization process, foreign investment was rather restricted. Then from the early 1980s, Korea shifted its policy towards actively attracting FDI to reduce its dependence on loans. By that time, the nation's heavy industry drive was phasing out with some obvious successes as well as signs of inefficiency, and concern over the heavy burden of foreign debt emerged as a major problem both in Korea and developing countries as a whole.

Korea's FDI policy went through drastic change once again after the financial crisis in an effort to attract foreign investment in a more aggressive manner. Restrictions on foreign exchange transactions and the financial sector, which had been the biggest hindrance to inducing FDI, have since then lifted significantly. The objectives of Korea's FDI policy are to allow a smooth inflow of FDI by creating an investment-friendly environment, and to streamline policy with the nation's industrial policy objectives.

The Korean government, in the process of economic development, had preferred loans over FDI as a means to mobilizing foreign capital. This was mainly due to the concern about the control of foreign corporations over domestic industries. As a result, while Korean industries were protected to a considerable degree from foreign investment in the domestic market, the nation had to suffer from the foreign currency crisis. Though the crisis had many root causes of a more structural nature, it was triggered when the nation failed to meet soaring claims in foreign currencies, including the repayment of short-term loans. In an effort to overcome the crisis, Korea was forced to drastically open its domestic markets to FDI, which helped secure badly needed foreign capital without repayment burdens.

Vietnam has actively promoted the introduction of FDI as a measure for mobilizing foreign capital. Although the policy is known to have brought fruitful outcomes, the nation will gradually have to raise foreign capital through loans, depending on the circumstances that arise on its path to economic growth.

## *Future Challenges*

For Vietnam to sustain its economic development through enhancing the role of FDI in the future, some improvements must be made in its FDI policy. First, restrictive regulations should be relaxed, such as those requiring that the legal capital of foreign-invested enterprises (either joint ventures or 100% foreign-owned enterprises) has to exceed 30% of the total invested capital, and that the foreign equity share has to exceed 30% in the case of joint ventures. Second, a sound financial system must be established, along with a legal system that encompasses property-related laws, for the smooth operation of the market economy.

Third, more aggressive measures need to be taken for the privatization of the public sector. Although the number of public enterprises has now been reduced to 38% compared to the initial stages of reform, revenues from the privatized entities account for only 8% of the total revenue raised by the entire public sector. The acceleration of privatization or equitization is in progress, even though the pace might be affected by several factors including various economic reform measures for enhancing corporate competitiveness, private sector expansion, financial reform, and capital market vitalization. Fourth, efforts must be stepped up to root out corruption, one of the major obstacles to more active FDI in Vietnam.

In conclusion, for the market economy to firmly take root in Vietnam, there must be an improvement in the foreign investment environment, and various measures including public sector reform and the eradication of corruption must be taken consistently.

# 1. The Current Status of FDI in Vietnam

## 1-1. Characteristics of the Vietnamese Market

The most prominent strength of the Vietnamese economy since the opening of its market has been the rich pool of a highly-skilled, low-wage workforce. Foreign companies investing in Vietnam can gain a relatively easy access to high-quality manpower. This strength is attributable to the solid basic education that the citizens enjoy under the socialist regime. Also, thanks to the tradition of capitalism in South Vietnam, the transition to a market economy is known to have taken place in a relatively smooth manner. Moreover, Vietnamese parents are more passionate about their children's education than those in many other neighboring countries, probably due to the influence of Confucianism.

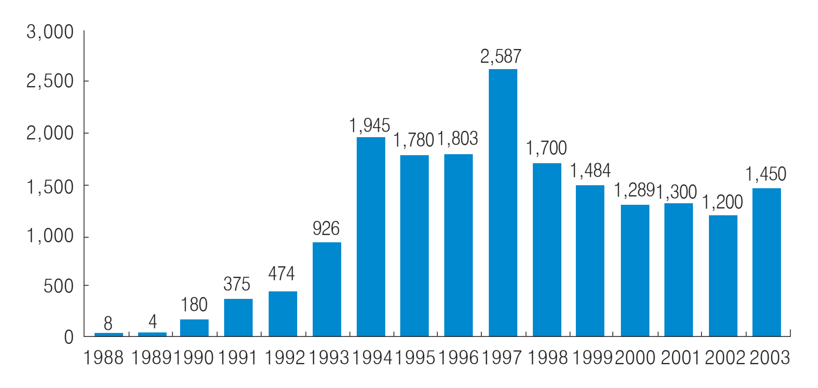
Political stability is another strength that Vietnam enjoys. The nation's political system assigns adequate checks and balances among the General Secretary, Prime Minister and President at the central level, and similar structures exist at the local level. Without any major challenges against the current system, this stability is expected to be maintained for quite a while. As a result, the current industrialization policy of attracting FDI seems to be headed towards a smooth sailing. Last but not least, Vietnam is rich in natural resources such as petroleum and gas. The aforementioned characteristics are encouraging many foreign enterprises to invest in Vietnam despite its many demerits, including a poor social infrastructure, bureaucracy, the limited scope of market economy and a weak legal system.

## 1-2. The Current Status of FDI

### 1-2-1. FDI Inflow

The progress of FDI inflow from 1988 (the year from which statistics are available) to 2003 can be categorized into the following three periods: 1988 to 1993, 1994 to 1997, and 1998 to 2003. Before 1994, FDI was concentrated in the petroleum and gas sectors. Investments in the petroleum sector, in particular, played a key role in boosting petroleum exports during this period. Since 1994, FDI started expanding to various sectors including real estate and manufacturing. This was because before the financial crisis hit Asia at the end of 1997, many East Asian countries greatly enlarged their foreign investment in low-wage neighboring countries. FDI during this period was not only an important source of investment in Vietnam, but also played a pivotal role in Vietnam's advancement into the global market through foreign-invested companies.

<Figure 5-1> FDI Inflows into Vietnam (Unit: US$ million)




Source: http://www.stats.unctad.org/fdi

The Asian financial crisis, however, resulted in the drastic contraction of FDI in Vietnam after 1997, notably in the real estate sector. Another factor that caused the reduction of FDI was Vietnam's domestic political environment. Conservatives in Vietnamese political circles started to raise their voices concerning the pace of reform and the concomitant side effects. This way of thinking by the conservatives led to a slowdown of economic reform.

As the inflow of FDI continued to decline, Vietnam elected the reformist Nong Duc Manh as the General Secretary at the 9th Communist Convention in 2001. Ever since, the nation has been pursuing various reform policies including the adoption of new corporate laws, revision of foreign investment-related laws, and accelerated ownership reform of state-owned companies.

Moreover, at the ceremony commemorating the 75$^{th}$ anniversary of the Communist Party in February 2005, General Secretary Manh made remarks implying his acknowledgement that the series of economic crises since Vietnam's reunification were partially attributable to the rigidity of Communist ideology. He also stressed that corruption must be eradicated among Communist Party members. Such remarks are interpreted as showing the government's will to accelerate socio-economic reform, which will lead to a gradual increase in FDI inflows into Vietnam.

### 1-2-2. Volume of FDI Inflow by Country

As of the end of 2004, approved FDI in Vietnam recorded a total of 5,110 cases, amounting to US$ 45.8 billion, while the actual amount of inflows reached US$ 26.8 billion.

According to country, Singapore topped the list with a total amount of 334 approved cases,

<Table 5-1> Volume of FDI Inflows by Country* (Unit: US $ million)

| Country/Territory | Number of Projects | Registered Capital | Disbursed Capital |
|---|---|---|---|
| Singapore | 334 | 7,982.9 | 3,381.1 |
| Taiwan | 1,259 | 7,258.4 | 3,145.8 |
| Japan | 490 | 5,386.9 | 4,253.3 |
| Korea | 840 | 4,751.7 | 2,888.8 |
| Hong Kong | 326 | 3,228.2 | 1,941.8 |
| B.V. Islands | 212 | 2,430.4 | 1,141.3 |
| Netherlands | 53 | 1,835.3 | 1,974.7 |
| Thailand | 116 | 1,384.9 | 756.8 |
| Malaysia | 163 | 1,319.00 | 811.4 |
| US | 215 | 1,281.3 | 729.9 |
| UK | 62 | 1,217.5 | 600.2 |
| Others | 898 | 5,536.6 | 4,898.1 |
| Total | 5,110 | 45,766.3 | 26,772.7 |

*Total amount as of the end of 2004
Source: "Vietnam Investment Review," Feb. 21-27, 2005

recording nearly US$ 8 billion in the amount approved and US$ 3.4 billion in the actual amount invested. Following Singapore were Taiwan, Japan and Korea. Korea ranked fourth with 840 cases and almost US$ 2.9 billion in the amount of actual FDI inflows.

What is interesting here is that among the top ten investors, capital from overseas Chinese, e.g. those in Singapore, Taiwan and Hong Kong, accounted for as much as 32% in terms of actual disbursement and over 40% in terms of approval. This indicates the increasing influence and power of the ethnic Chinese in the Vietnamese economy. Also, in the cases of Singapore and Hong Kong, the average number of approved FDI per case was relatively large due to the large amount of investments made in real estate, such as hotels and resorts.

### 1-2-3. FDI Volume by Sector

FDI inflows into the industrial sector accounted for 69% of total FDI in terms of disbursement. Within this sector, the heavy industry took up 28% and 25% in terms of the number of cases and the investment volume, respectively, showing active investments in capital-intensive projects. In contrast, investments in the light industry accounted for only 12.6% of the total, which explains why FDI inflows as a whole did not create as many jobs as anticipated.

Investment inflows into agriculture, forestry and fisheries were not as large either, accounting for only 6.3%. Investments in the service industry reached 25%, but it was concentrated in the tourism sector, such as in hotel construction and operation.

It should also be noted that the actual investments made by foreign corporations after obtaining FDI approval only reached 58% of their planned investments. Likely reasons for this slow progress include complicated and time-consuming administrative procedures due to the bureaucracy of the Vietnamese government, an ambiguous legal system, and corruption among government officials. These impediments may have led to the scaling-down or abandonment of investments in the process of carrying out their businesses in Vietnam.

<Table 5-2> Volume of FDI Inflows by Sector* (Unit: US$ million)

| Sector | Number | NumberRegistered Capital | | Disbursed Capital | |
|---|---|---|---|---|---|
| | | amount | (%) | amount | (%) |
| 1. Industry | 3,423 | 26,634.8 | 52.8 | 18,460.9 | 69.0 |
| Oil & Gas | 27 | 1,898.1 | 4.1 | 4,434.7 | 16.6 |
| Light Industry | 1,403 | 7,131.6 | 15.6 | 3,362.3 | 12.6 |
| Heavy Industry | 1,407 | 10,884.9 | 23.8 | 6,587.9 | 24.6 |
| Food & Beverage Industry | 230 | 2,838.5 | 6.2 | 2,038.0 | 7.6 |
| Construction | 293 | 3,881.7 | 8.5 | 2,038.0 | 7.6 |
| 2. Agriculture & Forestry | 696 | 3,417.0 | 7.5 | 1,698.2 | 6.3 |
| Agriculture & Forestry | 591 | 3,130.4 | 6.8 | 1,548.6 | 5.8 |
| Aquaculture | 105 | 286.5 | 0.6 | 149.6 | 0.6 |
| 3. Service | 991 | 15,714.5 | 34.3 | 6,613.6 | 24.7 |
| Transportation, Telecomm | 143 | 2,567.8 | 5.6 | 918.5 | 3.4 |
| Hotel & Tourism | 166 | 3,605.0 | 7.9 | 2,198.8 | 8.2 |
| Banking & Finance | 56 | 738.6 | 1.6 | 632.4 | 2.4 |
| Culture & Education | 179 | 665.9 | 1.5 | 342.0 | 1.3 |
| New Urban Area | 3 | 2,466.7 | 5.4 | 51.3 | 0.2 |
| Office Building & Apartment | 104 | 3,635.6 | 7.9 | 1,611.9 | 6.0 |
| IZ & EPZ | 20 | 986.1 | 2.2 | 521.4 | 1.9 |
| Others | 320 | 1,048.8 | 2.3 | 337.3 | 1.3 |
| Total | 5,110 | 45,766.3 | 100.0 | 26,772.7 | 100.0 |

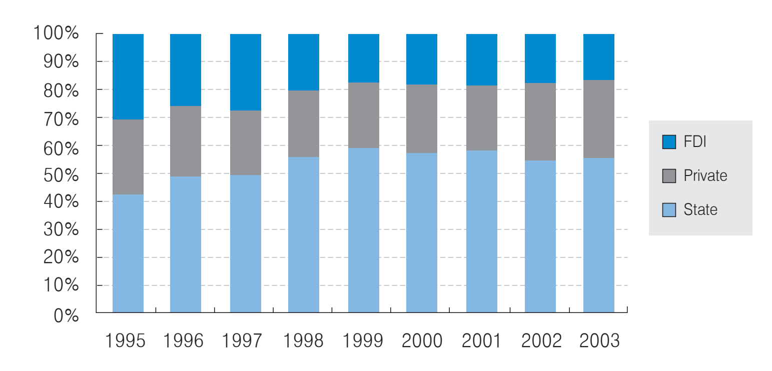
*Total amount as of the end of 2004
Source: "Vietnam Investment Review," Feb. 21-27, 2005

## 2. The Economic Impact of FDI in Vietnam

### 2-1. Overview

The inflow of international investment capital is deemed effective for the economic growth and welfare enhancement of developing countries. FDI, in particular, represents a very stable source of foreign capital compared to other forms of foreign capital, since it does not entail any contractual burdens of repayment. Also, FDI is an important means of transferring technologies and know-how from foreign-invested enterprises and helps Vietnamese firms gain access to the global market. Vietnam has been in active pursuit of reform and market opening through the Doi Moi policy, and has been making utmost efforts to attract FDI by revising its foreign investment law in 1987.

<Figure 5-2> Composition of Investment Sources




Source: GSO, Statistical Yearbook, 2003.

Since the 1990s, FDI has played a vital role in raising investment capital for Vietnam's economic growth. The FDI share in total investments peaked in 1995 by recording 30.4%, but showed a drastic downturn after the Asian financial crisis. As of 2003, the share stood at a mere 17.5%.

## 2-2. Economic Impact by Sector

### 2-2-1. GDP Growth Effect

While FDI's share of total investments greatly decreased after the Asian financial crisis, its impact on Vietnam's GDP rose significantly. According to the estimate of the MPI (Ministry of Planning and Investment), FDI's contribution to GDP growth more than doubled from 6.3% in 1995 to 13.3% in 2000. The enlarged impact of FDI seems to have stemmed from its increased contribution to various economic activities, most notably, industrial production, exports and government revenue.

Until the early 1990s, industrial production by foreign-invested companies accounted for less than 10% of Vietnam's total industrial output. The share, however, started to rise from 1995, reaching 35% in 2000. This growth rate has even surpassed that of the investments made by the public sector. Before 1995, FDI was mostly concentrated in the mining sector (42%), but with investments expanding into other areas, the figure went down to 32% in 2000.

<Table 5-3> FDI's Impact on GDP and Exports

| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|
| Contribution to GDP (%) | 6.3 | 7.4 | 9.0 | 10.0 | 12.3 | 13.3 |
| Contribution to Exports (%) | 8.1 | 10.8 | 19.5 | 21.2 | 22.4 | 23.2 |

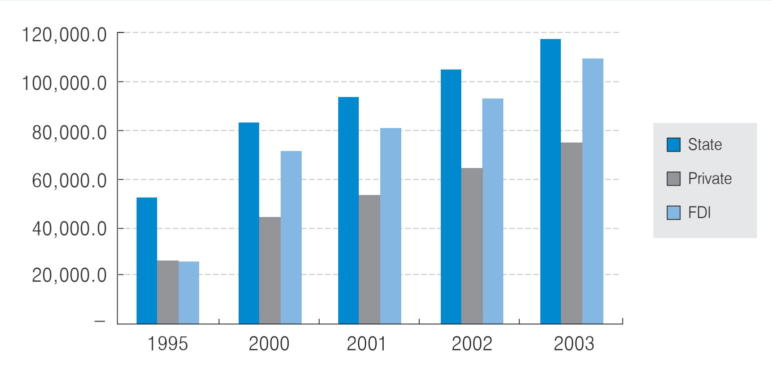
Source: http://www.mpi.gov.vn

FDI in Vietnam also greatly contributed to growth in exports after the financial crisis. In 1997, in particular, the contribution of FDI to exports rose drastically to 19.5% from 10.8% in the previous year. Since then, the contribution of FDI to exports has been on a gradual rise.

In 2002, exports generated by FDI were concentrated in electronics, shoes, and clothing and textiles. Of the total exports from each of these categories, 82% of electronic goods, 42% of shoes and 25% of clothing and textiles were generated by FDI. FDI in Vietnam boosted exports not only through foreign-invested companies, but also indirectly by nurturing the growth of domestic enterprises.

FDI also boosted the Vietnamese government's revenue. Between 1997 and 2000, 5.7% of the government revenue originated from foreign-invested companies. When taking into account government earnings from the petroleum and gas sector, government revenue coming from FDI is estimated to have exceeded 20% of total revenue.

<Figure 5-3> Industrial Output by Sector (Unit: VND 1 billion**)




**As of the end of 2004, US$ 1 = VND 15,740
Source: GSO, Statistical Yearbook 2003

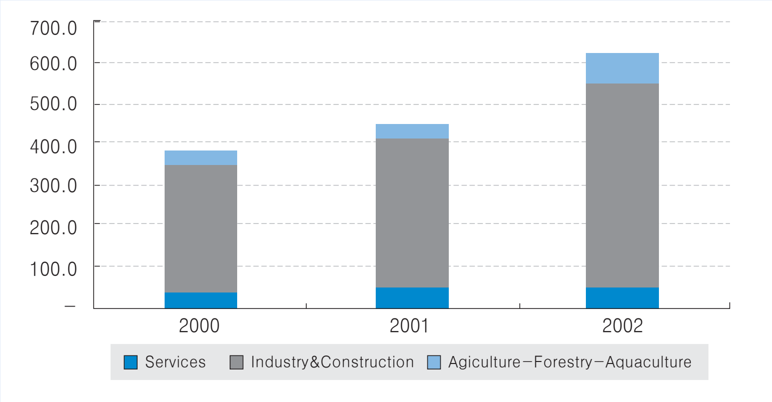
## 2-2-2. Employment Creation Effect

Job creation is one of the key contributions expected from FDI. Unfortunately, the contribution of FDI to employment generation has failed to meet such expectations in Vietnam. Despite the fact that FDI has made significant contributions to enhancing the nation's GDP, investment and exports, the number of workers at foreign-invested corporations only accounted for 2% of Vietnam's total workforce, as of 2000. By sector, the shares of employment for foreign-invested companies stood at 6.4% in the industrial and construction sectors, 0.4% in services, and 0.2% in agriculture. This indicates that employment was created mostly in the manufacturing and construction sectors. Similar ratios have been maintained since 2000, as well.

The reason why foreign-invested companies have not created as many jobs as expected is because of the relatively high labor productivity of these companies, due to the usage of advanced technologies in the production process. Also, they depend on imports for a considerable portion of raw materials and intermediate goods for their production. According to reports by the ADB, imported raw materials and intermediate goods for foreign-invested enterprises in Vietnam accounted for 74% of their total revenue in 1999, and 82% in 2000. This is because the manufacturing processes of these enterprises have mostly involved the stages of final production only.

Final electronic goods are subject to high import tariffs in Vietnam. In the cases of a major Korean electronics corporation, there have been instances where final products for export to Vietnam were partially unassembled at local factories of neighboring countries and then reassembled in Vietnam.

<Figure 5-4> Employment Creation through FDI by Sector (Unit: 1000 people)




Source: ADB, Vietnam: Foreign Direct Investment and Post-crisis Regional Integration, Sept. 2004

Another reason for the relatively poor performance in job creation is that approximately 50% of the total investments into Vietnam has been focused on capital-intensive industries, including automobiles, motorcycles, steel, cement, resources development and hotels. The shares of outstanding FDI inflows by sector as of the end of 2004 are 24.6% for the heavy industry, 16.6% for petroleum and gas, and 8.2% for hotels and tourism, all of which are capital-intensive. In particular, FDI in the agricultural sector, which takes up two-thirds of Vietnam's total employment and 25% of the nation's GDP, accounted for only 5.8%.

