

ADB

# Making Markets Work Better for the Poor

Proceedings of the Inception Workshop  
November 2003



**PROJECT INCEPTION**  
**SUMMARY OF THE DISCUSSION**

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**Asian Development Bank**  
**Making Markets Work Better for the Poor**  
**INCEPTION EVENTS**  
**HANOI - November 17th to 20th 2003**

## 1. Background

A series of inception events were held in Hanoi to officially launch the regional technical assistance project “Making Markets Work Better for the Poor”. These events comprised two half-day technical working group meetings on the 17<sup>th</sup> and 18<sup>th</sup> of November and a main inception workshop on 20<sup>th</sup> November. A website for the project was unveiled during this occasion. The papers referred to in this summary are available on the website ([www.markets4poor.org](http://www.markets4poor.org)).

Kazu Sakai, Deputy Director General, Mekong Department opened the first of the working group sessions. Alessandro Pio of the Asian Development Bank (ADB) Viet Nam Resident Mission (VRM) and Prof. Nguyen Quang Thai, General Secretary of the Viet Nam Economics Association jointly chaired the inception workshop. (See attachment 1 for the agenda of the inception workshop and attachment 2 for a list of participants).

The introductory comments highlighted three key features. First, the project, with its emphasis on the development of “knowledge products” will strengthen ADB’s move towards becoming a “knowledge-based” organization. The project will produce knowledge outputs that can be used for planning better development interventions and shaping more effective policies for promoting growth and poverty reduction. Second, the project is focused on the key issue of achieving sustainable pro-poor growth. The overall goal of the project is to bring the opportunities presented by the power and efficiency of the market closer to the lives of the poor. In this way, the project will bring new, complementary perspectives to existing poverty reduction strategies and processes based on public programs and interventions. Finally, because of its three-country coverage, the project is part of the process of developing coherent and effective sub-regional initiatives.

## 2. Introduction to the project

Alan Johnson, the project coordinator, gave a presentation on the scope and nature of the project.

Brahm Prakash, Director, Poverty Reduction and Social Development Division, Regional and Sustainable Development Department, ADB in a discussant intervention referred to the critical role of markets in promoting growth through the lowering of coordination costs and transactions costs in the economy. These effects are especially important in a dynamic, globalising context in which technological change results in the relocation of the production of mature or “commoditised” products to lower cost locations. These relocations offered new opportunities to participate in and add to global value chains. However, markets were also segmented and modular in nature. It was important to ensure that the benefits of participation in global value chains were accessible to the poor. The poor needed to participate in markets on a more perennial basis. The state had a critical role to play in providing a sound regulatory environment, supplying relevant information, offering financial support and facilitating skills development.

Martin Rama, Lead Economist of the World Bank in Viet Nam suggested that the project needed to address three key questions: (i) Which markets are most relevant for the poor? Although factor markets and certain product markets were an obvious focus, service markets – in which the poor are consumers – should not be overlooked (ii) What kind of intervention is proposed? Will the project aim to achieve influence on public policy? Or is the focus on specific regulations – or self regulation? What is the role of the trading system? Should the state be involved in direct supply, price controls, subsidies or guarantees? (iii) Which

methodology? It may also be useful to draw in the perspectives of other stakeholders such as service providers and private companies.

Several issues were raised in the plenary discussion session that followed:

**Clarifications:** There were a number of questions about the project design and objectives. They included the definition of markets used in the project, the ways to coordinate the activities of the project with implementation of the Viet Nam Comprehensive Poverty Reduction and Growth Strategy (CPRGS) and how to deal with issues of governance and critical role of local government.

**Research activities:** Most of the comments, however, focused on the research component of the project. The suggested topics for research included: impacts on workers in the context of globalization, equitisation of State Owned Enterprises (SOEs), corporate social responsibility and trade between Viet Nam, Laos and Cambodia. It was suggested that business associations and business groups should be involved in the research as well as local and international non-Governmental organisations (NGOs). The research should look at both the rich and the poor in order to fully understand the dynamics of market-based growth and poverty reduction.

**Capacity building:** The importance of capacity building for local researchers was highlighted. One suggested approach is that international researchers would not be the report writers themselves but would provide support and guidance for local researchers. The research should be evidence-based and empirical.