The distribution of jobs created by FDI among different sectors as of 2001 was 77% in industry, 13% in services and transportation, and only 10% in agriculture, forestry and fisheries. In 2002, of the 650,000 jobs created by FDI, the industrial sector occupied 83%, while only 10% and 7% were taken by the agricultural and service sectors, respectively. Within the industrial sector, the light industry comprising of clothing, textile, shoes and other consumer goods accounted for 51% of employment creation by foreign-invested corporations.

### 2-2-3. Technological Transfers and Educational Training Effects

Along with investment capital, FDI inflows into Vietnam during the past 15 years have also introduced advanced technologies and management skills. The technologies used by foreign-invested companies are far advanced than those of the Vietnamese companies, especially in the fields of petroleum and gas, telecommunications, chemicals, electrics and automobiles. The Vietnamese government had expected a significant transfer of these advanced technologies, especially for joint venture companies or firms with Business Cooperation Contracts (BCC)[76].

76) A Business Cooperation Contract (BCC) takes the form of investment, where in conducting a business in Vietnam, no separate corporation is established, but rather, an FDI company and a domestic company jointly

Nonetheless, the actual transfer effect seems to have been very insignificant. In other words, although foreign-invested companies have been playing a central role in Vietnam's economic and technological advancement, the ripple effect on Vietnamese firms has been limited.

This may be attributed to several factors. First of all, most enterprises in Vietnam, particularly state-run ones, have not fully adjusted to the market economy, and thus are not adequately equipped with systems that can effectively absorb advanced technologies. Also, the link between research and development functions and actual production is very weak. Foreign-invested companies themselves have not shown a strong will to transfer their technologies to Vietnam. Sometimes, the poor technological capabilities of Vietnamese firms have been a large constraint on their capacity to absorb capital from foreign invested firms. However, in some sectors including the IT sector, there have been some successful cases of technological transfers from foreign-invested companies.[77)] These cases are a good precedent for other Vietnamese enterprises.

Meanwhile, FDI has contributed greatly to educating and training the middle managers of Vietnamese enterprises. So far, 300,000 general workers, 25,000 technicians/engineers and 6,000 managers are known to have been educated or trained by foreign-invested enterprises.

### 2-2-4. Alleviation of Regional Disparities

One of the distinctive characteristics of the economic development process in Vietnam is that poverty is still prevalent, particularly in the rural areas, despite significant reductions in overall poverty since the adoption of the Doi Moi policy, and the relatively small income disparities at the time of launching the reforms and market opening. Thus, it is worthwhile to examine the geographical distribution of FDI within Vietnam to evaluate the effect of FDI on regional disparities.

Notably, 74% of FDI in Vietnam is concentrated in five cities[78)], where only 15% of the total population resides. Consequently, the remaining 56 regions with 85% of the total population receive only 26% of the total FDI.  Such geographical concentration indicates that foreign investors, except for those in resources development and tourism, favor big cities that have large markets and social infrastructure as their investment destinations.

operate the business on the basis of a mutual agreement. Since there no separate corporation is established, contractual responsibilities are unlimited.

77) Technological transfers are made: ① between an FDI company and its Vietnamese partner in the case of a joint venture company, ② from a joint venture company to institutions and corporations in Vietnam, and ③ from multinational corporations to Vietnam s domestic corporations.

78) Vietnam s urban population stands at 25% of the total population. The top five cities in terms of the volume of FDI are HCMC, Hanoi, Dong Nai, Binh Duong and Ba Ria-Vung Tau.

<Table 5-4> Status of FDI Attraction by Region* (Unit: US$ million)

| City | Projects | Registered Capital | Disbursed Capital |
|---|---|---|---|
| HCMC | 1,590 | 11,518 | 6,078 |
| Hanoi | 549 | 8,019 | 3,702 |
| Dong Nai | 608 | 7,528 | 3,613 |
| Binh Duong | 902 | 4,241 | 1,767 |
| BaRia-VungTau | 108 | 2,132 | 1,398 |
| Haiphong | 164 | 1,791 | 1,252 |
| Oil & Gas | 27 | 1,898 | 4,435 |
| Others | 1,162 | 8,638 | 4,528 |
| Total | 5,110 | 45,766 | 26,773 |

*Total amount as of the end of 2004
Source: "Vietnam Investment Review," Feb. 21-27, 2005

Therefore, it was inevitable that the public sector allocate its own investments in other regions (rural areas) where most have-nots reside. For example, 85% of investments in the northern central coastal region and the central mountainous region, and 79% in the northern region have been made by the public sector. This implies that investments by Vietnam's public sector have been determined based not so much on economic calculations, but rather on political considerations. In an effort to address such issues, the Vietnamese government has recently adopted a policy to attract FDI first and foremost to the northern region, by providing investment incentives and conditional approvals to potential investors.

## 2-2-5. Relative Contractions of the Private Sector

Despite the rapid growth of the private sector in Vietnam since the adoption of the market opening policy, the sector has played a limited role in terms of generating GDP and employment. As can be seen in Diagram 2, whereas the share of the public sector in total investments rose from 42.0% in 1995 to 58.1% in 2001, that of the private sector declined from 27.6% to 23.6%.

Given the rapid growth of the Vietnamese economy, the contraction of the private sector's share in investments is quite contrary to one's expectations. Of course, there may exist many unregistered small-scale businessmen and handcrafters working at home who have not been reflected in the official statistics. Nonetheless, it is undeniable that in the past decade, by preferring FDI over domestic private investment for its economic development, the Vietnamese government has ultimately failed to promote domestic private investment.

Disadvantages of private enterprises become evident when establishing a joint venture company with a foreign-invested firm. For the sake of administrative procedures, the foreign-invested company naturally prefers a public enterprise over a private one as its local partner. Furthermore, capital investment for real estate usage is allowed only to public enterprises, and not private ones. These aspects have undermined the development of Vietnam's private sector.

In order to boost the development of the private sector, a truly competitive market should be fostered, where private and public enterprises compete against each other on a level playing field. Private enterprises should be given the rights to real estate usage and be allowed to utilize it as an asset. In addition, the financial market must be further developed and matured so private enterprises can have better access to credit. To this end, market principles should be in full play for the efficient allocation of resources in the financial market.

## 3. The Korean Policy of Foreign Capital Mobilization

### 3-1. Overview

In the process of economic development through export-driven industrialization since the early 1960s, Korea had no choice but to depend on foreign capital to a large extent. Until the late 1950s, Korea was heavily dependent on foreign aid, as the nation was in a chaotic situation trying to build an independent country in transition from the Japanese colonial rule, followed by the tragic Korean War. Foreign aid, however, started to quickly phase out in the 1960s, forcing Korea to secure necessary foreign exchange on its own and be more serious about economic development. With the launch of the first five-year economic development plan in the early 1960s, Korea began to induce foreign capital in the form of loans.

Loans and FDI have the same effect in that they supplement limited domestic savings. The difference, however, is that while loans bring liability for repayments of the principal and interests, no such obligations are attached to FDI, although it is possible to retrieve the original amount of investments. Thus, FDI does not lead to any foreign debt issues, which is very important from the viewpoint of foreign liability management. Furthermore, FDI often brings in not only money but also technologies and managerial know-how which can be transferred to local firms, and directly creates employment.

The downside of FDI is that by allowing the direct undertaking of domestic businesses to foreign-invested companies, they may gain substantial control over domestic industries. These foreign investors may even try to intervene in policymaking processes to maximize their interests at the expense of those of the hosting country. Some FDI may simply be transfers of declining or pollution-causing industries to the developing world.

Ever since Korea launched its ambitious economic development plan, mobilization of foreign capital focused on loans, in contrast with other developing countries. This policy resulted in the snowballing of foreign debt to the point that repayments of the principal and interests became so burdensome in the early 1980s and the late 1990s, the latter which, unfortunately, led to the financial (foreign currency) crisis.

### 3-2. Korea's Foreign Capital Mobilization Policy

#### 3-2-1. Different Stages of Korea's Foreign Capital Procurement Policy

*Preparation (1962-1971)*

The years from 1962 to 1971 are recognized as the take-off period in Korea's economic development process, involving the pursuit of two consecutive five-year economic development plans. The first plan, from 1962 to 1966, was focused on the agricultural sector, while preparing for ambitious industrialization by securing energy resources and expanding certain key industries. As a means to attract foreign capital, the Korean government publicly stated the business sectors in which it was hoping to get FDI. Moreover, to enhance the role of the private sector in attracting foreign capital, the government enacted and/or revised related laws. It also established a Foreign Capital Inducement Office within its Economic Planning Board, and had the office take charge of all businesses related to foreign capital inducement.

The second five-year plan, implemented in 1967, was geared towards the modernization of agriculture and improvement of the industrial structure with a view to establishing foundations for a more self-sufficient economy. To this end, top policy priority was given to improving the trade balance through increasing exports, and seeking industrial advancement by strengthening the heavy and chemical industries.

In order to acquire foreign capital for these tasks, the Korean government made efforts to maximize its use of long-term low interest public loans and actively attract FDI, while gradually decreasing its reliance on commercial loans. Nonetheless, the growth of commercial loans turned out to be much faster than that of public loans, which created many side-effects, including severe financial distress by borrowing firms due to heavy debt service burdens.

<Table 5-5> Korea's Foreign Capital Mobilization (Unit: US$ million)

| Year | ODA | Loan | | FDI(A) | Total Foreign Capital (B) | A/B (%) |
|---|---|---|---|---|---|---|
| | | Public | Commercial | | | |
| ~1960 | 2,935 | - | - | - | 2,935 | - |
| 1965 | 131 | 11 | 28 | 11 | 181 | 6.08 |
| 1970 | 83 | 147 | 283 | 25 | 538 | 4.65 |
| 1975 | 1 | 476 | 802 | 69 | 1,348 | 5.12 |
| 1980 | 0 | 1,516 | 1,402 | 131 | 3,049 | 4.30 |
| 1981 | 0 | 1,690 | 1,247 | 152 | 3,089 | 4.92 |
| 1982 | 0 | 1,868 | 914 | 129 | 2,911 | 4.43 |
| 1983 | 0 | 1,494 | 973 | 123 | 2,590 | 4.75 |
| 1984 | - | 1,424 | 858 | 193 | 2,475 | 7.80 |
| 1985 | - | 1,024 | 964 | 236 | 2,224 | 10.61 |
| 1986 | - | 880 | 1,620 | 477 | 2,977 | 16.02 |
| 1987 | - | 1,109 | 1,558 | 626 | 3,293 | 19.01 |
| 1988 | - | 981 | 988 | 894 | 2,863 | 31.23 |
| 1989 | - | 477 | 860 | 812 | 2,149 | 37.79 |
| 1990 | - | 417 | 30 | 895 | 1,342 | 66.69 |

Source: The Bank of Korea, Economic Statistics Yearbook, various issues.

## *Full-scale Mobilization (1972-1978)*

The third five-year plan, which commenced in 1972, was focused on the drastic development of the agricultural sector to enlarge the income of farmers and fishermen, and the nurturing of the heavy and chemical industries including steel, electronics, machinery, petrochemicals, shipbuilding and others. It was believed that the development of the heavy and chemical industries would not only substitute imports, but become the basis of sustained export growth. Underlying this belief of Korean policymakers were rapid increases in domestic wages and growing protectionism in industrialized nations against light manufactured goods from developing countries.

The foreign capital mobilization plans during this period (1972-1976) included prioritizing the inflow of long-term low interest public loans and attracting FDI in a more active manner to ease repayment burdens, and diversifying loan sources to International Financial Institutions such as the World Bank and the Asian Development Bank (ADB), and also to the European region.

The principal objectives of the fourth five-year plan, executed from 1977, were to raise more investment funds domestically, to improve the balance of payments, and to make further advancements in the industrial structure. In borrowing from abroad, the Korean government tried to shift from supplier credit to buyer credit, and attempted to avoid importing facilities on a turn-key basis. Despite such efforts, however, these attempts were not very successful because both the Korean government and corporations were overly ambitious with their investment plans and domestic technological capabilities were not strong enough.

## *Selective Inducement of Foreign Capital (1979-1986)*

The end of the 1970s was marked by the drastic deterioration of international economic situations: high interest rates, growing trade protectionism in the wake of the oil price shocks, and recession in the world economy. As the major focus of Korea's policy was on building the heavy chemical industries, it suffered severe consequences. Many of the heavy and chemical firms were under severe financial stress due to difficulties in finding export markets, low capacity utilization, and a heavy burden of debt repayment. The government had no choice but to take aggressive industrial restructuring measures such as investment adjustments, mergers, and forced specialization, and to provide emergency bailout loans.

At the same time, to cope with the widening imbalance of payment deficits, the government and banks made all-out efforts to secure foreign capital. Fortunately, the World Bank was extending structural adjustment loans to developing countries to alleviate their balance of payment problems. The loans were extended on the condition that the recipient countries undertake overall economic restructuring. Korea benefited from the structural adjustment loans twice (US$ 250 million in December 1981, US$ 300 million in November 1983), on the conditions that the nation pursue import liberalization by adjusting the tariff structure, make changes in the energy pricing system, and undertake industrial restructuring. For the following industrial finance loans (US$ 255 million in June 1983, US$ 222 million in October 1985), the World Bank demanded financial liberalization through the deregulation of interest rates, autonomy of financial institutions, and the abolition of the government's policy loans.

The fifth five-year plan covering the 1982-86 period was geared towards vitalizing market functions by reducing government intervention in the economy, while also putting great emphasis on price stabilization to curb high inflation since the late 1970s. Thanks to restrictive monetary and fiscal management, the Korean economy attained price stability since 1983 as well as a new momentum for growth. Also, the result of the ambitious heavy and chemical industry drive during the 1970s finally started to pay off with growing exports of these products. Reflecting these economic situations, the Korean government updated the fifth plan for the 1984-86 period. The revised plan sought reduced reliance on short-term foreign capital and loans on a turn-key basis to encourage the increased participation of domestic enterprises for feasibility studies and basic construction work.

In particular, the Ministry of Finance (now the Ministry of Finance and Economy) of Korea revised the nation's FDI policy in July 1984 from a positive list system to a negative list system, and later on facilitated technology transfers by only requiring notification instead of government approval. Also, by shortening the tax-exemption period for foreign-invested companies, the government shifted its policy towards a more selective inducement of foreign capital.

### *Becoming a Creditor Country (1986-1991)*

Thanks to the successful implementation of the fifth five-year plan, Korea was able to achieve price stability and regain its industrial competitiveness, recording an average annual growth rate of 12% from 1986 to 1988. Assisted by the strong Japanese yen, the nation's chronic current account deficit was turned into a substantial surplus, making the nation self-reliant in financing its investments for sustained growth. In this situation, the Korean government introduced a new system requiring authorization to induce commercial loans and significantly narrowing down eligible industries to high-growth industries that were likely to improve the industrial structure. At the same time, the government encouraged the inflow of long-term low interest loans in an effort to minimize borrowing costs.

Also, with the establishment of the Economic Development Cooperation Fund (EDCF) Act in December 1986, Korea established a structural basis to assist other countries with its economic cooperation fund. In December 1987, the nation granted its first loans to Indonesia and Nigeria, elevating its status to a creditor country from a debtor country.

### 3-2-2. Evaluation of Korea's Foreign Capital Mobilization Policy

Korea's economic development strategy has been focused on attracting foreign capital to strengthen the manufacturing sector, which would enhance the nation's export capacity, thereby leading to sustained economic growth. At the same time, efforts were made to enlarge domestic savings to ultimately reduce reliance on foreign capital.

Until the first oil price shock in the early and mid 1970s, when the international financial market was relatively stable and the costs of foreign funds were low, inducing foreign capital had been a helpful measure for the maximization of economic growth. However, the two major oil shocks in the 1970s rendered this policy un sustainable due to the snowballing of foreign debts arising from deteriorating trade balances and surging interest expenses.

Korea's foreign capital mobilization policy since the 1960s can be characterized as follows. First, due to the lack of policy consistency and long-term strategies, only ex post adjustments were made. Although the government was capable of taking countermeasures by reflecting changes in the overall economic trends and conditions in its rolling medium-term plan, it never succeeded in this task.

For example, the government expected that the promotion of industrialization and exports partly financed by foreign capital would ultimately decrease Korea's dependency on foreign capital, thanks to the improved balance of payments. Contrary to this expectation, the dependency deepened even further with the growth in exports, as imports of raw materials and intermediate goods necessary for the expansion of exports also increased. In addition, in the early 1980s, due to the snowballing of foreign debts, Korea had no choice but to attract more foreign capital in order to service its existing debt.

One of the main culprits of the severe foreign debt burden was the lack of countermeasures, which may have resulted from the absence of clear understanding by the authorities on the tolerable level of foreign debt. Another problem was the government's preoccupation with economic growth performance. In managing a set of macroeconomic objectives including growth, price stability, and external balances or debt, the government's policy preferences tilted towards economic growth unless the other two objectives got out of control to the extent that it would threaten the growth objective as well.

Second, the basic objectives of the foreign capital mobilization policy and related laws were not successfully fulfilled. This is not to say that the government officials and/or entrepreneurs violated the laws, but that they failed, for example, to restrict commercial loans with unfavorable terms despite the established policy of putting restraints on the inducement of such loans. Many enterprises relying on such loans suffered from serious financial distress due to heavy repayment burdens. Throughout much of the 1960s and the 1970s, domestic interest rates were much higher than international interest rates. This differences in interest rates often prompted domestic firms to actively seek foreign loans without giving due consideration to the concomitant foreign exchange risks.

Third, throughout the developmental process from the 1960s to the 1970s, the nation was so eager to introduce foreign capital that it often failed to conduct close examinations or thorough reviews of the loan conditions and to establish an adequate system for conducting such reviews. When the private sector wanted to borrow from abroad, the government was supposed to comprehensively review all aspects of the loan before deciding whether to grant approval or not. Items subject to reviews included loan conditions, borrower's repayment capability, effect on the balance of international payments, employment generation and technological transfers, etc. The government, however, did not have much choice when the general conditions of the international financial market were unfavorable and the balance of payments seriously deteriorated.

Fourth, Korea's foreign capital mobilization records show that more emphasis had been put on loans than FDI. More specifically, the total FDI inflow into the nation between 1962 and 1991 remained at US$ 7.9 billion, which accounted for only 20% of total loans. To a large extent, this poor performance might indicate that Korea did not have much to offer, except for the large endowment of a relatively well-educated workforce, to foreign investors in terms of its geopolitical state, political stability and natural resources (more discussions in the next section).

Fifth, due to the lack of understanding on multinational corporations regarding FDI, Korea had been too conservative in attracting foreign investments. For instance, the government severely discouraged FDI by trying to keep the ownership share of domestic partners over 51% when granting authorization for a joint venture. This was simply at odds with the general operational rule of multilateral corporations.

Sixth, before the revision of the FDI policy in 1984, same rules applied to all FDI once they were approved by the government, regardless of the size of investments or contributions to the nation's economy. In other words, under the foreign capital inducement laws, all foreign invested companies received the exactly same conditions regarding the exemption of tariffs and value-added taxes (VAT) on imported goods, and the exemption/reduction of other taxes for a certain period. Such undifferentiated application of tax benefits not only lacked logical validity, but also drew in a lot of criticism that foreign invested companies were generally getting too much favors compared to domestic enterprises.

## 3-3. Korea's FDI Policy

### 3-3-1. Evolution of Korea's FDI Policy

Korea's FDI policy before the currency crisis in the late 1990s went through three different phases. At the beginning of the industrialization process, FDI was restricted. Then from the early 1980s, Korea tried to decrease its dependence on foreign loans while seeking measures to actively utilize FDI. Behind this policy shift were growing concerns over foreign debt, both domestically and internationally, as well as progresses in industrialization even at a substantial cost.

Phase I (from 1962 to 1983), which was the earlier stage of industrialization, may be defined as the phase of "limited investment." At this time, Korea was maintaining a very passive attitude towards FDI, as the nation was concerned about foreign investors' control over the domestic industries. During this phase, Korea depended more on license contracts and the dispatch of engineers than on FDI for the transfer of advanced technologies.

Phase II (from 1984 to 1989) mainly involved shifting the policy focus from restriction to inducement, and may be termed as the phase of "basis establishment." In July 1984, the Korean government transformed its FDI policy from a "positive list system" (listing the types of businesses where FDI is permitted) to a "negative list system" (listing only the business categories where FDI is restricted).

Phase III (from 1990 to 1997) involved the drastic easing of restrictions on foreign investment

<Table 5-6> Changes in Korea's FDI Inducement Policy

| Phases | PhasesMain Details |
|---|---|
| I. Limited Investment (1962-1983) | • Preference of loans over FDI as foreign capital mobilization method<br>• Concerned about foreign investors' control over domestic industries |
| II. Basis Establishment (1984-1989) | • Transition from a positive list system to a negative list system<br>• Abolition of the 50% limit on foreign investors' ownership in restricted business categories |
| III. Liberalization (1990-1997) | • Introduction of the FDI Notification System ("91): Notification become the norm and approval is required in exceptional cases only ("92)<br>• Establishment of a 5-year FDI plan ("93)<br>• Introduction of one-stop services for the deliberation process regarding plant construction ("95)<br>• Investment for friendly M&A permitted ("97) |
| IV. Active Inducement (1998-) | • Number of investment-restricted business categories reduced additionally (May "98)<br>• Foreign-invested companies' M&A with domestic companies permitted on all fronts (May "98)<br>• Liberalization of foreign exchange transactions (June "98)<br>• Opening of real estate for sale on all fronts to foreign investors and the adoption of Foreign Investment Promotion Act (July "98) |

Source: Jang & Jeon, "FDI Policy in the Global Economy," 2000.

and active opening, and thus may be described as the phase of "liberalization." Through policy changes in 1991 and 1992, new foreign investors were only required to notify the authorities, no longer requiring mandatory formal government approvals in most of the cases. In 1993, a five-year (1993-1997) FDI plan was introduced to remove restrictions on 132 business categories out of a total of 224 restricted ones. Afterwards, the plan was implemented three times.

### 3-3-2. Post-Financial Crisis FDI Policy

Korea's FDI policy went through another drastic change after the financial crisis, in an effort to attract investment in a more aggressive manner. Restrictions on foreign exchange transactions and the financial sector, which had been the biggest hindrances to inducing FDI, have since then lifted significantly. Furthermore, to provide a better legal framework for supporting FDI inducement, the Foreign Investment Promotion Act was introduced in July 1998. Subsequently, active measures have been taken to attract FDI. More specifically, the number of business categories subject to investment restrictions has been drastically reduced, and foreign investment procedures have been simplified. Streamline investment incentives improve business environment and build an effective support system. Also, FDI companies are given many incentives such as tax reduction or exemption, lower fees/prices for real estate rent/purchase, and designation of foreign investment zones.

### 3-3-3. Direction of Korea's FDI Policy

The objectives of Korea's FDI policy are to create an investment-friendly environment to induce the smooth inflow of FDI, and to streamline the policy with industrial policy objectives. Concrete goals include enhancing the competitiveness of the parts and materials industry, and promoting the development of the knowledge-based services sector such as IT and cultural industries through FDI.

The vision of Korea's FDI policy conforms to the global economy and comprises of the following three aspects. It involves ① fostering a virtuous circle of FDI attraction and enhancing industrial competitiveness, ② furthering globalization of the economy through promoting smooth and strategic FDI inducement, and ③ strengthening Korea's position as the hub of Northeast Asia by utilizing the nation's location between Japan and China in terms of geography and industrial development.

## 3-4. Recommendations for Vietnam's FDI Policy

As previously mentioned, the Korean government, in the process of the nation's economic development, had preferred loans over FDI as a means to mobilizing foreign capital. The government and business circles were concerned about the control of foreign corporations over domestic industries. As a result, while domestic industries were protected to a considerable degree, the nation suffered from the foreign currency crisis, which is partly attributable to heavy foreign debt. This ultimately led to a rapid market opening in an effort to overcome the crisis.

Vietnam has been promoting the FDI attraction policy as a measure to mobilize foreign capital. This policy should be continued given the relative merits of FDI compared to other forms of foreign capital. At the same time, the nation will gradually have to seek measures to mobilize foreign capital through loans depending on the future path of the Vietnamese economy and situations in the international financial market. Debt can be a much cheaper way of mobilizing foreign capital than FDI, as long as the level and structure of foreign debt does not increase Vietnam's vulnerability to a foreign exchange crisis. Thus, the choice between FDI and debt should be made, among other things, in consideration of the nation's debt repayment capacity, debt conditions, and expected benefits unique to FDI.

Korea, since the 1990s, has been pursuing a policy of actively attracting foreign investment with the main focus on acquiring advanced technologies through FDI. In Vietnam's case, FDI seems to have contributed relatively little to technology transfers so far. This rather disappointing result must have been caused by low productivity at most Vietnamese companies and their lack of capacity to absorb advanced technologies.

For the Vietnamese economy to grow in a sustainable manner, the technology gap between Vietnam and other forerunning developing countries must be bridged swiftly. Therefore, it is suggested that the Vietnamese government set the goal of acquiring advanced technologies, and concentrate its efforts on meeting this goal. The narrowing of technological gaps in selected areas will allow Vietnamese firms to make better use of FDI by more effectively absorbing advanced technologies from foreign-invested firms.

# 4. Future Challenges

## 4-1. Improvement of FDI Policy

Following the 6th Communist Convention, where the market opening reform policy was declared, Vietnam established its first foreign investment law in December 1987. The introduction of the law signified Vietnam's determination to shift gears from the existing socialist regime to a market economy, and was followed by the commencement of the so-called "Vietnamese socialistic market economy."

The foreign investment law and its enforcement order were revised five times since 1987 to provide a more optimal investment environment to foreign investors. In the process, many obstacles to investment have been removed. For example, restrictions on foreign exchange transactions have been eased, and taxes on the remittance of profits or surplus have been lowered as well.

In addition, foreign-invested companies are able to directly hire workers on their own. In the case of a joint venture corporation, various tasks related to making real estate arrangements, including the migration of natives from particular estates, which has previously been the responsibility of foreign-invested companies, have become the responsibilities of Vietnamese partners. Furthermore, foreign investors can obtain secured loans on the estate of newly established corporations.

<Table 5-7> Investment-Related Costs in Southeast Asian Cities (Unit: US$)

| | HCMC | Hanoi | Beijing | Bangkok | Singapore | Jakarta | Manila | Kuala Lumpur |
|---|---|---|---|---|---|---|---|---|
| Office Rent (month, per $m^2$) | 21 | 24 | 30-60 | 11.03 | 40.64 | 14-20 | 4.52-7.23 | 9.92-17.68 |
| Electricity (per KW) | 0.05-0.07 | 0.05-0.07 | 0.03-0.09 | 0.04 | 0.07 | 0.05 | 0.09 | 0.05 |
| Marine Cost to Yokohama Port | 900 | 1,300 | 500 | 1.200 | 575 | 890 | 850-1,100 | 575 |
| Maximum Personal Income Tax Rate | 50% | 50% | 45% | 37% | 22% | 35% | 32% | 28% |
| Average Wage (per month) | 102-138 | 79-119 | 79-139 | 184 | 432-557 | 133 | 170 | 202 |

Source: Saigon Giaiphong, June 23, 2004

Since 2001, the central government transferred its right to grant authorizations and permits of FDI under a certain amount to local governments, thereby establishing a system that encourages competition among local governments to offer more favorable conditions to foreign-invested companies in terms of taxation, taxes on the remittance of profits or surplus, and land usage fees.

Despite such efforts and improvements, there still remain many restrictions related to the methods of equity investment and investment capital mobilization. One example is the requirement that the legal capital of both joint ventures and 100% foreign-owned enterprises has to exceed 30% of the total invested capital, which necessitates excessively high initial investment costs for the foreign-invested companies in Vietnam.

In the case of joint venture enterprises, foreign equity share has to top 30%. Also, for the manufacturing of motorcycles, one of the main transportation means in Vietnam, a high local content ratio has to be met. To induce this high ratio, tariffs on relevant parts have been raised. One concern is that such local content requirements often result in the production of vehicles that lack competitiveness.

On top of this, Vietnam imposes strict restrictions on the acquisition of stocks of local enterprises and M&As by foreign-invested companies. Foreign-invested companies are allowed to acquire and own up to 30% of the shares of domestic corporations in the 35 investment-approved sectors. However, to actually do so, it is mandatory that they must receive a prior approval from the Prime Minister's Office. Moreover, the two tariff price system that partially remains in the telecommunications and harbor usage fees puts Vietnam at a disadvantage when competing with neighboring countries to attract FDI.

On the other hand, to reduce the chronic trade deficit that has persisted since the introduction of the market opening policy, Vietnam has been nurturing import-substitution industries, encouraging joint ventures with foreign-invested enterprises in relevant fields. However, with the Vietnamese government levying high import tariffs on products targeted for import-substitution, the nation's export competitiveness has rather weakened. As the enterprises enjoy higher profits in the domestic market than in the export market, they are not strongly motivated to improve quality for export competitiveness.

Even though import tariffs have decreased significantly since 1997, import protection for major export items has been further strengthened. In line with the nation's ASEAN membership and the CEPT (Common Effective Preferential Tariff) of AFTA, Vietnam must lower tariff rates on all manufactured products from countries within the region to 0 - 5% by 2006. Thus, strengthening the competitiveness of domestic industries is a matter of great urgency for the nation in preparing itself for the tariffs reduction.

On the other hand, Vietnam will only attract FDI under a favorable business environment. More specifically, such an environment requires improvements in the legal system, reforms in the public sector, eradication of corruption, development of the private sector, expansion of social infrastructure, and reform of the financial system.

## 4-2. Reform by Sector

### 4-2-1. Improvement of the Legal System

Vietnamese laws have been changing in a rapid and inconsistent manner in various areas, including tax, foreign exchange, labor and real estate. In spite of numerous efforts to adjust the laws to the market economy, the task seems to be far from complete. The slow process is, to a large extent, due to the lack of proper human resources and institutions that are responsible for establishing new laws. It is especially urgent that laws related to property rights be firmly established, as these laws are most essential to the effective operation of a market economy.

For the smooth administration of the property rights system, various enforcement orders and their execution are necessary, including those related to the provision of secured loans to foreign-invested companies. This is a prerequisite for the active involvement of Vietnamese financial institutions in loan services, and also for the vitalization of the Vietnamese financial and capital markets.

Although the execution system of property rights is currently stipulated under the civil and corporate laws of Vietnam, there are many difficulties in the actual disposition and withdrawal of collateral. This results in excessive demands from financial institutions for guarantees or their reluctance to extend loans, which makes it much more difficult for Vietnamese companies to raise funds on the security of their assets.

4-2-2. Public Sector Reform

Reform of SOEs in Vietnam has thus far been focused on enhancing management efficiency rather than on drastic ownership reform. Emphasis has been put on creating competitive markets, phasing out state subsidies, and separating ownership and management in SOEs. The government no longer exercises direct control over SOEs in many aspects of enterprise management. SOEs can now freely make decisions on their loan application to financial institutions, recruitment of workers and their wages, and production and sales of their products and services. By abolishing state subsidies to SOEs, Vietnam was able to cut government spending.

Still, the mentality of managers in most of SOEs is to fully embrace the market principles. Old habits die hard. They often continue to make attemtps to receive loans for investment or working capital from state-run banks with the help of government authority rather than on a competitive basis. This means that private investors with more profitable investment plans are "crowded out." Deficits of SOEs are being compensated by the government budget or loans from state-run banks, making the sector suffer from soft-budget constraints and moral hazards.

Vietnam's SOE reform has been conducted in three main aspects. First, the assets of SOEs were revalued in 1991, and, based on their management performance, only those above a certain standard were re-registered as SOEs. As a result, the number of SOEs decreased from 12,297 in 1989 to 6,264 in 1994, down to 4,704 in 2003. Second, non-strategic SOEs were equitized, and the workers were given priority rights to purchase equity shares. Vietnamese citizens were allowed to buy the shares up to 15% of total shares, and for foreigners, up to 30%. Third, efforts were made to form enterprise groups, called General Corporations (GC)[79], consisting of related SOEs as their members. However, the process of SOE ownership reform has been very slow: the ration of SOE ownership transferred to the private sector remains at a mere 8% in terms of output.

Some factors delaying the process of privatization/equitization include: ① the passive attitude of the managers and workers of SOEs towards privatization/equitization due to concerns over losing their jobs, ② difficulties in listing the equity shares on the Stock Exchange due to the underdeveloped stock market in Vietnam, and ③ the 30% limit on FDI in SOEs. More fundamentally, Vietnamese politicians and senior government officials are rather cautious in pushing privatization, fearing that it would undermine the socialist orientation of the nation.

### 4-2-3. Eradication of Corruption

Widespread corruption is indeed a serious social hazard in Vietnam to the extent that many foreign-invested companies regard it as the biggest obstacle to making investments and operating their businesses. The cases of corruption unveiled in the early 1990s mostly involved embezzlement of state coffers, smuggling, trade of illegal products, tax frauds and acceptance of briberies. Recently, however, corruption is taking on new forms, such as the violation of budget and income-related laws, misuse of joint venture firms, illegal usage of the public purse, and violation of regulations related to real estate and construction.

Certain structural problems have led to the prevalence of corruption in Vietnam. A prominent example is that SOEs, on which the Communist Party bureaucrats have a firm grip, are allowed

79) As part of public sector reform, the Vietnamese government integrated many SOEs in selected industries representing more than 50% of state capital into 18 gigantic enterprise groups, now known as General Corporations (GC) between 1995 and 1996, It also created 79 smaller-scale GCs representing roughly 15% of state capital. The goal of the integration was to prevent excessive competition among companies with similar characteristics, and to pursue economies of scale, thereby making it more convenient for the government to look over the SOE sector. Contrary to these objectives, however, by binding many companies within a group, the GCs attempted to gain force and take monopolistic actions. Also, the decision-making process of each company within a GC has become extremely complicated and inflexible. Another problem is the tendency of cross-subsidization among member firms whenever an enterprise is in financial distress □ implying the misallocation of financial resources within GCs.

to conduct trade-related businesses. Since the 1990s, a considerable number of SOEs have been investigated for their linkages to corruption. Another structural problem is the assignment of human resources based on personal connections. This has not only made whistle-blowing nearly impossible, but has also functioned as a protective measure for government officials involved in corruption cases. Also, procedures related to the establishment and operation of enterprises has often left ample room for discretionary decisions by government officials. In addition, punishment for corruption is not severe enough, and law enforcement is generally ineffective and often conducted in an unjust manner.

Under the recognition that widespread corruption among government officials and executives of SOEs has been undermining the efficiency of the whole economy, the Vietnamese government has promoted policies to root out corruption. For example, an Anti-corruption Committee was introduced this year, and the National Assembly has given its approval to the establishment of the State Audit. It remains to be seen to what extent these initiatives will contribute to anti-corruption efforts.

## 4-3. Financial Reform

The Doi Moi policy brought about a significant change to Vietnam's financial sector, as well. The financial reform in 1988 resulted in the abolishment of the past monopoly in banking through the separation of commercial banking functions from the central bank. Interest rates were adjusted to offer positive real interest rates to depositors, and to lesson or eliminate rate differentiation according to economic sector. By now, most interest rates have been deregulated. Also, entry barriers to the financial industry have been eased.

Still, many shortcomings remain in the Vietnamese financial sector. First of all, the banking sector is very much concentrated in the public sector. On the demand side, SOEs have been the major beneficiaries of banking services, and on the supply side, banking services are predominantly provided by state-owned commercial banks (SOCBs). Second, there still seems to be widespread state intervention in the management of banks. For instance, state-owned banks are believed to be subject to state guidelines concerning interest rates beyond the official regulation of the minimum deposit rates and the maximum lending rates.

Third, the private sector still has very limited access to bank loans. Probably due to inertia from the past, SOCBs show definite preference for the public sector. Lastly, infrastructure for financial services remains poor. For instance, the Vietnamese financial sector is almost like a composition of individual banks operating with no linkage to one another, even between banks and their subsidiary financial firms. This means that settlement systems are inadequate, financial services are poor, and resource allocation is inefficient among geographical regions. The poor settlement system drives people to rely mainly on cash and gold for financial transactions.

Priorities for reform of the financial sector in the coming years should be given to the restructuring of SOCBs and the pursuit of balanced development for financial markets to better serve the emerging private sector. Equitization of SOCBs should be accelerated along with the establishment of proper corporate governance mechanisms, so they can be managed truly on a commercial basis. Vietnam should also consider fostering community-based, non-bank financial institutions, which are mainly geared towards meeting the financial services needs of small and family enterprises. Of course, development of the capital market is also essential to enable larger enterprises to mobilize long-term capital as well as to facilitate equitization and privatization of SOEs. It should be re-emphasized that the most essential factor for the development of financial/capital markets is a sound legal system that can adequately protect the rights of creditors and investors.

# Bibliography


An, Dinh Van. Developing the Socialist-Oriented Market Economy in Vietnam. CIEM, 2003.

Arkadie, Brain Van & Raymond Mallon. VIETNAM: A Transition Tiger? Asia Pacific Press, 2003.

Doanh, L. D. FDI in Vietnam: Results, Achievements, Challenges and Prospects. Aug. 2002.

Jang, Yoon-jong & Joo-sung Jeon. FDI Policy for the Global Economy. Eulyoo Cultural Press, Oct. 2000.

Kang, Gwang-ha. Five-year Economic Development Plan. SNU Press, Aug. 2000.

Kang, Seok-in. Inducing Foreign Capital and Korea's Economic Development. Beomshin Press, Feb. 1997

Kim, Joon-dong. Hindrances and Measures to Promoting FDI. KIEP, Dec. 1997.

Kim, Joon-dong. Inward FDI Regime and Evidences of Spillover Effect in Korea. KIEP, Jun. 1999.

Kim, Seung-jin. Improvement Measures for Investment Incentive System. KDI, Apr. 1999.

Lee, Byung-ki. Analysis of FDI's Ripple Effect on Productivity. KDI, 2002.

Lee, Jong-won. Korean Economic Theory. Yoolgok Publishing Co., Mar. 2002.

Park, Seung. Economic Development Theory. Pakyoungsa, Jun. 2000.

Whang In-joung, Economic Transformation of Korea, 1945-95: Issues and Responses. Sejong Institute, 1997.

ADB, Vietnam: Foreign Direct Investment and Postcrisis Regional Integration., Sept. 2004.

GSO , Statistical Yearbook. 2003.

GSO , Input-Output of Vietnam. , 2000, 2003.

IEWS, Vietnam's Legal System and Market Reform. Apr. 2002.

KAVS, Current Status and Challenges of Research on Korean and Vietnamese Studies. 2 Oct. 2004.

KEXIM, Status of Vietam and How to Advance into the Nation. Sept. 2004.

KEXIM, Statute Book on FDI in Vietnam, Dec. 1997.

KEXIM, Vietnam's Energy Industry Trend and Development Prospects. Dec. 2003.

McKenzie, Wood. South East Asia Upstream Services. 2003.

MUTRAP, The FACTOM Model: FDI attraction Comparison and Trade Openness Measure, EC-Vietnam. 2002.

Saigon Giaiphong. 23 Jun. 2004.