### **3. International experiences**

Athar Hussain, of the London School of Economics gave a presentation on the comparative experiences of transitional countries such as the ex-planned economies of Eastern Europe, the constituent parts of the former Soviet Union, Mongolia, China and Viet Nam. The experiences have been quite divergent with both “gradualist” and “big bang” approaches being adopted. Whilst a “big bang” approach may have been forced by problems such as hyperinflation, one unexpected outcome was that general price liberalisation in the mould of the so-called “Washington consensus” has led to such large falls in GDP in the former planned economies of Eastern Europe, the former Soviet Union and Mongolia. The second unexpected outcome has been the relative failure of mass privatisation to improve the efficiency of state enterprises. A more gradualist approach seems to have been effective for enterprise re-structuring. Some of the lessons from China were also drawn out. The state must play an active role in promoting a successful transition. China has seen distinct policy phases, starting with the household responsibility system in agriculture. Next came the “government entrepreneurship” hybrid of the township and village enterprise (TVE). Now the challenge is to create an institutional environment or “rules of the game” that will foster the sustained growth of the private sector.

Albena Melin, of DFID London, spoke about the “Making Markets Work Better for the Poor” (MMW4P) initiative that is now starting in different ways in a range of other countries including: Bangladesh, Bolivia, Brazil, India, South Africa and Nigeria. The focus of the MMW4P framework is different in individual countries, partly reflecting the unique local political and economic conditions. Nevertheless, there are also similarities and therefore opportunities for cross-learning from countries which are trying to implement MMW4P activities.

Urooj Malik, Country Director, Cambodia Resident Mission reported that Cambodia is a transitional economy with its own unique history and circumstances. He, therefore, noted that many lessons from other countries are relevant, but certain lessons are not applicable to Cambodia context. He underlined that poverty is pervasive in Cambodia, especially in rural

areas. ADB has focused on assisting the government in the formulation of the second socio-economic Development Plan. The Bank supports the Cambodian government's effort to reduce poverty in three priority areas. The first priority is to support the broad-based labor-intensive economic development in populous rural areas where most of the poor live. The second priority is to assist human and social development to enhance equitable access to the benefits of economic growth. The third priority is to promote private sector participation in development, particularly for labour-intensive non-agricultural activities by addressing key institutional and infrastructure weaknesses. In addition, the Bank is also active in awareness campaign such as publicising the land law.

Jim Nugent, Country Director, Laos Resident Mission, mentioned that there are no economies of scale in Laos because of its small population that is widely distributed. In addition, Laos is a landlocked country. However, it shares borders with all five Greater Mekong Sub-region (GMS) partners and has the potential to become the "land link" or "land bridge" between the GMS countries. It is important for MMW4P interventions to leverage existing work and consider local characteristics. There are many opportunities for the project to support Laos' National Poverty Eradication Program. The research activities under MMW4P would be carried out in collaboration with ADBI who provides mentoring support to local researchers and research institutes. Another focus could be on market linked capacity building.

#### **4. Markets and the livelihoods of the poor**

Andrew Dorward of Imperial College London gave a presentation on the links between the functioning of markets and the livelihoods of the poor (<http://www.markets4poor.org/English/DorwardFinal20pager-PDF.pdf>). Markets are important for poverty reduction because poor people's livelihoods depend to varying degrees on markets for labour, food, financial services, and land. In Viet Nam, an estimated 70% of farm production is sold rather than consumed in the household – up from 50% a decade earlier. Markets are an efficient mechanism for organising the exchange, coordination & allocation of many resources, goods and services in the economy. Consequently, well functioning markets improve incentives for trade and investment and hence growth and poverty reduction. But markets may also fail.

While the state has historically played a major role in overcoming market or coordination failure and in establishing non-standard institutional arrangements to overcome market failure problems, there are significant problems with the state led approach. One example is 'premature greying' of the state where there is a tendency for corruption, lack of innovativeness, general lack of pressure to be efficient and effective. Consequently there is a need to look for alternative non-state led institutional arrangements that can provide the same benefits more efficiently and effectively. This suggests a research agenda that focuses on comparative institutional analysis, bottom up institutional innovations, and perhaps, public private partnerships and regulatory approaches.