Vietnam Investment Review. 21-27 Feb. 2005.

http://www.eiu.com

http://www.stats.unctad.org/fdi

http://www.kita.net

http://www.mpi.gov.vn

http://www.viewswire.com

http://www.vir.com.vn

http://www.worldmarketsanalysis.com

Chapter 6

# The Export Promotion Financial Policy And Export-Import Bank of Vietnam

Chapter 6

# The Export Promotion Financial Policy And Export-Import Bank of Vietnam

*Eungho Ahn*
*Korea Eximbank*

## Executive Summary

### *Introduction*

Vietnam is one of the fastest growing economies in the world with an area of 330,000 km2 and a population of 82.6 million. From 2001 to 2004, the Vietnamese economy is estimated to have grown on an average of 7.2% a year. The outstanding economic performance began with the Renovation (Doi Moi) in 1986, and the market-oriented reforms in 1989 accompanied by the opening of the trade market and FDI provided the foundation for sustained economic growth. In this process, there is no doubt that the rapid increase of exports have played a central role, accounting for over 55% of the GDP.

While exports have played such an important role in the growth of the Vietnamese economy, Vietnam does not have many necessary trade financing facilities, which are taken for granted as instruments necessary for export promotion even in advanced economies, not to mention NIEs. What Vietnam currently has are outright export subsidies that must be phased out once Vietnam joins the WTO. Therefore, before its entry into the WTO, Vietnam needs to have appropriate financing tools that will help the Vietnamese industry to compete on a level playing field overseas. They include export credit services, which export credit agencies provide, and proper trade financing programs.

In this paper, we are going to review Korea's experience in its financial measures for export promotion and the operation of the export-import bank, and seek appropriate models for the Vietnamese export-import bank as well as financial instruments for trade promotion.

### *The Korean Experience*

Over the last four decades until 2004, the Korean economy grew on an average of 7% annually and the country became the 11th largest economy and 12th largest exporter in the world by 1996. Exports were the driving force behind Korea's sustained economic growth, particularly in the early years of industrialization. This was, at least in part, attributable to various export promotion measures, which would not have been allowed under the present WTO regime. However, with the entry into the GATT system in 1967, and later into the WTO in 1994, such direct export promotion measures were entirely abolished. Today, only indirect export promotion measures remain, including various trade financing schemes and export credit services.

As a pre-shipment financing scheme, short-term trade financing is available through commercial banks. In this case, the Bank of Korea, the central bank, provides financial resources for commercial banks through the Aggregate Credit Ceiling System. For post-shipment financing, exporters can issue bills of exchange to commercial banks, which can be rediscounted by the Korea Eximbank. The Korea Eximbank also provides factoring and forfaiting services as post-shipment financing.

As export credit services, the Korea Eximbank provides direct financing and guarantees, while the Korea Export Insurance Corporation is responsible for the export insurance business. In Korea, a separate model with two separate export credit institutions is deemed proper.

## *Establishment of the Vietnamese Export-Import Bank*

***Export Credit Agency***

An institution that provides official export-related support in the forms of direct financing or insurance/guarantees is called an export credit agency (ECA). Such an institution is usually government-owned or controlled. Sometimes, a private company runs the export credit business. In that case, the private company has a special agreement with the government and operates export credit functions on a government account. A type of ECA that lends directly is called an export-import bank. Some export-import banks issue insurance and guarantees, as well as providing direct financing.

From the viewpoint of export promotion, direct export credit is believed to be more effective than insurance or guarantees. With a credit rating almost equal to that of its government, it can easily borrow in the capital markets in its own name. Therefore, it has a larger autonomous financial base compared with the institution dealing with insurance and guarantees, whose autonomous sources of funding are limited to small insurance premiums and guarantee fees. As a result, an export-import bank can carry out the government policy more efficiently with direct loan programs.

It is deemed desirable for Vietnam to establish an independent export-import bank. However, in case of the Korea Eximbank, an existing banking institution called the Korea Exchange Bank carried out the export credit business in the early days of its operation. Vietnam may do the same in the beginning. The administration of export credit and other trade financing facilities can be entrusted to existing financial institutions such as the Development Assistance Fund (DAF), which already provides financial services for export-promotion.

***Provision of Financial Services***

As a lender/insurer of last resort, the Vietnamese export-import bank must provide basic export credit services including export insurance and/or guarantees. However, many export-import banks around the world usually provide not only genuine export credit, but also various trade-related financial services which fulfill various government policy objectives. Therefore, the basic financial services of the export-import bank must include Export Insurance and Guarantees, Medium- and Long-term Export Financing, Short-term Trade Financing, Rediscounting of Trade Bills, and SME Working Capital Loans. Demand for Medium- and Long-term Export Financing is not expected to be high in the near future. If necessary, the bank can also support Vietnamese exporters to participate in trade fairs and exhibitions.

In addition, as a trade-related financial institution, the Vietnamese export-import bank must build a strong research group focusing on international trade, investment and partner countries. Exporters will also benefit from the knowledge gained through the research activities.

***Organization of the Export-Import Bank***

In any institution, a proper organizational structure is one of the keys to efficient management. The suggested organization will require a Board of Directors for overall policy guidelines, a Managing Board to decide and resolve important matters pertaining to the bank's daily operations. Depending on the scope of the financial services provided, the bank will have diverse departments such as an Export Insurance Department, an Export Finance Department, and a Country Studies Department. For overall operation, it needs a General Affairs Department, a Treasury and International Finance Department, a Legal Department and a Risk Management Department. In light of the growing importance and advanced techniques of risk management, a separate Risk Management Department is necessary. Also, given the characteristics of the bank, there will be many international contracts regarding export and financing. Therefore, the Legal Department must be staffed with lawyers who are familiar with international private laws.

***Source of Financing***

As a special government bank, capital subscription from the government must be the main source of financing, especially in the early stages of its operation. Established with government funding, the export-import bank can enjoy cost advantages in financing and is able to provide stable and consistent export credit services. Additionally, it can borrow from the government account. The Korea Eximbank sometimes borrows from the National Investment Fund, which the government established in the Bank of Korea for the purpose of executing industrial policies.

As the institution matures, borrowing from home and abroad will increase. This will in turn contribute to the development of Vietnamese expertise in international financing and the domestic bond market, depending on the situation.

***Risk Management***

Today's financial markets are full of uncertainty, and financial transactions involve many risks including interest rates, foreign exchange rate changes, and default risks. Individual financial institutions are subject to the risk of maturity mismatches between loans and debts. One of the weak aspects of the Vietnamese financial sector is risk management. Of course, a professional appraisal of projects must be the building block of the sound management of a banking institution. However, on top of this, the evaluation of various risks and the appropriate allocation of such risks are very important for the sound operation of the export-import bank. Therefore, a separate risk management department is necessary to take care of various risks. Major risks to be managed include credit risks, market risks, liquidity risks and various other risks.

Essential for efficient risk management are a good "risk culture" within the institution and a well-designed risk management system. The management must fully understand the importance of risk management and have strong will to practice risk management. Such strong intentions must spread to all corners of the institution, and become a part of its culture.

***Training***

The Vietnamese export-import bank must also serve as the focal point where foreign trade and trade financing experts are concentrated. As such, the export-import bank must provide the necessary environment for specialists, including research on trade and partner countries. A well-built network of export-import banks, the authorities concerned, and research institutes can have a synergetic effect on practical research on relevant subjects and cultivate experts in the field.

As a country going through transformation into a market-oriented economy, professionals and experts are needed in many areas. Banking is one such sector. To solve the problems arising from the lack of expertise, professional training in this field must be provided in the near future, both domestically and internationally. Active participation in international workshops/conferences and exchange with foreign ECAs for on-the-job-training and information exchanges must be promoted.

## *Conclusion*

As with other developing countries in Asia, it is time for Vietnam to establish an export-import bank. The functions and services of export-import banks differ depending on the need and situation of each country. Whatever form the new Vietnamese export-import bank takes and whatever services it may provide, a number of important points must be taken into consideration.

First, it must serve as the lender/insurer of last resort. As such, it should provide basic official support itself. Providing direct financing can be very effective because it is simple and the effect is direct. It is also recommended that it start the export insurance business.

Second, it must provide a new source of export financing that Vietnamese exporters can tap into. Currently, Vietnamese exporters can only benefit from limited export financing facilities. It is recommended that it start providing working capital loans or guarantees as well as other short-term trade financing for exporting companies.

Third, by specializing in export finance, it must serve as the center of expertise on international trade and trade financing. As such, it must promote research on international cooperation and export financing, and should serve as an information center, maintaining up-to-date information and engaging in information exchanges with similar agencies overseas.

Even though Vietnam needs an export-import bank that specializes in export financing as well as proper export credits, it does not necessarily have to be an independent entity from the beginning.The Korean Eximbank was established seven years after the introduction of the Act. Likewise, the ECA operation in Vietnam may be entrusted, for some time, to an existing institution such as the DAF after the introduction of the appropriate law. Whether to assign the insurance operation to the same institution or not requires more time and consideration. In the early stages at least, it can borrow the expertise of the insurance industry, and entrust export insurance operations to state-owned insurance companies such as Bao Viet.

Currently, the Vietnamese banking sector is dominated by a few SOCBs and has just begun the process of partial privatization (equitization). Over all, SOCBs have been managed inefficiently and still carry a considerable amount of bad loans. Such problems must be minimized in the newly established export-import bank by maintaining financial soundness and a high level of expertise in its management.

# 1. Introduction

Vietnam is one of the fastest growing economies in the world with an area of 330,000 Km2 and a population of 82.6 million. From 2001 to 2004, the Vietnamese economy is estimated to have grown on an average of 7.2% a year. During the same period, only China recorded a higher economic growth rate of 8.2%. The outstanding economic performance began with the Renovation (Doi Moi) in 1986. Then, the market-oriented reforms in 1989, accompanied by the opening of the trade market and FDI, integrated Vietnam into the regional and world economy and established the foundation for sustained economic growth. There is no doubt that the rapid increase of exports had played a central role in this process.

While exports have played such an important role in the growth of the Vietnamese economy, Vietnam does not have enough trade financing[80] facilities that are taken for granted as necessary instruments for export promotion even in advanced economies and other NIEs. What Vietnam currently has are outright export subsidies which must be phased out after Vietnam's entry into the WTO. Therefore, before its accession to the WTO, Vietnam must be equipped with necessary financing tools which will help the Vietnamese industry to compete on a level playing field in the global market.

The purpose of this paper is to provide useful suggestions to improve the competitiveness of Vietnamese exporters in financial matters. The main emphasis is on the establishment of the Vietnamese ECA, regardless of whether it is to be called an export-import bank or not. However, trade-financing aspects will also be covered.

80) Separate from export credit, which is to be explained later, the term trade financing usually refers to short-term financing to facilitate export transactions on a commercial base.

## 2. Vietnam's Exports

### 2-1. Major Exports

During the last four years from 2001 to 2004, Vietnam's exports increased on an average annual rate of 16.3%, while the economy grew at an average rate of 7.2%,. Thus, exports were the main engine for sustained economic growth. In 2004, the total volume of exports amounted to US$ 26,504 million, accounting for 59% of Vietnam's GDP.

Vietnam is relatively a newcomer to the global economy. As such, Vietnam's major exports are raw materials, agricultural and marine products, and light industry products including footwear and garments. Crude oil has been the most lucrative foreign currency winner accounting for more than 20% of the total export revenue. In 2004, it amounted to US$ 5,666 million, representing 21.4% of total exports. Only recently has there been gradual increases in the exports of manufactured goods, including consumer electronics, computers, footwear,

<Table 6-1> Major Vietnamese Exports (US$ million)

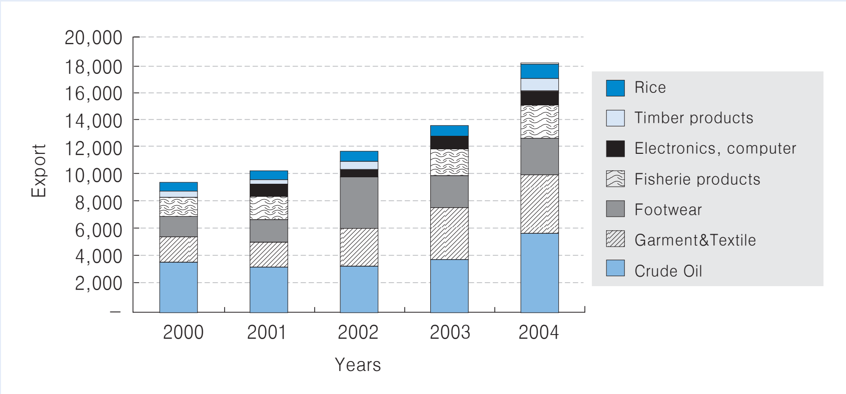
| Major Exports | 2000 | 2001 | 2002 | 2003 | 2004 | Average Growth Rate(%) |
|---|---|---|---|---|---|---|
| Crude Oil | 3,503 | 3,126 | 3,274 | 3,821 | 5,666 | 13 |
| Garments & Textiles | 1,892 | 1,975 | 2,752 | 3,609 | 4,319 | 23 |
| Footwear | 1,472 | 1,587 | 1,867 | 2,261 | 2,604 | 15 |
| Fisheries products | 1,479 | 1,816 | 2,023 | 2,200 | 2,397 | 13 |
| Electronics, computers | | 710 | 492 | 855 | 1,077 | 152 |
| Timber products | 311 | 344 | 436 | 42 | 1,054 | 36 |
| Rice | 668 | 624 | 726 | 720 | 941 | 9 |
| Coffee | 501 | 391 | 322 | 505 | 594 | 4 |
| Rubber | 166 | 166 | 271 | 378 | 579 | 37 |
| Cashew nuts | | 152 | 209 | 277 | 425 | 41[2] |
| Wire electricity and cables | | 181 | 186 | 292 | 385 | 29[2] |
| Others | 4,492 | 3,957 | 4,149 | 5,192 | 6,463 | 10 |
| **Total** | **14,483** | **15,029** | **16,706** | **20,149** | **26,504** | **16** |

Notes: 1. Geometric mean for last 4 years
2. Geometric mean for last 3 years
Source: General Statistics Office (GSO), Vietnam

garment and textiles, although their shares in the total export volume remain relatively stable.

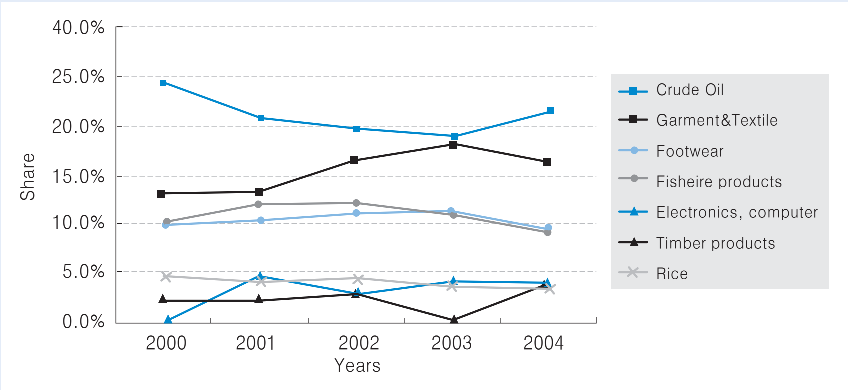
In 2004, the export revenue increased by 31.5%. Even though most principal exports increased, large increases in oil and commodity prices were the main factors for the huge growth in exports. The share of principal exports including crude oil, garments and textiles, footwear, fisheries products, electronics and computers, timber, and rice was about 70% of total exports.

<Figure 6-1> Trend of Major Exports (US$ million)




Source: GSO

<Figure 6-2> Changes in the Vietnamese Export Structure (2000 - 2004)




Source: GSO

## 2-2. Vietnam's Major Export Markets

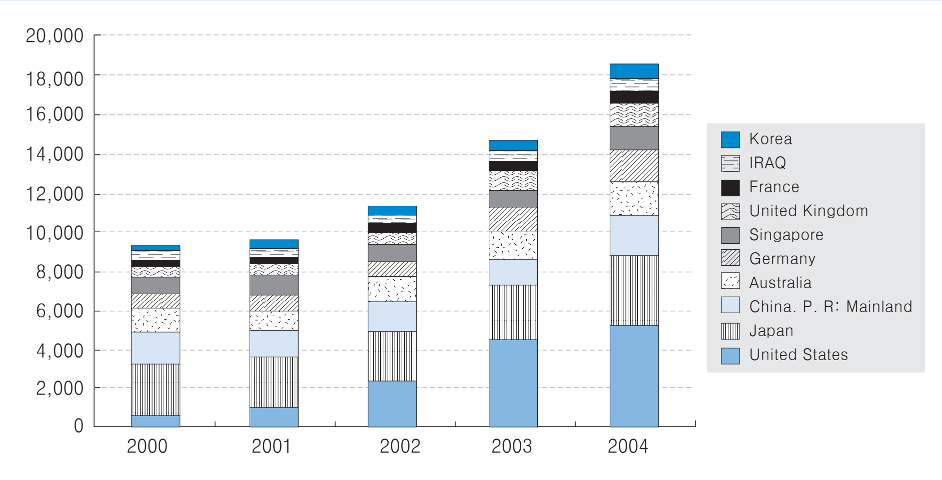
Vietnam's Major export markets are mostly advanced economies and China. The exception is Iraq, where efforts for economic recovery after the war continue. Advanced economies include the United States, Japan, Australia, and other European countries. The share of the 10 largest export markets accounts for about 70% of total exports. The share of the 20 largest export markets recorded about 80% in 2004.

<Table 6-2> Vietnam's Major Export Markets

| | 2000 | 2001 | 2002 | 2003 | 2004 |
|---|---|---|---|---|---|
| UNITED STATES | 733 | 1,066 | 2,453 | 4,463 | 5,206 |
| JAPAN | 2,575 | 2,510 | 2,437 | 2,808 | 3,507 |
| CHINA | 1,536 | 1,417 | 1,518 | 1,323 | 2,184 |
| AUSTRALIA | 1,272 | 1,042 | 1,328 | 1,476 | 1,798 |
| GERMANY | 730 | 722 | 729 | 1,181 | 1,478 |
| SINGAPORE | 886 | 1,044 | 961 | 931 | 1,229 |
| UNITED KINGDOM | 479 | 512 | 572 | 903 | 1,191 |
| FRANCE | 383 | 469 | 439 | 580 | 647 |
| RAQ | 322 | 405 | 440 | 489 | 636 |
| KOREA | 353 | 406 | 469 | 464 | 610 |

Source: Korea Trade Association

<Figure 6-3> Trend of Vietnamese Exports in 10 Largest Markets (US$ million)



## 2-3. Exports in the Vietnamese Economy

The share of exports in the Vietnamese economy is one of the largest in the region, and it is increasing every year. Since 2000, it mostly remained above 55% of GDP. As the export growth rate is much higher than that of economic growth, the contribution ratio of exports in the Vietnamese economy also remained very high at over 95%.[81)] In 2004 alone, it was 106%.

<Table 6-3> Export Shares of GDP among ASEAN Countries

| | 2000 | 2001 | 2002 | 2003 | Per Capita Income (US$, 2004) |
|---|---|---|---|---|---|
| Vietnam | 55.0 | 54.6 | 56.8 | 59.6 | 550 |
| Cambodia | 36.9 | 37.0 | 44.1 | 44.6 | 320 |
| Indonesia | 41.4 | 39.9 | 33.0 | 29.3 | 1,140 |
| Malaysia | 109.0 | 100.0 | 99.1 | 101.8 | 4,650 |
| Myanmar | 18.8 | 31.0 | 33.4 | 25.8 | 150 |
| Philippines | 50.2 | 44.6 | 45.2 | 45.1 | 1,170 |
| Thailand | 56.3 | 56.2 | 53.6 | 56.1 | 2,540 |

Source: Statistical Handbook (2005), OECD (2005)

81) The contribution ratio is measured through dividing the export increase by the GDP increase. Even though some economists use this method to calculate the export contribution ratio for convenience, its interpretation must be used with limitations. This applies even when the calculation is based on the US dollar. For example, the ratio will increase if oil exports increase in value terms due to a price-hike, even without any increases in the quantity of exports. Besides, the export amount is in gross terms, while GDP is in real terms. In this case, oil exports do not contribute to GDP growth. Thus, it is very difficult to calculate genuine export contribution.