Edwin Shanks gave presentation on grassroots consultation exercise in Central Highlands and Ho Chi Minh City to investigate potential topics for research. The main points raised in the discussion were the following:

*Types of the poor:* Who are the poor that the project should focus on? Broad-based growth in Viet Nam has been remarkably successful at reducing the overall rate of poverty incidence from 58% in 1993 to 29% in 2002. However, poverty incidence is higher (35%) in rural areas – and higher still amongst specific population groups such as ethnic minorities (70%). While food poverty has been almost eliminated in urban areas, it still affects more than forty percent of the population among ethnic minorities, and has shown almost no decline over the last four years. Should the focus be on geographical areas with a greater *incidence and depth of poverty* e.g. Central Highlands (52% poverty incidence) or NW Highlands (70%)? Or should the focus be areas with greater *poverty density*? The two delta areas and the

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North Central coast account for over half of the poor in Viet Nam. Moreover, market-based interventions may be more effective in these more densely populated areas.

*Migration:* The issue of labor migration needs to be addressed adequately. The low returns in agriculture as well as employment growth in non-farm sectors has resulted in substantial migration from rural to urban areas. It is estimated that around one million people move to cities in Viet Nam every year. There are also other types of migration, such as rural-rural migration and cross-border migration.

*Methodology:* In terms of methodology, it was suggested that quantitative methods can be usefully combined with qualitative survey techniques. In addition, there should be a thorough review of international and Vietnamese literature in order to correctly identify the focus of the program and to avoid duplication.

Adam McCarty of Mekong Economics advised that research proposals should be micro-managed and lead to very specific Terms of Reference. A thorough literature review would help to identify problem areas and potential study areas. To maximize the value of research, he suggested involving various outputs that were discussed and studied over time by the government, donors, local organizations and postgraduate students. Dissemination of research outputs, which should be relevant and readable to real policy makers, needs an explicit marketing strategy.

Rana Hasan noted that in view of the existence of a lot of research on Viet Nam, there is a need to focus on value adding issues. In examining the poverty-market linkages, he advised to target those poor who are not geographically isolated from markets, but participate in them on disadvantageous terms. Regarding the labor issues, the transition to non-farm employment should be studied in two aspects: one where the farming community is contemplating getting off the farm and another where the off-farm employment is expanding. The Viet Nam Household Living Standards Survey (VHLSS) dataset should be used together with Participatory Poverty Assessment (PPA) results for this topic. Strengthening social safety nets is important to protect vulnerable groups of farmers from downturns in the prices of their products as they try to diversify. Finally, political economy issues should not be overlooked, particularly the identification of losers of a policy change and associated costs the losers would suffer.

**Markets and safety nets:** It was suggested that subsidised market access might be an effective and dignified way of providing safety net welfare support to some poor groups of people – especially able-bodied people in remote or other marginalised situations. There are many dangers to such an approach, but it may be more cost effective than more conventional safety net systems, while reducing dangers of dependency and encouraging development of market, commercial and other skills, as well as links into the market economy.

## **5. Factor Markets:**

There were three discussant interventions on the factor markets issues. The main points raised were:

Labor market: Vo Tri Thanh of the Central Institute of Economic Management (CIEM) highlighted several characteristics of the Vietnamese labour market. Viet Nam has a very young population with about 60% of the population is under 30. The unemployment rate is highest among the age bracket of 20 to 25. There is a contrast between the public sector and the private sector. They differ in employment stability, competition pressure, insurance, and access to public services. Another important characteristic is a mismatch between demand and supply of labour by sector and necessary skills. The abundant labour force originating from rural areas is largely absorbed by low productivity and low value-adding sectors such as garments and footwear as well as in the services sector. Certain emerging

issues deserve attention. Rural-urban migration and urbanisation is on the rise. There is currently both legal and illegal cross-border migration. World Trade Organisation (WTO) accession and regional economic integration also have impacts on labour market and poverty.

**Capital market:** William Smith of the World Council of Credit Unions (WOCCU) noted that the operation of financial markets has indirect and direct impacts on poverty reduction. He suggested a range of issues worthy of research regarding how Viet Nam's financial markets affect the national economy and therefore, the poverty reduction indirectly. With respect to direct impacts of financial markets on the situation of the poor, particular issues were suggested, including the impact of government intervention in financial markets in favour of the poor, the regulatory environment, institutional development, market conditions, and cultural and social environment. Regarding research approaches, a variety of institutional analysis, household and market analysis were recommended.