# 3. Financial Policies for Export Promotion

## 3-1. Current Financial Policies for Export Promotion in Vietnam

The Government of Vietnamese (GOV) provides various export promotion measures for the exporters. They include tax incentives, special favors in the export-processing zones (EPZs) or low-priority geographical areas, and export subsidy programs.

As for tax incentives, there are import-tax rebates on imported goods used in processing other goods destined for export, and corporate income tax (CIT) reductions for incomes from export revenues worth more than 50% of the annual income. These include cases of i) exports in the first year of direct export, ii) exports of new lines of goods with novel environmentally friendly or useful characteristics, iii) exports to new countries or territories for the individual firm, and iv) additional increments in export incomes from year to year.

Besides the fiscal export promotion measures, the GOV runs financial subsidy programs, but they are inconsistent with the WTO regime and as a result, must be revised or abolished once Vietnam joins the WTO. Beside the financial subsidy program, financial export promotion programs are very limited, and Vietnamese exporters do not enjoy the various trade financing schemes which are common among developed economies, including the use of Trade Bills.

### *(a) Trade Financing*

In Vietnam, the state-owned commercial banks (SOCBs) and foreign banks provide working capital and post-shipment financing for exporting firms. However, such financial support is very limited, and most of the beneficiaries are state-owned enterprises (SOEs) and large joint ventures. Even though SOCBs are allowed to provide credit without collaterals, they usually ask collaterals for lending, and only real estate and Treasury Bonds are accepted as collaterals. As a result, many exporting firms without sufficient assets for collaterals face difficulties in financing from SOCBs. However, most SOEs and joint ventures with SOEs normally do not encounter such problems in dealing with SOCBs because of their privileged access to SOCBs. As a result, the small and medium-sized private firms experience many hardships in financing.

### *(b) Short-term Export Promotion Credit of the Development Assistance Fund*

The Development Assistance Fund (DAF) was established as a government institution in 1999 to serve as the government's development and investment credit mechanism to industries and areas in need of investment promotion, and to contribute to the smooth implementation of the government's socio-economic development policies. The Short-term Export Promotion Credit is a subsidy program that provides working capital for the exporter with contracts.

Exporters only have to pay 80% of the long and medium-term loan rates. However, this program is hardly utilized by private firms because the complicated and time consuming loan application procedures. Furthermore, under the WTO regime, this is an apparent subsidy program and cannot be permitted once Vietnam joins the WTO.

<Table 6-4> Export Credit Commitment and Disbursements of DAF 2001- 2004

(Unit: Amount VND 1,000)

| | 2001 | | 2002 | | 2003 | | 2004 | |
|---|---|---|---|---|---|---|---|---|
| | Case | Amount | Case | Amount | Case | Amount | Case | Amount |
| Commitment | 87 | 162,453 | 1,204 | 3,231,339 | 2,121 | 5,550,838 | 2,946 | 9,789,502 |
| By Items | | | | | | | | |
| Rice | 7 | 37,299 | 156 | 1,095,424 | 370 | 1,742,463 | 299 | 2,593,967 |
| Fishery | 46 | 71,073 | 590 | 1,182,347 | 1,013 | 2,295,041 | 1,489 | 3,784,156 |
| Cashew | | 0 | 52 | 138,624 | 160 | 338,446 | 288 | 583,139 |
| Garments & Textiles | 2 | 3,980 | 164 | 397,132 | - | - | 28 | 58,122 |
| Coffee | 13 | 14,881 | 34 | 80,783 | 86 | 179,286 | 157 | 698,150 |
| Others | 19 | 35,220 | 208 | 337,029 | 492 | 995,602 | 685 | 2,071,968 |
| Disbursements | | 141,910 | | 3,009,423 | | 6,298,835 | | 10,142,390 |
| Outstanding | | 109,545 | | 1,015,518 | | 1,145,520 | | 1,899,236 |

Source: Data supplied by DAF

### *(c) Export Insurance*

At present, Vietnamese exporters do not benefit from the export insurance service. The trade-related insurance program offered by Bao Viet, the dominant state-owned insurance company, covers only the losses and damages of exported goods. Even though other foreign insurers or joint ventures also offer similar insurances, they do not cover commercial and political risks that other ECAs do.

### *(d) Export Promotion Fund*

The Department of Enterprise Finance under the Ministry of Finance administers this program. Established in 1999 to assist Vietnamese exporters to explore new markets and improve competitiveness, it is a subsidy program covering 13 products. Export assistance includes i) interest rate support through full or partial refund of interests incurred on commercial bank loans for purchasing agricultural products for export; ii) direct financial support for first-time exporters and exports to new markets, or goods with substantial price fluctuations; iii) cash rewards and bonuses (cash grants) to exporters of loss-making goods due to lack of competitiveness or high risks; and iv) reimbursements for export market development and trade promotion (refer to Box 2.1.1.).

### Box 2.1.1. The Export Promotion Fund (EPF)

The Department of Enterprise Finance under the Ministry of Finance administers the EPF. It was established in 1999 largely as a temporary measure to assist Vietnamese exporters, including through expanding markets and increasing competitiveness (Prime Minister's Decision No. 195/1999/QD-TTg, 27 September 1999). It replaced the Price Stabilization Fund.

The EPF currently covers about 13 products. Some 70%-80% of assistance accrues to exporters of agricultural products. It is financed mainly by collections from import and export price differentials (differences between domestic selling and historical import/export parity prices), fees and charges on bidding of export quotas, and annual budgetary support. Assistance is provided to both state-owned enterprises and private companies. Export assistance includes interest rate support by way of fully or partially refunding interests incurred on commercial bank loans to purchase agricultural products for export; direct financial support, particularly to first time exporters, exports to new markets, or goods subject to major price fluctuations; and cash export rewards and bonuses to goods which are make losses due to their lack of competitiveness or high risk levels. Total expenditure from the EPF was VND 128.4 billion (US$ 9.2 million) in 2000, the latest year for which such information is available. Although relatively small, expenditure seems to have risen somewhat recently in line with the expanded coverage of products eligible for support.

Export bonuses in the form of cash grants are paid to promote exports, especially of agricultural products. Although bonuses initially targeted agricultural exports, mainly rice, coffee, pork, canned fruits and vegetables, bonuses were extended from 2002 to also cover certain industrial products, such as certain plastic and mechanical goods, handicrafts, rattan and bamboo-ware. Bonuses are contingent on exports, and in 2002 bonus rates varied across eligible products ranging from VND 100 to VND 900 per US$ value of export, equivalent to a maximum subsidy rate of approximately 6%. Other exports eligible for the bonus in that year were fresh, dried and semi-processed fruits and vegetables, tea, peanuts, pepper and processed cashew nuts.

There was a change in the basis of payment for the export bonus in 2003 (Decision No. 1116/2003/QD-BTM, 9 September). The bonus is now based on the yearly increase in export revenues. Annual export bonuses total some VND 11-15 billion.

Cash export rewards are also paid to exporters subject to minimum export volumes or export growth. Conditions include mainly annual growth of export volume exceeding 20% and a minimum absolute increase of US$ 400,000; new exports exceeding US$100,000; annual exports of products manufactured from local raw materials or labor-intensive products (e.g. handicrafts, agricultural, forestry and marine products, garments and footwear) of at least US$ 10 million (US$ 3 million for handicrafts, fruits and pork); and exports exceeding US$ 50 million for all other (non-quota) products. In 2002, export rewards were paid to 223 enterprises and totaled an estimated VND 16.3 billion (US$1.1 million), equivalent to under US$ 5,000 per enterprise.

Certain expenditures for export market development and trade promotion have also been reimbursed since 2001 (the National Trade Promotion Programme). Eligible expenditures include trade promotion activities such as participation in trade fairs and exhibitions, market surveys, consultancy fees, and opening of trade promotion centres and representative offices abroad. Different subsidy rates apply at either 0.1% or 0.2% of export value depending on the type of eligible expenditures, but the amount of support is capped at 50% or 70% of the exporter's actual eligible expenditures. Many products are eligible, including marine products, rice, tea, coffee, fruits and vegetables, garments and textiles to non-quota markets, wood products, toys, plastics and mechanical products, and processed foodstuffs with domestic materials.

Subsidies for trade promotion as a share of EPF expenditures have risen rapidly from 1% in 2001 to 23% in 2003, while that of export rewards has increased gradually during this period from 31% to 46%. While the level of export subsidies remains relatively low, there is an upward trend. For example, in the case of rice, the subsidized quantity has increased from one million to two million tons. Similarly, coffee has been added to the list and received substantial subsidies to compensate for losses.

*- supplied by MOF of Vietnam*

### *(e) On-lending*

Most of the on-lending agreements between Vietnamese banks and foreign banks are to support Vietnamese imports from foreign countries. However, there are also some on-lending agreements to promote Vietnamese exports. As such, in March 2004, Vietnam and the EU agreed to establish a US$ 15 million fund to assist Vietnamese small and medium-sized enterprises (SMEs) in exporting goods to the EU. This fund would provide the SMEs with easier access to financial resources needed for production and procurement of export goods.

## 3-2. Brief Introduction of Korea's Export Promotion Financial Policy

Over the last four decades until 2004, the Korean economy grew on an annual average of 7% and the Korea became the 11th largest economy and 12th largest exporter in the world by 1996. Like Japan and other East Asian NIEs, Korea's economic success was largely based on exports. Korea's exports grew consistently faster than did those of other OECD countries. During the same period, Korea's exports increased on an average of 21.0% annually. In 2004, Korea remained the world's 12th largest exporter by exporting US$ 253.8 billion, accounting for 2.8% of the world's export volume. Today, the share of exports in GDP is 37%, and the export sector accounts for 18% of total employment. Especially, 82% of manufacturing jobs are in the export sector.

The various export promotion measures of the Korean government, which would not have been permitted under the present WTO regime, must have played an important role in the early years of export-oriented economic development. They included direct subsidy financing, application of preferential foreign exchange rates for the exporters and the export-import link system, etc. However, with the entry into the GATT system in 1967, and later into the WTO in 1994, such direct export promotion measures were entirely abolished. Today, as indirect export promotion measures, the Bank of Korea (BOK), the central bank, provides commercial banks with funds necessary for trade financing, and the Korean government provides export credit. As official export credit agencies[82)], the Korea Export-Import Bank provides direct loans and guarantees, and the Korea Export Credit Corporation provides export insurance.

### *(a) Pre-shipment Financing (Trade Financing)*

The Korean banking system provides pre-shipment trade financing for exporters as well as producers of export products, or their raw materials and half-finished products. Commercial banks provide working capital for the production or purchase of export goods, and they can refinance a portion of the necessary fund at a favorable rate from the BOK. The BOK's Aggregate Credit Ceiling System (ACCS) regulates the refinancing.[83)] As a result, the ACCS also regulates the terms and conditions.

In determining the ceiling for each application for financing, there are two types of trade financing: Letter of Credit (L/C)-based financing and performance-based financing. They are

82) The definition and functions of export credit agencies will be discussed later, in detail.

83) The Aggregate Credit Ceiling System was introduced in 1994 to minimize financing by the government. Under the system, the BOK sets a ceiling on its overall refinancing provided to banks. The rediscounts of commercial bills, trade financing, and loans for the production of basic materials and parts were incorporated into this system. Most policy funds, meanwhile, were either shifted over to the fiscal budget or discontinued. As a government policy institution, the Korea Eximbank provides additional short-term blanket financing for SMEs which are not subject to ACCS. For details, see BOK (2003).

again divided according to the usage of the loan: production; purchase of raw material and intermediary goods; purchase of final goods. Terms and conditions vary, depending on the usage of the financing. Also, a blanket financing is available for both types of trade financing. In this case, it is unnecessary to specify the usage of the loan when applying. The exporter can use the fund for any purpose. Therefore, this type of blanket financing is more convenient, but is only available for SMEs whose annual export volume is less than US$ 50 million.

Trade financing has been a very effective means for export promotion. A bank can extend trade financing at a lower interest rate compared to general market rates, within the relevant credit line allocated from the BOK. Trade financing is linked to the appropriate time of the beneficiary's needs such as production, purchase of raw materials or finished products, and so forth. Local producers or subcontractors, who indirectly contribute to exports, can benefit from trade financing by means of local L/C issued by a local bank (foreign exchange bank) at the request of beneficiary. Since the refinancing through the ACCS is not limited to the export industry, it does not violate the WTO Agreement.

### *L/C-based finance*

This is a transaction-based finance: The bank decides the credit amount and terms and conditions in consideration of the exporter's past export performance, turn-over, and creditworthiness. This scheme is relatively cumbersome and is usually used by a relatively new applicant. At each request, the exporter should submit all documents evidencing the transaction, including L/C, export contracts, etc. The coverage is the f.o.b value of each transaction.

### *Performance-based finance*

The credit line of an exporter is decided based on the export performance during a certain period (usually 6 months or 1 year) just before the loan request. Once the credit line is established, the borrower can draw the needed fund at any time. This facility is preferred over L/C-based credit by exporters because of its convenience.

### *(b) Post-shipment Financing*

There are a few types of post-shipment financing. First, an exporter who has completed shipment with a D/A or D/P contract or usance L/C can be paid before the due date by issuing and negotiating (selling at discount) a trade bill of exchange at a commercial bank. Based on the bills of exchange purchased, the commercial banks reissue new bills. Then the Korea Eximbank rediscounts them. The rediscount by Korea Eximbank provides an additional source of refinancing for commercial banks engaged in purchasing bills of exchange.

Second, exporters can use the factoring and forfaiting services. Factoring is a trade finance mechanism whereby an exporter sells receivables at a discount to a factor. In general, after the factor has purchased a receivable, the importer or buyer directly pays the factor. The factors may or may not have recourse to the exporter in the event of nonpayment or delayed payment by the buyer or importer. The factors not only provide financing services, but also provide other "factoring services", including credit investigation for the customers, execution of other secretarial works and cover for credit risk. Forfaiting also involves the purchase at a discount of promissory notes or bills of exchange by a forfaiter. The payment instruments are normally guaranteed by a bank. The discount reflects financing costs according to the payment due date and the risks involved.

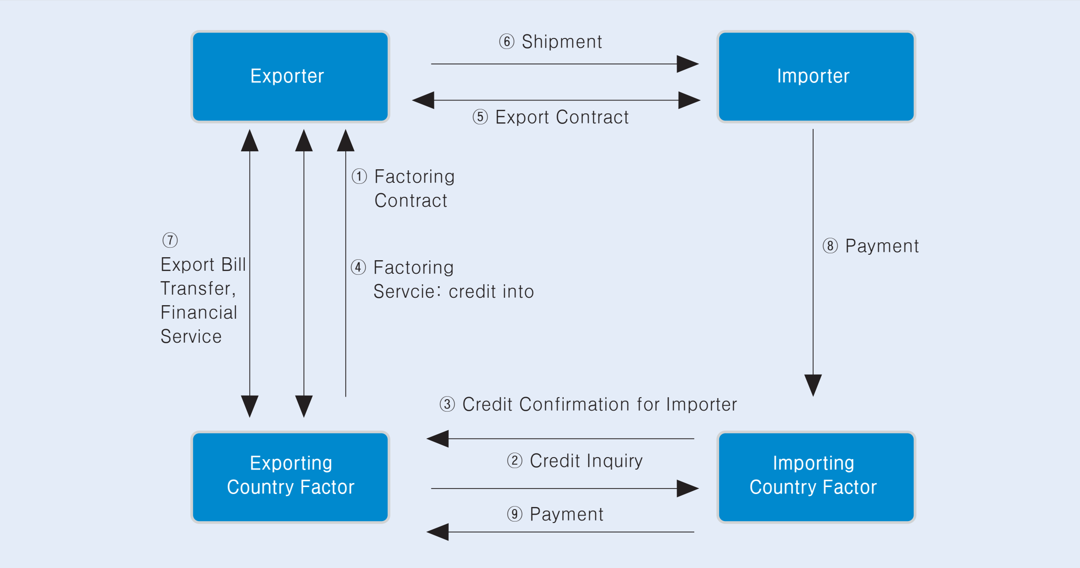
When using this service, the uncertainty of payment collection disappears and exporters can be paid in full after receiving a discount in advance. The Korea Eximbank provides both services.

<Table 6-5> Forfaiting and Factoring

| | Forfaiting | Factoring |
|---|---|---|
| Major Subject | Negotiable instrument (L/C) | Non-negotiable instrument (D/A contract) |
| Eligible Bonds | Individually confirmed bonds at the present | Comprehensive and sustainable bonds including present and future bonds |
| Limit | 100% of contract amount | 80% of contract amount 1 |
| Payment Term | Within 3 months to 7 yrs post-shipment | Short-term transaction (30 to 180 days) |
| Others | Confidentiality of information on dealers | Extra services on collection, accounting |

Note: 1 The rest is paid to the exporter directly after settlement.

<Figure 6-4> Process of International Factoring



### *(c) Export Credit* [84]

Export credit is an official support which is permitted in the WTO regime. Many advanced economies and developing countries provide export credit services. Export credit services provide protection against possible risks that may rise during international transactions. Sometimes, export credit is provided as direct financing. In international bidding for large projects, financing becomes more important than just the bidding price for the project. Therefore, whether an export credit is available or not for the project, which is sometimes called cover availability, can be a decisive factor in winning the bid.

In Korea, all export credit instruments are available. They include direct financing, guarantees, and interest rate support (IRS)[85] by the Korea Eximbank, and export insurance by the KEIC. Details of export credits will be discussed later.

## 3-3. Policy Recommendations

### *(a) WTO Disciplines and Subsidies*

Vietnam currently does not have significant export promotion financial policies except for the DAF's export subsidy program. Even this program must be phased out once Vietnam joins the WTO. When introducing new export promotion policies, Vietnam must take into consideration the WTO principles, especially the Agreement on Subsidies and Countervailing Measures (ASCM). According to Article 1 of the ASCM, a subsidy is deemed to exist if i) a financial contribution is provided ii) by a government or any public body, and iii) a benefit is conferred to the recipients. However, even if a subsidy is proved to exist, unless the measures are limited to certain enterprises or industries ("specificity"), countervailing measures cannot be taken against the subsidy[86].

In the WTO framework, there are three types of subsidies: i) prohibited subsidies, ii) actionable subsidies, and iii) non-actionable subsidies. Twelve examples of prohibited subsidies are listed and illustrated in Annex I of the Agreement (Box 2.3.1 Annex I: Illustrative List of Export Subsidies). For the first two types of subsidies, countries determining that their

84) Details of export credit are going to be discussed later in section III: Establishment of the Export-Import Bank of Vietnam.

85) A system of periodical mutual settlements between ECA and commercial banks extending export credits under a special agreement covering a credit contract between them. Under the agreement, such banks are eligible for subsidies on fixed interest on export credits from the state budget, via the ECA.

86) The ACCS of the BOK is not limited to certain enterprises or industries, so it does not bear the specificity characteristic stipulated in the ASCM. Therefore, although it is a subsidy program, countervailing measures cannot be taken against it.

industries or companies are disadvantaged in competition can take countervailing measures. Therefore, future export promotion measures must be designed so they would not invoke unnecessary trade disputes.

In this regard, today's various government subsidy programs for export promotion are contingent on export performance and, accordingly, inconsistent with the WTO principles. As a result, revisions and repeals of the programs need to follow once Vietnam joins the WTO. As a preliminary step, such subsidy programs must be reduced gradually so that the Vietnamese export industry can eventually strengthen and adapt themselves to a new export environment without being subsidized by the government.

### Box 2.3.1 ANNEX I: IILLUSTRATIVE LIST OF EXPORT SUBSIDIES

(a) The provision by governments of direct subsidies to a firm or an industry contingent upon export performance.

(b) Currency retention schemes or any similar practices which involve a bonus on exports.

(c) Internal transport and freight charges on export shipments, provided or mandated by governments, on terms more favourable than for domestic shipments.

(d) The provision by governments or their agencies either directly or indirectly through governmentmandated schemes, of imported or domestic products or services for use in the production of exported goods, on terms or conditions more favourable than for provision of like or directly competitive products or services for use in the production of goods for domestic consumption, if (in the case of products) such terms or conditions are more favourable than those commercially available on world markets to their exporters.