**Land Market:** Nguyen Hanh Nam of the Mekong Private Sector Development Facility (MPDF) noted that Vietnamese land market is comparatively undeveloped. The land law is currently undergoing its third revision. The latest revision may bring the law more into line with the practicalities of a market economy. But there are still a number of controversial issues. How are the prices of land use rights to be determined? Are the mechanisms for transferability or for the conversion of land use rights clear? How easily can land as an economic asset, be converted to other types of productive asset (e.g. through sale or as a form of collateral)? What are the implications of different leasehold terms? But greater ease of land transferability and sale may be a "two-edged sword". For example, land transfers may lead to a more economically efficient use of land resources (e.g. land consolidation and greater farm productivity in agriculture, as well as the facilitation of investments in manufacturing industry). On the other hand farm consolidation leads to landlessness and may lead on to greater poverty in areas where off-farm employment opportunities are limited. Mekong Delta provinces such as Tra Vinh and An Giang were cited as examples of a land market leading to a rapidly growing landless rural population.

## **6. Globalization, markets and the poor**

### **6.1 Agricultural Products:**

Dominic Smith of Agrifood Consulting made a presentation on "The operation of commodity markets and their impacts on livelihoods in Viet Nam" (<http://www.markets4poor.org/English/Smith-The%20operation%20of%20commodity%20markets.pdf>). Comments and discussion on the presentation could be grouped into four major themes:

**Selection of commodities or products:** Some participants questioned why particular commodities i.e. rice, coffee, sugar and tea were selected. Are they really the crops grown by the poor? In upland areas, livestock and other crops such as maize and taro may be more important to the poor. In rice, the extent of intensification is such that the potential for further poverty reduction impacts may be limited. A consensus emerged that it may be better to study systems, networks and value chains, rather than the production of specific commodities. To enable the poor to participate in networks and value chains, the project should study the implementation of the contract system of Decision 80 as well as organizational structures and linkages between participants in value chains. The importance of the specialised functions of processing and marketing should not be overlooked.

**Role of Government:** The role of the Government was discussed extensively in this and other sessions. The relative roles of the market and Government in the processes of economic coordination and resource allocation is an overarching theme for the whole project. In the area of agricultural commodity production the Government had clear roles in terms of providing laws, the overall regulatory environment and the enforcement of the regulations e.g. contract enforcement or the recognition of intellectual (or other) property

rights. Government was also seen to have a clear role in terms of providing basic services and infrastructure – including targeted programmes for the poor. More controversial was the extent to which the state should be directly involved in production, marketing and the management of rural organisations (e.g. cooperatives).

Diversification: Diversification is an important means of reducing risk. However, it was observed that in some areas farmers merely shifted from rice to another crop, which is substitution rather than a real diversification. Substitution did not provide the potential benefits of risk mitigation. In order to participate in diversified markets and value chains, there needs to be a flow of high quality information to farmers.

Information: Some participants highlighted the role of information in planning process and in increasing the market power of the poor. It is important that information be provided in a form that can be accessed by the poor and is timely and relevant. The Government may not automatically be the best and sole information provider.

## **6.2 Non-agricultural Products**

Steve Parker of the United States Agency for International Development (USAID) funded Support for Trade Acceleration Viet Nam (STAR) project introduced the subject of Viet Nam's international economic integration in the context of the Viet Nam-US Bilateral Trade Agreement (BTA). The demographic structure of Viet Nam means that job creation is a key development priority. In addition, in Viet Nam, the "political settlement" is based upon continuing improvements in living standards. Against these challenges, Viet Nam suffers from a number of constraints. There is a large, unfinished, reform agenda. The private sector is undeveloped with few large firms and few successful joint ventures. Low levels of savings may provide a "supply-side" constraint in terms of mobilising resources for investment. In addition, Viet Nam remains pre-industrial. The new global context for Viet Nam (including BTA and the ASEAN Free Trade Agreement (AFTA)) may limit Viet Nam's options. Previous East Asian industrialisation models have used simultaneous import substitution and export promotion strategies. This "dual system" may not be an option for Viet Nam. A new model of "open market industrialisation" may be needed.