(e) The full or partial exemption remission, or deferral specifically related to exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises.

(f) The allowance of special deductions directly related to exports or export performance, over and above those granted in respect to production for domestic consumption, in the calculation of the base on which direct taxes are charged.

(g) The exemption or remission, in respect of the production and distribution of exported products, of indirect taxes in excess of those levied in respect of the production and distribution of like products when sold for domestic consumption.

(h) The exemption, remission or deferral of priorstage cumulative indirect taxes on goods or services used in the production of exported products in excess of the exemption, remission or deferral of like priorstage cumulative indirect taxes on goods or services used in the production of like products when sold for domestic consumption; provided, however, that priorstage cumulative indirect taxes may be exempted, remitted or deferred on exported products even when not exempted, remitted or deferred on like products when sold for domestic consumption, if the priorstage cumulative indirect taxes are levied on inputs that are consumed in the production of the exported product (making normal allowance for waste). This item shall be interpreted in accordance with the guidelines on consumption of inputs in the production process contained in AnnexII.

(i) The remission or drawback of import charges in excess of those levied on imported inputs that are consumed in the production of the exported product (making normal allowance for waste); provided, however, that in particular cases a firm may use a quantity of home market inputs equal to, and having the same quality and characteristics as, the imported inputs as a substitute for them in order to benefit from this provision if the import and the corresponding export operations both occur within a reasonable time period, not to exceed two years. This item shall be interpreted in accordance with the guidelines on consumption of inputs in the production process contained in Annex II and the guidelines in the determination of substitution drawback systems as export subsidies contained in AnnexIII.

(j) The provision by governments (or special institutions controlled by governments) of export credit guarantee or insurance programmes, of insurance or guarantee programmes against increases in the cost of exported products or of exchange risk programmes, at premium rates which are inadequate to cover the longterm operating costs and losses of the programmes.

(k) The grant by governments (or special institutions controlled by and/or acting under the authority of governments) of export credits at rates below those which they actually have to pay for the funds so employed (or would have to pay if they borrowed on international capital markets in order to obtain funds of the same maturity and other credit terms and denominated in the same currency as the export credit), or the payment by them of all or part of the costs incurred by exporters or financial institutions in obtaining credits, in so far as they are used to secure a material advantage in the field of export credit terms.

Provided, however, that if a Member is a party to an international undertaking on official export credits to which at least twelve original Members to this Agreement are parties as of 1 January 1979 (or a successor undertaking which has been adopted by those original Members), or if in practice a Member applies the interest rates provisions of the relevant undertaking, an export credit practice which is in conformity with those provisions shall not be considered an export subsidy prohibited by this Agreement.

(l) Any other charge on the public account constituting an export subsidy in the sense of Article XVI of GATT 1994.

### *(b) Trade Financing*

At this moment, Vietnam does not have a proper government-supported trade financing scheme which is consistent with the WTO principles. Letter of Credit (L/C) procedures and negotiation of L/C are used for export transactions in Vietnam. However, unlike Korea, most financial support for exporters is provided through a special relationship between SOCBs and SOEs. Therefore, export financing for private enterprises are very limited.

For general financial support to exporters, the government can help commercial banks to refinance their export-related financing. The BOK's ACCS can be a model for a comprehensive refinancing scheme for Vietnamese commercial banks. Also, a financial facility like the rediscounting program by the Korea Eximbank can provide a new source of funds for commercial banks to expand their trade financing business. Furthermore, as the use of L/C procedures decreases globally, other compensatory measures must be introduced to secure transactions, including export insurance, factoring and forfaiting.

### *(c) Export Credit*

Export credit is needed for insurance/guarantees for commercial and political risks, especially those concerning mid and long-term transactions. In Vietnam, the current stage of development would not require much medium and long-term export credit, because most exports are based on short-term transactions. However, it is necessary to cover Vietnamese exporters from possible credit and political risks of trade partners. Although major importers of Vietnamese goods are from advanced economies, it does not mean that Vietnamese exporters are free from commercial risks of the buyers. For this reason, many newly industrialized economies in Asia have ECAs, whether they are called export-import banks or export insurance agencies. They provide insurance or direct financing to cover such risks.

Besides, as governmental financial institutions, ECAs carry out other various government policies, directing credit toward policy sectors. Furthermore, they usually have specialists and expertise in international financing, trade and other international transaction-related issues. As such, they serve as information hubs for researchers, exporters and policy-makers. Therefore, it is time to consider the establishment of an export credit agency or export-import bank in Vietnam.

<Table 6-6> List of Asian and Pacific ECAs

| Country | ECAs |
|---|---|
| **Australia** | EFIC - Export Finance & Insurance Corporation |
| **China** | Export-Import Bank of China<br>SINOSURE - China Export & Credit Insurance Corporation |
| **Chinese Taipei** | TEBC - Taipei Export-Import Bank of China |
| **Hong Kong** | HKEC - Hong Kong Export Credit Insurance Corporation |
| **India** | Export-Import Bank of India<br>ECGC - Export Credit Guarantee Corporation of India Limited |
| **Indonesia** | PT. Bank Ekspor Indonesia (Persero)<br>ASEI - Asuransi Ekspor Indonesia |
| **Japan** | Japanese Bank for International Cooperation<br>NEXI - Nippon Export and Investment Insurance |
| **Korea** | Korea Eximbank<br>KEIC - Korea Export Insurance Corporation |
| **Malaysia** | Export-Import Bank of Malaysia<br>MECIB - Malaysia Export Credit Insurance Berhard |
| **Philippines** | PhilEXIM, |
| **Singapore** | ECICS - ECICS Ltd |
| **Sri Lanka** | SLECIC - Sri Lanka Export Credit Insurance Corporation |
| **Thailand** | Export-Import Bank of Thailand |

# 4. Establishment of the Export-Import Bank of Vietnam

## 4-1. Introduction

### *(a) Definition of Export Credit and Export Credit Agencies*

Export credit describes a wide range of facilities and can mean different things in different contexts. It is a type of "official support" provided by or on behalf of a government for the export of goods and/or services, including financial leases. They include[87]:

- Export credit guarantees or insurance (pure cover)
- Official financing support including: direct credit/financing and refinancing; and interest rate support (IRS), or
- Any combination of the above.

It also includes credit extended during the period before goods are shipped or projects are completed (the pre-shipment period), and the period after delivery or acceptance of the goods or completion of the project (the post-shipment period).

An institution that provides all or part of these services is called an export credit agency (ECA). Such an institution is usually government-owned or controlled. However, sometimes private companies may run export credit businesses with a special agreement with their government. Still, in this case, the export credit business is separated from the commercial account and is run on a government account. A government-owned or controlled ECA is sometimes called an official ECA, distinguished from the private institution and functioning on behalf of the government, operating on a government account. A type of ECA that lends directly is called an export-import bank. Some export-import banks issue insurance and guarantees, as well as providing direct financing.

### *(b) Economic Justification for ECAs*

Most advanced economies and many developing countries have ECAs for the following reasons:

***Imperfect market and market failure***. Commercial banks are usually reluctant to support high-risk, large-scale projects. However, sometimes for the sake of national interest, it is necessary to support a project due to positive externalities. Export credit makes up for market failure, protecting against such risks by providing insurance or direct financing. Therefore,

87) See OECD (2004)

ECAs usually do not compete with, but complement the private sector[88].

***Fostering domestic industries, strengthening competition.*** Many advanced economies have ECAs, so that domestic firms can compete overseas on a level playing field for fair competition.

***Furthering economic development***. As a government institution, ECAs carry out various policies in exporting countries in a range of areas of trade, financial, and industrial policy, thereby contributing to the economic development of the country.

Besides these economic reasons, ECAs can serve as an information center, maintaining up-to-date information regarding trade and export credit, and exchanging it with similar agencies overseas. It can achieve economies of scale in information management. ECAs also serve as focal points to concentrate experts of foreign trade and international financial financing. As such, it can provide expertise for exporters and banks in various facets of export and international financing practices.

### *(c) Types of Risks Covered*

By issuing an insurance policy (insurance agency) or providing direct financing (export-import bank), ECAs mostly cover the following two types of risks.[89]

***Political risks (Sovereign risks)***

A political risk is the risk of nonpayment on an export contract or project due to action by the host government of an importer or buyer host government. Such action may include intervention to prevent the transfer of payments, cancellation of a license, or acts of war or civil war. In recent decades, the most common political risk claims were due to the inability to convert and transfer foreign exchange.

***Commercial risks***

A commercial risk is the risk of nonpayment by a private buyer or commercial bank or a public buyer due to default, insolvency or bankruptcy, or failure or unwillingness to take delivery of the goods (i.e. repudiation). Usually excluded are cases where disputes arise between exporters and importers concerning product quality, delivery dates, performance, and so on. Claims will generally not be considered until these disputes are resolved.

### *(d) International Discipline*

Two major international agreements govern the operation of ECAs. They are the OECD

88) ECAs are also known to have comparative advantages in negotiations of foreign state debt because of their political leverage with the borrowers.

89) See Malcom Stephens (1999).

Arrangement on Officially Supported Export Credits (Arrangement) and the WTO Agreement on Subsidies and Countervailing Measures (ASCM). The Arrangement covers the terms and conditions of export credits with repayment terms of more than 2 years, and restrictions in the use of tied-aid. The Arrangement is not a legally binding agreement, but the participants in the Arrangement regularly meet and discuss export credit-related issues to establish a level playing field for fair competition in international trade. Export credit stipulated in the Arrangement has many aspects of export promotion subsidies. However, the WTO allows the use of subsidies that are accepted in international fora. Therefore, export credit is considered as a subsidy that is acceptable under the WTO regime.[90)]

## 4-2. Functions of the Export-Import Bank

### *(a) ECA Models*

There is no such thing as a typical export credit agency. They all come in different shapes and sizes. For example, as mentioned in the previous section, some are government departments, or public corporations, or private companies retaining links with their government for at least part of their businesses. Some do only short-term businesses, and some do only medium and long-term businesses, and others do both. Some only insure or issues guarantees, some lend, and others do both. Some are called insurers and others export-import banks. Therefore, it will be best to define an ECA in terms of the functions of the institution rather than its status or type.

Just as there is no typical ECA, neither is there any single perfect model for an ECA. It is also very dangerous to simply try to transplant one model from a country to a very different another.

<Table 6-7> ECA Models

| | Integrated Type | | Separated Type |
|---|---|---|---|
| US | US EXIM: loans, insurance, guarantees | Korea | KEXIM : loans, guarantees<br>KEIC: insurance |
| Canada | EDC: loans, insurance, guarantees | Japan | JBIC: loans, guarantees<br>NEXI: insurance |
| UK | ECGD: IRS, insurance, guarantees | France | Natexis: loans, guarantees, IRS<br>COFACE: insurance |
| Australia | EFIC: loans, insurance, guarantees | Germany | KfW: loans, guarantees<br>HERMES: insurance, guarantees |
| Taiwan | EIBT: loans, insurance, guarantees | China | EIBC: loans, guarantees<br>SINOSURE: insurance |

90) See WTO (1994)

The status and facilities of an export credit agency need to take into consideration the country's situation and needs, which may well change over time.

Among the major ECAs, there two basic types of ECAs: one provides both finance and insurance services, and the other provides those two services in separate entities.

### *(b) Pros and Cons of the Two Types of ECAs*

Even though the decision on which type of ECA to choose largely depends on the economic situation and needs of the country, as well as the development of commercial banks, there are both merits and demerits of integration and separation.

*Pros of the integrated system*

- An integrated system can create a synergetic effect for credit and insurance, since it can effectively collect market information and perform due diligence.
- Efficiency can be further enhanced by utilizing facilities and staffs to perform multi-tasks, which would ultimately reduce administrative and related costs.
- Moreover, the integrated system allows a one-stop service that would provide customer convenience and reduce transaction costs that would otherwise overlap.

*Pros of the separated system*

While integrated system has some merits, it also has demerits that become, in turn, merits of the separated system.

- First, it is necessary to distinguish the features of each category: export insurance, export credit loans, and guarantees. They may all appear similar at first glance; however, there are fundamental differences.
- Primarily, an export insurance agency is more risk-taking than an export credit loan agency, since the law of large numbers applies in insurance. Insurance is a typical financial sector where the law of large numbers works. For the law to work, the number of the sample must be very large. Therefore, insurance companies make every effort to enlarge the base. On the other hand, banks usually run their operation rather conservatively. Therefore, an export insurance agency is more risk-taking than an export credit loan agency. Accordingly, conflicts of interest may arise if both risk-averse export credit loans and risk-taking export insurances are under a single management.
- Especially, for developing countries, limited capacity and experience in export credit insurance will result in losses for the insurance business. As a result, due to insurance operations, the credit rating of the integrated institution can be lowered, which would possibly incur additional funding costs.

It is very likely that the Vietnamese export insurance business will lose money due to the lack of experience and expertise in the field. Therefore, considering the pros and cons mentioned above and export credit business prospects, a separated system may be more desirable for Vietnam because an integrated export-import bank will face difficulties maintaining financial soundness, due to the export credit insurance business.

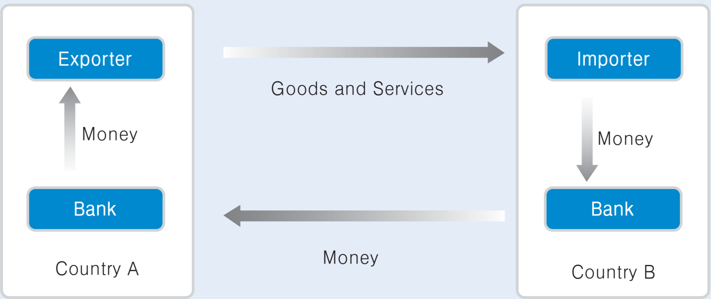
### *(c) Direct Loan or Insurance/Guarantee*

From the viewpoint of export promotion, direct export credit is more effective than insurance and guarantees. With a credit rating almost equal to that of its government, it can easily borrow in capital markets in its own name. Therefore, it has a larger autonomous financial base compared with insurance and guarantees, whose autonomous source for funding is limited to small insurance premiums and guarantee fees. As a result, an export-import bank can carry out the government policy more efficiently through the direct loan program (See Dun, Angus and Martin Knight, 1982, reprinted in Lee, Jaimin, 1996).

### *(d) Basic ECA Operations*

Most world trade is conducted based on either the payment on receipt of goods, or of payment within 180 days of receipt. Since this is a cross-boarder transaction, many unanticipated situations arise, which may result in nonpayment. Furthermore, when a project is large and ensuing repayment of the loan is long, the risk involved increases further. The primary function of ECAs is to remove or reduce such uncertainties and risks, or at least to shift them away from exporters and their banks to ECAs by issuing insurance or directly providing loans for projects that commercial banks are reluctant to support. Supplier credit and buyer credits are their two principal mechanisms.

<Figure 6-5> Trade Transaction with Payment through Banks

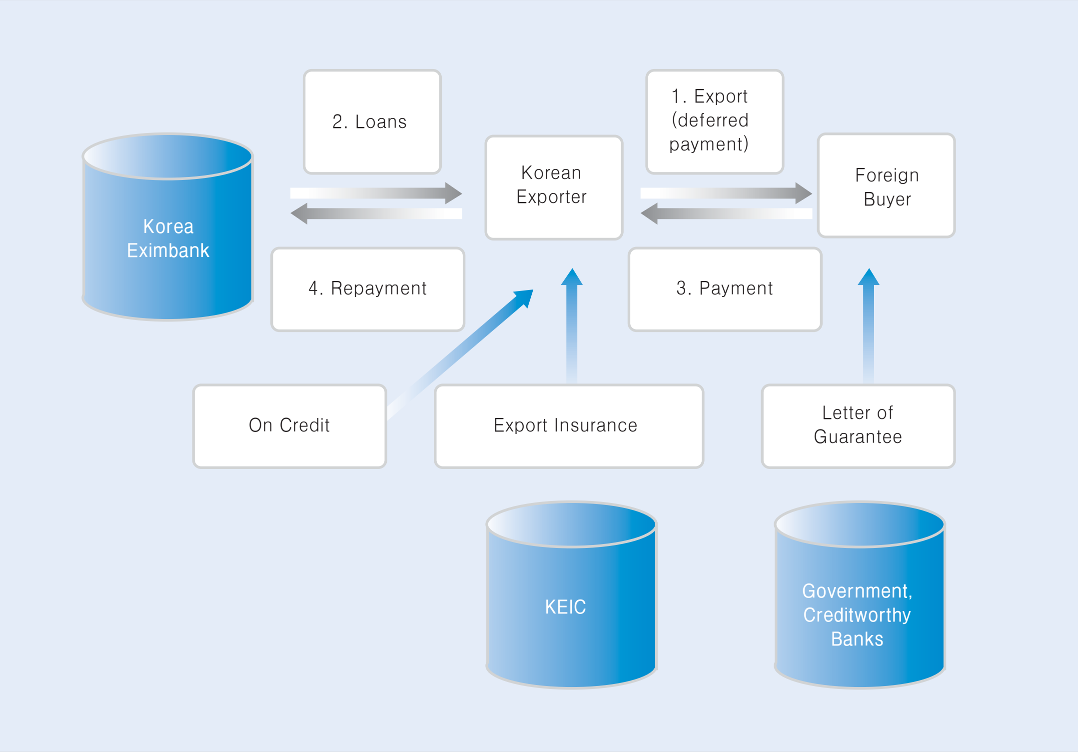



### *Supplier credit*

The exporter extends medium and long-term credits to the buyer as part of the contractual arrangement, for which the export credit agency provides cover to the exporter. ECAs either sell exporter insurance against some of the risks that the importer will not pay (supplier credit insurance: Figure 6-7) or directly provide loans for the exporter, so the exporter is paid the full amount of the contract (supplier credit: Figure 6-6). The exporter may assign the benefits under the insurance policy to its bank, as security for the bank advancing the funds (Figure 6-8).

There are several types of supplier credit. It can vary depending on the institution that provides it. At the Korea Eximbank, supplier credit (financing) is extended to the Korean exporter so the exporter can be fully paid with the amount of the contract at the time of delivery of export goods or completion of projects. In this case, the exporter becomes the borrower. After the delivery, the importer makes payments to the exporter on a deferred payment base[91]. Sometimes, the Korea Eximbank requires the exporter to be covered by an insurance policy, but with good credit, the exporter can benefit from the supplier credit on credit.