On the other hand, Viet Nam has responded very strongly to the incentives contained within the US-Viet Nam BTA that was concluded at the end of 2001. The US has become the largest market for Vietnamese exports, accounting for over 20% of total exports, and around half of Viet Nam's overall growth in exports. Most of the export growth has come from labour-intensive manufactured exports – particularly clothing – although footwear and furniture are also significant. The growth of these sectors will play a critical role in creating non-farm employment opportunities. There are questions about the ability of farming itself to raise living standards on the scale required. A question was raised about the extent of "domestic value added" and backward-linkages to the economy from these manufactured exports. However, there are also positive externalities to be considered such as learning how to export. Such areas include the insurance and financing aspects of exporting which would be critical skills for future movements up the global value chain.

## **7. Next steps**

Following the workshop, a short-list of potential research topics is being identified. This list will be circulated and posted on the MMW4P website. The content of the list will also be discussed with a "core group" of Vietnamese Government representatives, research institutes, donors and NGOs with a view to validating the choice of topics as well as identifying potential research partners. The first proposals would be prepared before Tet (the Vietnamese lunar new year holiday in the week 21-26 Jan 2004).

## **INTRODUCTION TO THE PROJECT**

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# Making Markets Work Better for the Poor: An Introduction to the Project

Alan Johnson

*Project Co-ordinator*

## 1. Introduction

The effective functioning of markets is critical to achieving growth and poverty reduction in Vietnam. To deepen our understanding of the links between growth, poverty reduction and the functioning of markets, the ADB approved a USD 2.4 million regional project covering Vietnam Laos and Cambodia entitled Making Markets Work Better for the Poor (MMWBP)<sup>1</sup>. The project will last for three years and has started operations in Vietnam. Parallel activities in Laos and Cambodia, supported by the ADB Institute, will shortly be underway.

The overall goal of the project, in the three project countries, is “to bring the power and efficiency of the market closer to the lives of the poor”. With its focus on market development, the project is an “opportunity-side” intervention, examining potential opportunities for the poor to obtain a greater proportion of the benefits that result from economy-wide growth. The project will therefore provide a useful complement to existing development interventions based on service delivery. The material below draws on a number of sources including the original “making markets work” framework paper prepared for DFID by Oxford Policy Management, the ADB regional technical assistance project document, the papers prepared for this inception workshop as well as various academic works on markets, livelihoods and institutions.

## 2. Conceptual Background

### 2.1 *What is a market?*

The concept of a market is central to economics. But markets are rarely well defined. For example, a student’s dictionary of economics defines a market simply as “a medium for exchanges between buyers and sellers”. In general, there is a tendency to equate existing market systems with the theoretical model of a functioning market derived from neo-classical economics.

A more comprehensive definition of market exchange is an “economically qualified purposeful interchange of commodities on the basis of equivalent obligations at a mutually agreed upon exchange rate... in a cluster of exchange and rivalry relations” (Fourie, quoted on OMPL 2001). The key elements of this definition are the:

- (a) direct bilateral relationship between buyer and seller,
- (b) framework of adversarial competition within which the exchange takes place; and
- (c) fact that the exchange is mutually agreed, but not necessarily mutually beneficial

### 2.2 *Importance of markets for growth and poverty reduction*

As Athar Hussain points out in his paper on the experiences of transition economies, “the fall of central planning reaffirmed the importance of markets in economic development. In terms of supplying products and satisfying certain wants markets have no proven rivals”. Markets are an efficient - and unrivalled - mechanism for the exchange, coordination & allocation of many resources, goods and services in an economy. Well functioning markets that support competition and lower transactions costs provide incentives for trade and investment and

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<sup>1</sup> The project is co-financed by the Government of the United Kingdom and the Asian Development Bank Institute.

hence growth and poverty reduction. Poor people's livelihoods often depend on directly on their ability to participate in markets for labour, food, financial services, and land. Markets are critical to livelihood development because of the linkages they offer to the local economy and beyond. But markets often fail.

### **2.3 Market failures**

Dorward and Poole (2003) describe three types of market failure:

- (a) Public goods which are available to all, but cannot be charged for on the basis of individual consumption (e.g. a clean environment).
- (b) Private goods – where the transactions risks and costs are too high. The risks are associated with a failure to honour agreements to pay or deliver or from a “co-ordination failure” where other parts of the value-chain, or other linked markets, are not functioning.
- (c) Access where poor, excluded, groups such as ethnic minorities are unable to participate in markets.