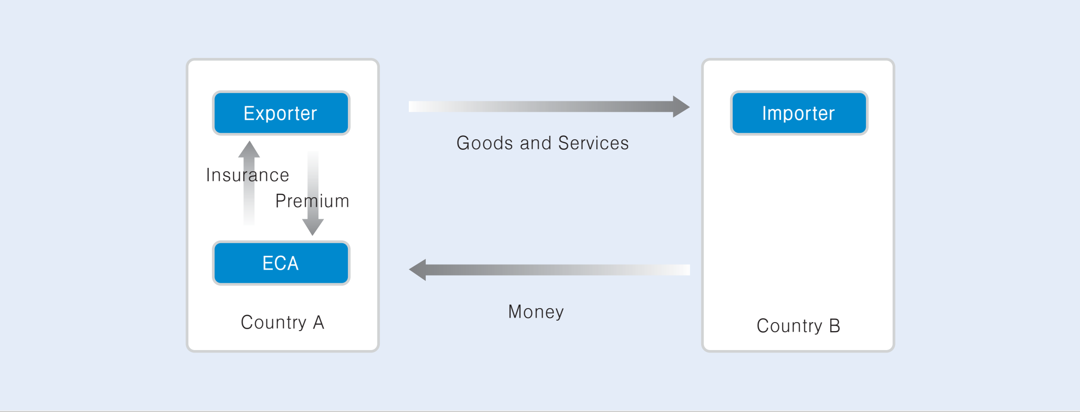
<Figure 6-6> Flow of Supplier Credit of Korea Eximbank



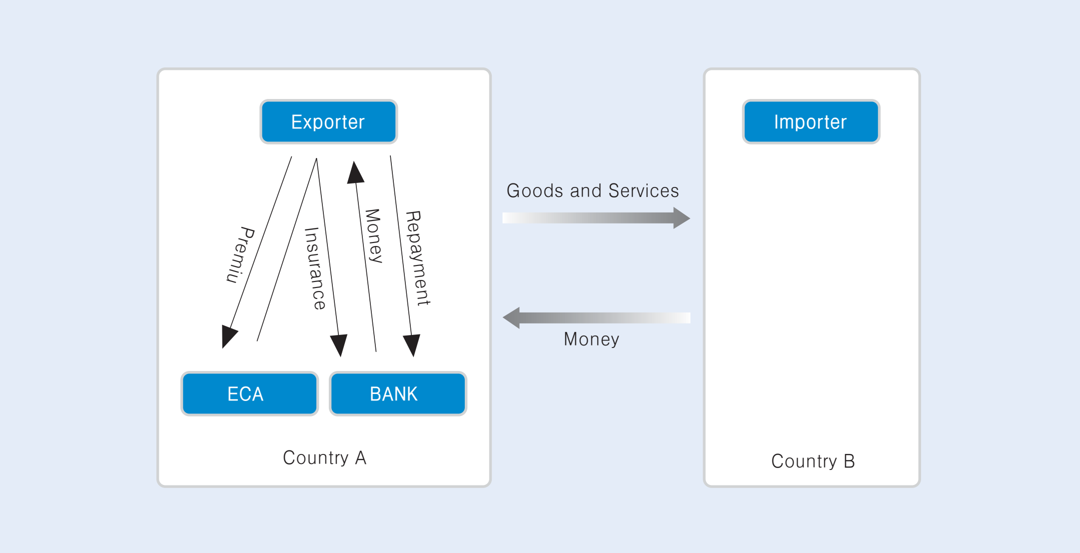

On the other hand, one of the most traditional and straightforward models of an export credit function is supplier credit insurance (Figure 6-7 and Figure 6-8). The exporter signs a contract to export goods and services to the importer. The ECA then sells the exporter insurance against some of the risk that the importer will not pay. The risks covered include both commercial risks and political risks. Figure 6-8 shows an extension of the model, where the exporter can assign the benefits under the insurance policy to a bank as collateral for the bank advancing the funds.

91) The OECD Arrangement regulates the maximum repayment term of the loan. Maximum repayment terms vary according to the classification of the destination of the projects. Normally, it ranges between 5 and 10 years. Separate sector understandings allow longer repayment periods, depending on the sectors.

<Figure 6-7> Supplier Credit Insurance




<Figure 6-8> Supplier Credit Insurance with Assignment to a Bank



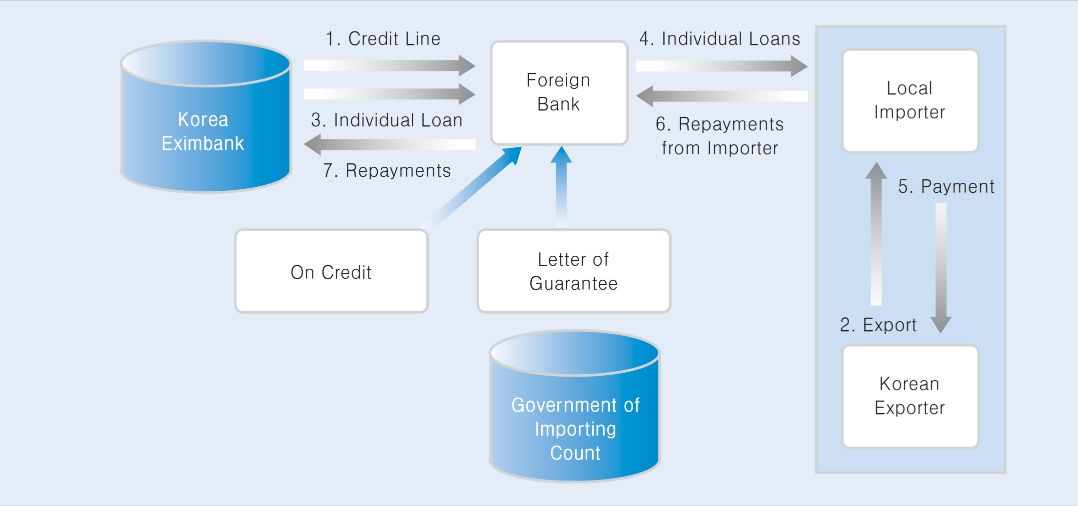

## *Buyer credit*

**There are two types of buyer credit financing.**

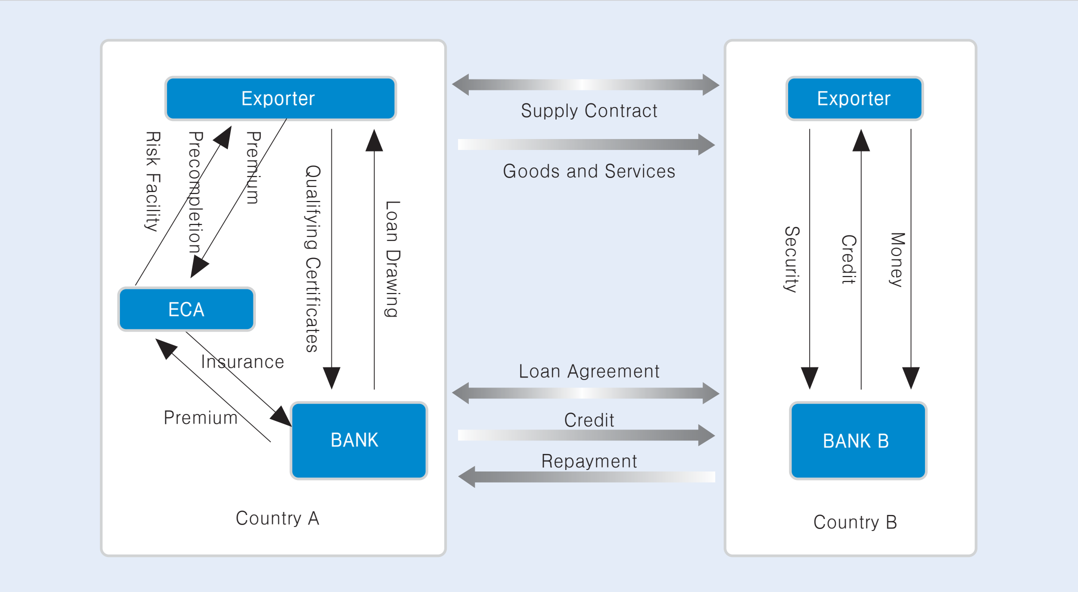
Line of Credit (On-lending): Credits used to finance transactions are contained in a loan agreement between a lending bank in the exporter's country and a bank in the buyer's country, separate from the export contract between exporter and importers. The exporter is paid by the bank in its country more or less on a cash basis, as work is done or goods are finished and shipped. The borrowing bank then repays the loan over a pre-agreed credit period after completion of the project. Then, the foreign banks can provide loans to their local importers of the goods from the line of the credit providing country. A line of credit can be set up either with respect to a single project (Project Line of Credit), or for more general purposes (General Purpose Line of Credit). The importer must arrange to repay the loan to the borrowing bank.

In this procedure, two types of ECA facilities can be provided. First, ECAs can directly serve as the lending bank (Figure 6-9), or the ECA's cover is issued to the lending bank against the risk from default by the borrowing bank (Figure 6-10).

<Figure 6-9> Line of Credit Procedure of the Korea Eximbank

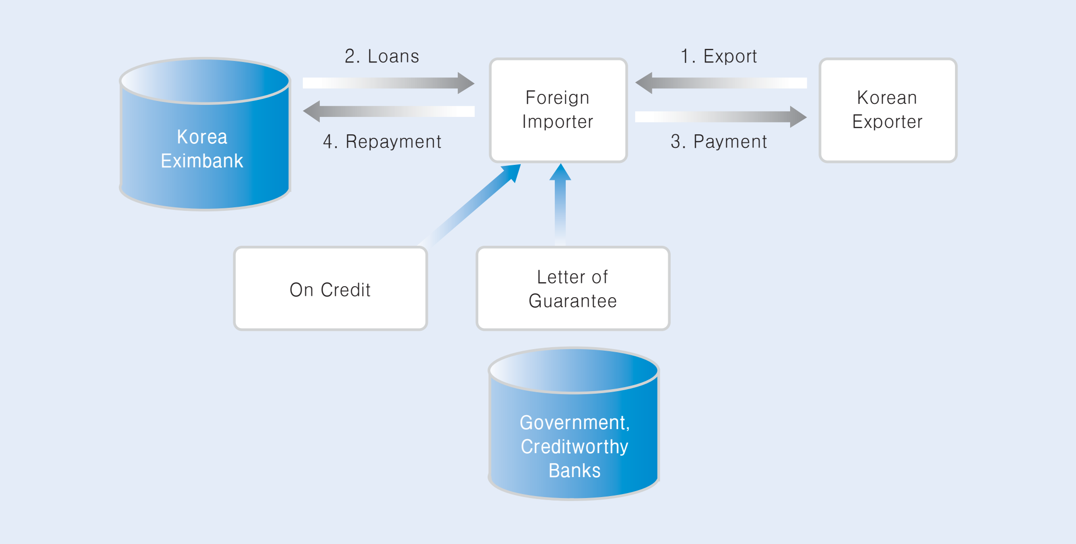



<Figure 6-10> Buyer Credit Insurance



Direct Loan: Direct Loan means that credit is directly given to a foreign importer. It is sometimes called buyer credit. Under this program, the export-import bank directly enters into loan agreements with a foreign buyer and provides them with loans that are used to pay the Korean exporters. Again, buyer credit insurance can be issued to the lending bank in the exporting country, when such direct loans are provided by commercial banks.

<Figure 6-11> Flow of the Korea Eximbank's Direct Loans




## 4-3. Financial Services of the Korea Eximbank[92)]

### *(a) Introduction to the Korea Eximbank*

The Korea Eximbank was established in 1976 as a special government financial institution. For its establishment, a special legislation, the Korea Export-Import Bank Act, was prepared in 1969. The Eximbank was established seven years after the introduction of the Act because it was expected that the volume of exports credit would be limited at the beginning. However, the seven years of preparation afterwards turned out to be very useful for the efficient operation of the Eximbank, providing sufficient experience and expertise. The Korea Eximbank began to provide export insurance facilities since 1977. However, in 1992, the export insurance operation was separated from the Korea Eximbank and the Korea Export Insurance Corporation (KEIC)

92) For details of each financial service, refer to http://www.koreaexim.go.kr

was set up, instead.

As an ECA, the Korea Eximbank's mission is to promote the sound development of the national economy and economic cooperation with foreign countries. To achieve its goals, the Eximbank started its business by providing medium and long-term credit for heavy industry exports.

As a government institution, it has responded to various government policy calls to support Korean exporters. In the early stage as an ECA before the 1990s, the Korea Eximbank's main policy objective was to improve trade balance by fostering domestic industries. During this period, the Korea Eximbank's services focused on the heavy and chemical industry exports by providing deferred payment-based supplier credit, overseas investment, and overseas resource development.

In the 1990s prior to the financial crisis, the Korea Eximbank went through a period of maturation by diversifying its services to support Korean exporters to compete in the global market. It began to provide short-term trade financing and support new industries, such as electronics. During this period, the overall business volume increased very rapidly.

After the financial crisis in the late 1990s, as a government policy institution, the Korea Eximbank made efforts to assist the recovery of the Korean economy from economic turmoil. First, it extended its business line further to provide SMEs with easy access to export finance and expanded project-related guarantee businesses. In order to help increase the liquidity for commercial banks engaged in trade finance, the Korea Eximbank introduced the rediscounting of trade bills. In addition, many efforts were made to facilitate foreign buyers' access to the Korea Eximbank's financial services, including project finance, framework agreements[93)], interest rate support and various types of line of credits. As a result, now the Korea Eximbank provides a variety of financial services, including loans and guarantees.

Most of the programs of the Korea Eximbank reflect the proper role of the institution as an ECA. While some programs may appear to be in direct competition with commercial banks, this is not the case. According to the law, operations of the Korea Eximbank are very limited, and competition with commercial banks is prohibited. Even in the fields where the Eximbank seems to be competing with commercial banks, the Eximbank fully assumes risks, eliminating uncertainties and providing easy access to export finance for exporters.

### *(b) Loans to Domestic Suppliers*

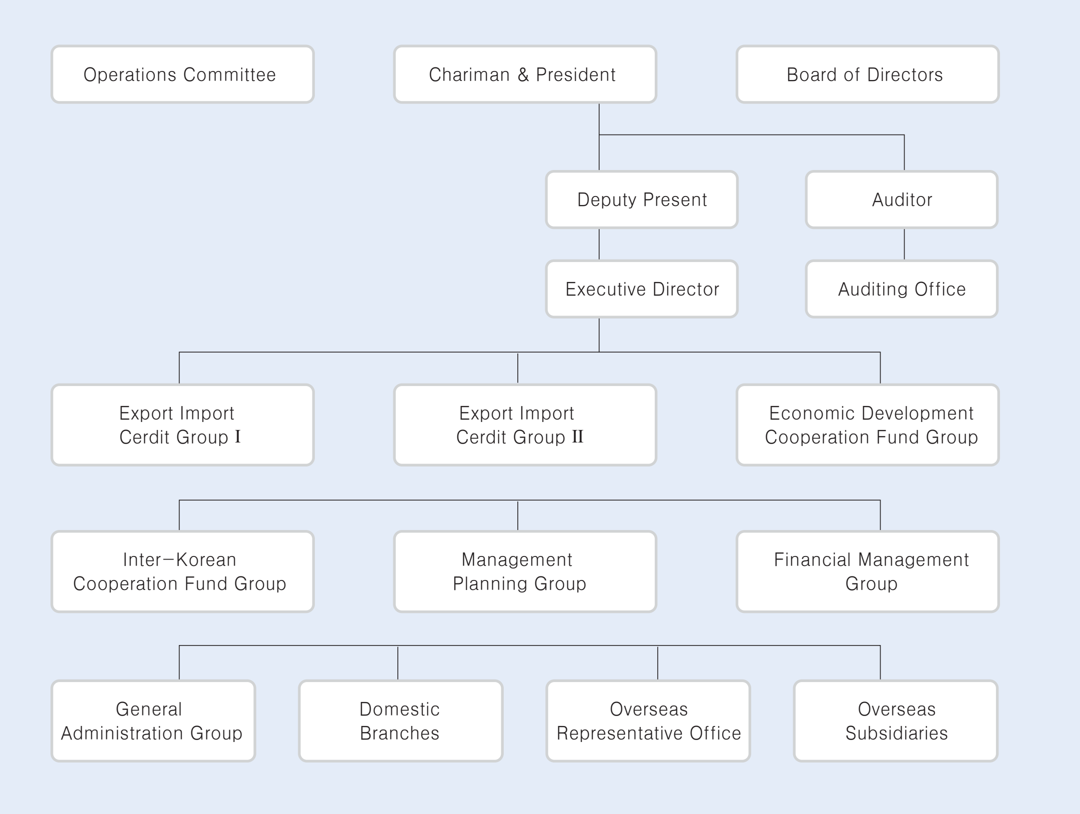
*Export loans*

Export loans are extended to Korean exporters as a supplier credit, to provide them with the

93) A co-financing agreement with other ECAs.

required funds to finance export transactions with repayment terms of two years or more. It is mainly designed to encourage the export of capital goods such as industrial plants, ships, and industrial machinery involving larger credits and longer repayment terms than what suppliers or commercial banks would provide.

<Figure 6-12> Organization Chart of the Korea Eximbank




Note: The Operations Committee is the top-level policy-making body of the Eximbank. Its members include the Chairman and President of the Eximbank, and eight representatives from the Ministry of Finance and Economy, the Ministry of Foreign Affairs and Trade, the Ministry of Commerce, Industry and Energy, the Financial Supervisory Commission, the Bank of Korea, the Korea Exchange Bank, the Korea Export Insurance Corporation, and the community of exporters.

## *Technical service credits*

Technical Service Credits are extended to Korean companies for the export of technical services abroad, including overseas construction projects with repayment terms of two years or more.

### *Short-term trade finance*

This loan is provided to Korean exporters who manufacture exporting goods under short-term export contracts (less than two years of repayment period after delivery).

### *Overseas investment credit*

This program is provided to Korean companies that invest abroad in the forms of capital subscription, acquisition of stocks, or long-term credit.

#### ***Major resources development credit***

This program is to support Korean firms in exploring natural resources and acquire mining rights abroad. It contributes to the stablization of the domestic supply of natural resources, as well as the strengthening of economic ties with countries exporting natural resources.

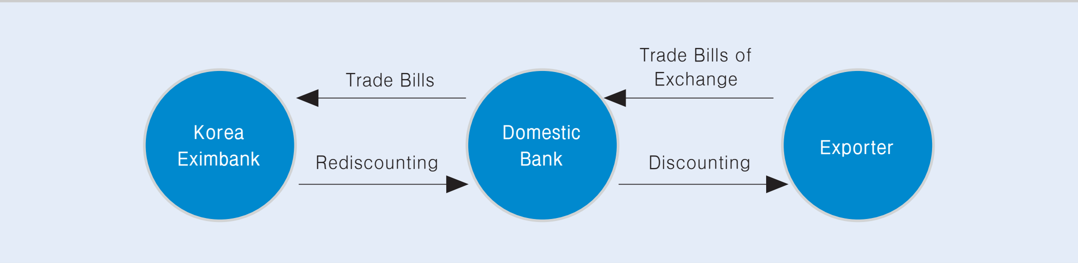
#### ***Import credit***

This credit was initially designed for the importation of essential material and major resources, of which stable and timely supply is critical to the national economy. However, this program can be used for the importation of industrial plants and high-tech products, including large commercial aircrafts.

#### ***Rediscount on trade bills***

This facility is a trade financing program in the form of rediscounting for domestic commercial banks. The commercial banks purchase trade bills issued by exporters based on usance L/C or D/A export contracts. Based on the trade bills of exchange that have been purchased (discounted), the commercial banks issue their own trade bills for rediscounting purposes, and the commercial bank-issued trade bills are rediscounted by the Korea Eximbank. This facility provides commercial banks with foreign currency for discounting the trade bills of exchange.

<Figure 6-13> Rediscount on Trade Bills



#### *Forfaiting*

At the Korea Eximbank, forfaiting is designed to help Korean exporting companies, whose bills of exchange regarding exports to developing countries are not readily accepted by Korean domestic commercial banks, due to the high credit risks involved in the transactions. The Korea Eximbank negotiates these bills of exchange issued under usance documentary Letters of Credit on a ‘without recourse’ basis, and without additional collateral.

#### *Factoring*

At Korea Eximbank, factoring is very similar to forfaiting, but differs in that factoring is used in cases of Open Account trade transaction. In this case, the Korea Eximbank purchases the claim of the exporting companies without recourse, and assumes the risk of nonpayment of the importers.

#### *Small business export credit*

This credit is provided to SMEs that manufacture exporting goods or supply materials needed by their primary exporters based on their past export performance.

### *(c) Loans to Foreign Buyers*

*Direct loans*

Direct Loans are export credit services that help foreign buyers purchase Korean goods and services with repayment terms of two years or more. Under this program, the Bank directly enters into loan agreements with foreign buyers and provides them with loans that are used to pay the Korean exporters when the shipping schedule is fixed.

*Project finance & structured financing*

These financial facilities are available to a foreign project company that intends to import plants, facilities and technical services from Korea for greenfield projects. The repayment of this financing depends on the project cash flows with limited recourse to the sponsors. Therefore, this form of financing does not require the typical export finance security package.

### *(d) Guarantees*

*Financial guarantees*

The Korea Eximbank’s financial guarantees provide repayment protection for the loans of co-financing bank to transactions that satisfy the Bank’s eligibility requirements. The Bank guarantees that, in the event of default, it will repay all of the principal and interest on the loan.

*Project-related guarantees*

The Korea Eximbank provides a foreign importer with a 100% guarantee that a Korean exporter will perform as contracted. Project-related guarantees include: Bid Bonds, Advance Payment Bonds, Performance Bonds, Retention Bonds, and Warranty Bonds.

### *(e) Interest Rate Support*

The Korea Eximbank provides interest rate support to domestic or foreign financial institutions that co-finance export credit with the Korea Eximbank at CIRR in accordance with the OECD Arrangement.

## 4-4. Financial Services of EXIM Thailand [94)]

The main function of the Korea Eximbank has always been to support Korean exporters of heavy and chemical industrial products. Today, these industries are the main engine for sustained economic growth and exports. However, Vietnam's economic and trade structures are very different from those of Korea. Therefore, it would not be wise to blindly copy the Korean model of ECA for Vietnam. In this sense, it is worthwhile to look into the ECA system of a neighboring country.

EXIM Thailand was established in 1993. Even though its history is relatively short, it provides all lines of export credit, including loans, guarantees, and insurance, within a single institution. It is noteworthy that EXIM Thailand offers a variety of working capital loans for the exporters besides term loans and insurance/guarantees. It also offers various small-scale credits that are very suitable for SMEs. In short, EXIM Thailand makes efforts to provide easy access to export finance.

### *(a) Working Capital Loans*

#### ***Pre-shipment financing***

A revolving line of credit in baht, US dollar, or yen is directly provided to exporters of all kinds of products to meet their pre-shipment financial needs. The US dollar and yen-denominated financing is aimed to lessen financial costs of exporters and to reduce foreign exchange risks since exporters can use the US dollar or yen proceeds to pay back the credit.

#### ***Pre-shipment financing for SMEs***

A revolving line of credit provided in baht to exporting SMEs to meet their pre and post-

94) These are excerpts from EXIM Thailand's website. For details of each financial service, see http://www.exim.go.th

shipment financial needs, with an interest rate lower than that of the baht-denominated Pre-Shipment Financing.

#### *Express export credit*

A revolving line of credit for pre-shipment financing is provided to small-scale and new exporters. A credit line of up to 2 million baht is available for each exporter with personal guarantees by company directors.

Exporter supplier's finance

A revolving line of credit is extended to exporter's suppliers to meet their pre-shipment and post-shipment financial needs.

#### *Packing credit plus*

This is a combination of a revolving credit line and export credit insurance to help enhance the confidence and competitiveness of Thai exporters, especially SMEs in their global market expansion. Under this facility, export credit insurance covers the risk of non-payment by overseas customers subject to the terms and conditions of EXIM Thailand.

#### *Financing facilities for re-export*

This facility aims to support the import of merchandise from suppliers in one country to re-export to buyers in another country, thereby enhancing Thailand's potential to become a regional trade center. Under this facility, EXIM Thailand opens L/C to support the purchase of merchandise from suppliers' countries to re-export to buyers' countries. This short-term credit facility has a repayment period corresponding to that of export payment.

#### *Negotiation of export bills*

This is a facility to provide post-shipment finance to exporters through export bills negotiation. This facility helps exporters to obtain funds to be used as working capital before the due date of export bills, and also covers exports to emerging markets.

### *(b) Term Loans*

#### *Term loans for business expansion*

This loan supports the expansion of the production capacity of exporters, such as factory expansion, purchase of additional machinery, investment in other fixed assets or new domestic manufacturing plants. Businesses eligible for support are export-oriented manufacturing businesses, those earning foreign currencies, or import substitution enterprises.

Long-term credit for the export of capital goods

This is a long-term credit aimed at enhancing the competitive edge of Thai exporters of new or used capital goods.

***Merchant marine financing***

This is a long-term credit facility extended to merchant marine businesses to finance the purchase of old or new ships. The objective is to promote the utilization of services offered by ships registered in Thailand while lessening dependence on foreign vessels, thereby, reducing the country's current account deficit.

***Trade fair financing***

This is a short to medium- term credit facility provided for the participation of SME exporters in trade fairs, for the purpose of creating business opportunities and expanding their customer base. A credit line of 0.5-1 million baht per trade fair with an annual prime rate of 1% is available.

### *(c) Financing for Overseas Projects*

***Financing facilities for overseas construction contracts.***

This is a facility to support various kinds of overseas contracts such as building renovation, machinery maintenance and technical consultancy.

***Financing facilities for overseas investment.***

This is a long-term credit to support Thai investors' overseas investment projects.

***Financing facility for Thai restaurants overseas..***

This facility is to support Thai investors who intend to open Thai restaurants in foreign countries.

### *(d) Short-term Export Credit Insurance*

#### *Short-term export credit insurance*

This is suitable for exporters with payment terms not exceeding 180 days. Exports to all buyers under D/P, D/A and/or O/A terms can be insured. In the case of L/C, the exporter can select the bank of their own choice.

### *Small export bill insurance*

This is offered to SME exporters possessing export bills under payment terms ranging from D/P sight to D/A 90 days after shipment, worth up to 1.2 million baht per buyer, and with the outstanding amount of the insured bills issued to all buyers not exceeding 2.5 million baht. To speed up the approval process, the Bank also excludes the verification of the buyers' creditworthiness for exports to existing buyers.

## *(e) Medium and Long-Term Insurance*

Medium and Long-term Insurance covers commercial and political losses relating to overseas trade transactions, i.e. export of goods and services including credits and loans to overseas buyers/borrowers, with credit terms exceeding 180 days. The insurance can cover losses occurred in both the pre-credit (pre-delivery period) and post-delivery (credit period) stages. This insurance was introduced in 2003.

<Table 6-8> Business Volume of Domestic Facilities of EXIM Thailand in 2004 (Unit: million Baht)

| | Working Capital Loan | | | Term Loan for Business Expansion | | |
|---|---|---|---|---|---|---|
| | 2004 | 2003 | Change(%) | 2004 | 2003 | Change(%) |
| New approvals | 12,374 | 11,956 | 3.5 | 4,362 | 3,925 | 11.1 |
| Credit | 11,645 | 11,258 | 3.4 | 4,362 | 3,925 | 11.1 |
| Guarantees | 729 | 698 | 4.4 | - | - | - |
| Approvals (year-end) | 59,002 | 50,624 | 16.5 | 10,431 | 7,812 | 33.5 |
| - Credit | 56,661 | 48,719 | 16.3 | 10,431 | 7,812 | 33.5 |
| - Guarantees | 2,341 | 1,905 | 22.9 | - | - | - |
| Outstanding credit facilities(year-end) | 24,588 | 22,538 | 9.1 | 7,684 | 6,027 | 27.5 |
| Guarantee obligations (year-end) | 2,595 | 1,019 | 154.7 | | | |

US$ = 41.0551 THB

## 4-5. Tentative Suggestions for the Vietnamese Export-Import Bank

Although Vietnam's financial institutions and foreign banks provide some trade-related financial services, they do not cover risks as ECAs do and the services are limited, mainly to SOEs. DAF provides a short-term export subsidy program, but it is not consistent with WTO regulations. Considering the export structure of Vietnam, it is too early for Vietnam to have an export-import bank like the Korea Eximbank, whose main function is to support exports of capital goods with deferred medium and long-term loan and project guarantees. However, as there are many good reasons to establish an export-import bank, it is time to consider one for Vietnam that specializes in trade-related finance.

### *(a) Types of Organization*

First, the Vietnamese government must consider which export credit and trade-related facilities the new Vietnamese export-import bank are about to provide. In providing the export credit and other trade financing facilities, we must consider the choice between the integrated model and the separated model.

We have discussed the pros and cons pf both the integrated and separated models. For Vietnam, a model that separates financing and insurance will be desirable, as previously explained. The separate model is workable, because both banking and insurance are under the single supervision of the Ministry of Finance, which makes facilitates the coordination of various export support measures in two separate institutions. With separate ECAs, both institutions can specialize in their respective fields.

Second, we must consider whether or not to establish a new institution for export credit businesses. Most of the export-import banks are independent institutions under government supervision. In addition, we have discussed several good reasons for having an export-import bank. Therefore, it is also desirable that Vietnam establishes an independent export-import bank. However, in the case of the Korea Eximbank, an existing banking institution, the Korea Exchange Bank, ran export credit businesses in the early days of its operation. Vietnam may do the same at the beginning. Administration of export credits and other trade financing facilities can be entrusted to existing financial institutions such as DAF, which already provides export-promotion financial services.

Also, at the beginning, it may be more desirable to entrust the export credit insurance business to existing government insurance companies, such as Bao Viet, before the export insurance business becomes full-fledged. By doing so, the export insurance business can benefit from the expertise and specialization of the existing insurance companies without making costly mistakes.

### *(b) Suggestions for Financial Services*

First, as a lender/insurer of last resort, the Vietnamese Eximbank must provide basic export credit services, including export insurance and/or guarantees. However, many export-import banks usually provide not only genuine export credit, but also many trade-related financial services that fulfill various government policy objectives. Therefore, the basic financial services may include the following:

#### *Export Insurance and Guarantees*

Vietnamese exporters need export insurance services covering basic commercial and political risks. However, as was mentioned earlier, it is better for Vietnam to separate export insurance from direct financing operations. Since this export insurance business is new to the Vietnamese financial sector, it may be desirable to entrust the export insurance business to a government-owned insurance company, such as Bao Viet, for daily administration. However, the export insurance operation must be separated from the commercial operation on the government account.

Vietnamese exporters also need project guarantees from the Vietnamese government to stimulate their exports. Currently, the demands for government guarantees are low because Vietnamese industry lacks competitiveness in overseas projects. However, Vietnamese exporters must find overseas projects to expand the export market, especially in labor-intensive projects in the services and construction sectors. A strong government guarantee support can give Vietnamese exporters a big boost in global competition.

#### *Medium and Long-term Export Financing*

Considering the Vietnamese trade structure, it may be too early for Vietnam to have a medium and long-term credit program on deferred payment base. Currently, Vietnam does not export plants and machineries, which require such a type of credit. However, for future use, a medium and long-term export financing program can be established. For the time being, it is desirable that the Vietnamese export-import bank concentrates on trade and SME financing as a policy institution.

#### *Short-term Trade Financing*

As discussed earlier, in Vietnam, most of the credit is given to SOEs and major joint ventures by SOCBs through their special relationship. As a result, private firms have difficulties finding appropriate sources for financing, and the situation is worse for SMEs. As a policy institution and a trade-oriented special bank, the Vietnamese export-import bank can address this issue by providing private exporters with direct working capital loans or guarantees so that they can gain access to other commercial banks.

### *Rediscounting of Trade Bills*

The Vietnamese export-import bank can provide the rediscounting service of trade bills, as does the Korea Eximbank. By doing so, Vietnamese commercial banks can have a new financial resource to depend on for the provision of trade financing, and it will expand the trade financing business of commercial banks.

### *SME Working Capital Loan*

As a government institution, the Vietnamese export-import bank must serve various policy goals for economic development. It can play an important role for SME exporters who face difficulties regarding export financing. It can provide specially designed financial services for SMEs, including working capital loans and negotiation of various receivables, such as L/C.

### *Other Services*

As a relative newcomer to the global market, Vietnam needs to actively make itself known to promote exports. Vietnamese exporters must regularly participate in various trade fairs and exhibitions. Like EXIM Thailand, the Vietnamese export-import bank can support such activities.

Also, as a trade-related financial center, Vietnamese export-import bank must build strong research group on international trade, investment and finance. Furthermore, in order to evaluate country risk properly, Vietnamese export-import bank must have a research department on the subject. The exporters will also benefit from the knowledge gained through the research activities.

## *(c) Organization of the Export-Import Bank*

The export-import bank must first consider the efficiency and qualifications of the staff when structuring the institution.

### *Board of directors*

The Board of Directors establishes basic policy guidelines pertaining to business operations and management of the bank. It will be composed of representatives from the government, the State Bank of Vietnam, and trade-related associations. The government can reflect its policy objectives through the board.

### *Managing/executive board*

The Managing/Executive Board is a decision-making body within the bank. The members of the Board include the President, the Deputy President, and Executive Directors. It decides and resolves important matters pertaining to the daily business of the bank.

### *General affairs department*

The General Affairs Department will be in charge of routine planning, human resource development and personnel affairs, logistics and other usual functions.

### *Export insurance department*

This is a proper ECA function, but this operation can be entrusted to an existing insurance company.

### *Export finance department*

This must be the major function of the Vietnamese export-import bank that provides new financial sources for exporters. This department provides medium- and long-term credit as well as short-term trade financing including rediscount of trade bills of exchange.

### *Country studies department*

In order to fully evaluate country risks and research partner countries, comprehensive research efforts by specialists are required. The outcome from this department will have a spill-over effect on the exporting community. The department can serve as the information center for international trade and country studies.

### *Risk management department*

The increased complexity of the international financial market demands rigorous risk management at a financial institution against various risks. Therefore, a separate risk management department is necessary to maintain the overall soundness of assets and liabilities.

### *Treasury and international financing department*

The majority of the necessary financing will come from the government. However, as the institution matures, it is necessary to finance abroad. In the future, the International Financing Department will become the center for experts in international financing, which will grow at a faster pace as the Vietnamese economy keeps growing and becomes globalized.

### *Legal department*

As a trade and international financing institution, the export-import bank will deal with many international contracts. Therefore, it is necessary to gather a group of experts in international private laws.

***Auditor***

An independent Auditor will examine the operation and accounting of the export-import bank.

### *(d) Source of Financing*

As a special government bank, capital subscription from the government must be the main source of financing for the export-import bank, especially in the early stages of its operation. By using government funds, the export-import bank can enjoy a cost advantage in financing and will be able to provide stable and consistent export credit operation. Additionally it can borrow from the government account. Korea Eximbank sometimes borrows from the National Investment Fund which the Korean government established in the Bank of Korea.

As the institution matures, borrowing from home and abroad will increase. This will in turn contribute to the development of Vietnamese expertise in international financing and the domestic bond market, depending on the situation.

### *(e) Risk Management*

Today's financial markets are full of uncertainty when it comes to interest rates, foreign exchange rate changes and default risks. Individual financial institutions are subject to the risk of maturity mismatches between loans and debts. Risk management is one of the weak aspects of the Vietnamese financial sector. Of course, professional appraisal of projects must be the basis for the sound management of a banking institution. However, on top of this, overall evaluation of various risks and appropriate allocation of such risks is very important for the soundness of operations.

As government-supported institutions, most ECAs are under political pressure to maintain financial soundness. In this circumstance, a separate risk management department is needed to take care of various risks. The risks to be managed include credit risks, market risks, liquidity risks, and others.

- Credit Risks: default risks and country risks
- Market Risks: interest rate risks and foreign exchange risks, as well as risks due to changes in commmodity prices in the market.
- Liquidity Risks: financing failure by the bank arising from the inability to fund increases in assets and meet obligations as they come due
- Other Risks: including operation risks, which can be caused by the misbehavior of bank personnel or operational failures, strategic risks due to bad decisions by the bank, and reputation risks due to bad reputation of the bank

For efficient risk management, it is necessary for the institution to have a good "risk culture" and a well-designed risk management system. The management must fully understand the importance of risk management and have strong will to practice risk management. Such strong intentions must spread to all corners of the institution, and become part of its culture.

In order to have efficient risk management systems and procedures, first of all, the risk management function must be separated and become independent from other business. Businesses in the front, middle and back offices must be separated and each office must have independence in making business decisions. The front office deals with daily financing businesses with due caution on risk management. The middle office specializes in overall risk management of the bank. The back office evaluates risk management activities. If each office does not have such independence, conflict of interests among various offices may hamper efficient risk management.

Second, risk management policy and procedures must be specified. They include the level of risk tolerance and documentation of limits of authority and responsibility of each office. A dynamic risk management system that identifies, measures, monitors and controls the risk must be built.

Third, an efficient infrastructure for risk management is necessary. It includes an efficient computer system and a reliable database. Also, the bank must have well-trained specialists in risk management who understand various risk management models and tools.

Fourth, a reasonable "limit management system[95]" for the working level must be established. Using this system, a limit of risk will be assigned to each working level. This is important because the first step of risk management is practiced at the working level. With reasonable risk limits set for the working level, each staff can work up to the limit within his own discretion. Also, it becomes easy to confirm and compare the risk level. For efficient risk management, it is necessary to quantify and integrate various risks.

(f) Training

As discussed before, the Vietnamese export-import bank can serve as the information center for foreign trade and international financing. As such, the export-import bank must invest on training to improve the quality of the staff and hire specialists in necessary fields. Furthermore, it must reach out to build an information network with other institutes and foreign ECAs. Active participation in international workshops/conferences and exchanges with foreign ECAs for on-the-job-training and information exchange is one way to increase contact with foreign ECAs.

Another issue is acquiring expertise in international business transactions. ECAs by their nature conclude various international contracts, which require a firm understanding of international legal systems. Therefore, the new export-import bank would need not only skilled financiers but also experienced international lawyers. It may be necessary to send staff abroad to study law.

95) A risk tolerance level is assigned to each office depending on the types of risks, sectors, and partner countries.

## 5. Conclusion

We have discussed the need for a Vietnamese export-import bank. As with other developing countries in Asia, it may be time for Vietnam to have an export-import bank of its own. It was explained that the functions and services of export-import banks are different, depending on the need and situation of each country. Financial services and important considerations that are desirable for efficient operation were suggested. Whatever shape the new Vietnamese export-import bank assumes and whatever services it may provide, a few important things must be taken into consideration.

First, it must serve as the lender/insurer of last resort. As such, it should provide basic official support by itself. It can provide direct financing, guarantees or insurance. If fund mobilization is not a problem, direct financing is very effective because it is simple and the effect is direct. It is also recommended that it start the export insurance business through a separate institution.

Second, it must provide new sources for export financing that Vietnamese exporters can tap into. Currently, the Vietnamese exporters can benefit only from limited export financing facilities. The situation is much worse for private SMEs. It is recommended that it start with providing working capital loans or guarantees and other short-term trade financing for exporting companies. It is not likely that long-term export credit will be necessary in the near future.

Third, by specializing in export finance, it must also serve as an information hub where expertise in foreign trade, trade financing, and country studies is available. As such, it must maintain up-to-date information and engage in active exchanges, both home and abroad.

In short, Vietnam needs an export-import bank that specializes in export financing as well as proper export credit. It does not necessarily have to be a separate entity from the beginning. As Korea's experience of establishing an export-import bank seven years after the introduction of the Act shows, after introduction of the appropriate law, the ECA operation can be entrusted to an existing institution such as DAF for some time. For a certain period, a new operational unit can accumulate expertise and experience in export credit as well as trade financing. Regarding export insurance, in the early stages at least, we can borrow the expertise of the insurance industry, and entrust export insurance operations to state-owned insurance companies such as Bao Viet.

Currently, the Vietnamese banking sector is dominated by a few SOCBs and is beginning the process of equitization/privatization. Over all, SOCBs are managed inefficiently and are carrying many bad loans. Such problems must be avoided for the new export-import bank. Financial soundness and high level of expertise in its operation must be maintained.

## References


Bang, Hee-Seok, Trade Business Practice, Bakyungsa, 2004 (in Korean)

Bank of Korea, Monetary Policy in Korea, 2003

Dunn, Angus and Martin Knight, Export Finance, Euromoney Publications, London, 1982

EIU, Country Commerce: Vietnam, 2005.4

EIU, Country report: Vietnam, 2005.5

EXIM Thailand, Annual Report 2004, Bangkok, 2005

General Statistics Office, Statistical Handbook, Statistical Publishing House, Hanoi, 2005

Korea Eximbank, Operational Manual, Seoul, 2005

Korea Eximbank, Annual Report 2004, Seoul, 2005

Lee, Jaimin, A Prototype Model of a Trade-Finance Facility in Developing Countries: an Export-Import Bank, Technical material prepared by the UNCTAD secretariat, United Nations Conference on Trade and Development

OECD, Arrangement on Officially Supported Export Credits, Paris, 2004

Stephens, Malcolm, The Changing Role of Export Credit Agencies, IMF, Washington, 1999

WTO, Agreement on Subsidies and Countervailing Measures, 1994