### **2.4 Market opportunities & threats**

Markets therefore offer both opportunities (driving and sustaining growth) and threats (market failures). The intensified competition resulting from greater market integration may also be a two edged sword bringing positive and negative aspects simultaneously. For example, markets may bring greater production efficiency & lower consumer prices, but also a livelihood loss for existing producers. In some cases, groups with excessive market power may shift the “rules of the game” to reduce market access and increase opportunities for “rent seeking”. Some rents are inefficient and growth retarding, other rents play an essential role in growth and development. Rents are sometimes necessary to get something produced. They can offset the uncertainty and transitional costs (which in theory do not exist in a perfect market) of investing in new technology.

Developing and strengthening institutions is critical for market development. But many attempts to correct market failure through state intervention have created a new problem of “state or government failure”.

## **3. Institutions and Markets: “Institutions rule!”**

A recent body of research into the long-run determinants of economic growth suggests that there is a high correlation between the quality of institutions and growth. Institutions in this context are defined as the “rules of the game” or formal and informal socio-economic arrangements. Research by Rodrik et al. (2002) demonstrates that institutions have a strong causal effect on growth. Institutions are shown to be more significant determinants of growth than either Government policy towards trade or geography. But there are no clear lessons about which specific institutions are critical. Indeed some suitable institutions may be “unorthodox”. Chang (2002) shows that many of the institutions recommended as part of a “good governance” package are the result – not the cause - of growth.

Rodrik makes the point that first order economic principles that have universal validity (property rights, market competition, sound money) do not map into unique policy packages. The mistake of the “Washington consensus” has been to jump too quickly from higher order principles to specific policy prescriptions (liberalization, privatisation, deregulation), resulting in an un-doable list of reforms. The most successful reforms are those that direct effort towards the binding constraints on growth. These specific binding constraints may be different in different contexts.

Khan (2002) examines how many Asian countries grew so rapidly in the 1980s despite widespread rent-seeking and corruption. He challenges the view that growth and development are related to the absence of rent-seeking, emphasising the need to distinguish between productive rents (to reward innovation, manage distributive conflicts) and unproductive ones. He rejects the liberal market model, which sees the most efficient market as one with no barriers to exit or entry, and therefore no economic rents. Instead he emphasises the key role of the state in managing rents productively, to support capitalist transformation and technology acquisition.

While Khan and Rodrik offer different perspectives, some common points seem to emerge which are of relevance:

- Solutions need to be country specific, taking account of pre-existing social and institutional structures; and aligning economic incentives with political and social realities.
- Following orthodox policy prescriptions on liberalization, privatisation, deregulation, secure property rights does not necessarily lead to higher growth; while some countries (especially in Asia) with unorthodox policies and high levels of corruption and rent-seeking have done spectacularly well.
- Predictability of institutional arrangements seems particularly important, so managing transitions is challenging.

#### 4. Which institutions are critical for market development and growth?

According to Rodrik, good institutions can be acquired, but this may require experimentation, willingness to depart from orthodoxy and attention to local conditions. Four main levels of institutions are relevant:

- i. **Government and political institutions** that have the capacity to maintain law and order, manage conflict, generate market-oriented incentives and lower the risk of expropriation.
- ii. **Regulatory institutions** such as laws regarding market conduct and enforcement of contracts, ownership rules, the property rights of current and future investors, product and service grades and standards;
- iii. **Infrastructural institutions** such as those regulating or maintaining public goods, including roads, power supply, communication networks, exchange and storage facilities, and market information services; and
- iv. **Market institutions** such as retail and wholesale firms, traders, brokers, cooperatives, producer and consumer associations, financial service providers, lawyers;

Some examples of “non-standard or unorthodox market arrangements” in reducing costs, enabling transactions and technical change are described in Dorward et al (2003). Three different cases are cited covering East Asian development, the Microfinance revolution and the Green Revolution. There is also a need for distinct policy and institutional phases relating to the stage and level of development. These may cover:

- (1) The provision of basic market infrastructure
- (2) The basic reforms that unleash growth e.g. the distribution of land use rights
- (3) The institutions required to sustain growth and the operation of private markets

These phases also take place in association with a number of fundamental transitions from:

- Plan to market or from administrative allocation and exchange to a decentralised, market-based allocation and exchange;
- Informal subsistence production and consumption to formal, exchange-based production and consumption
- Food deficit to food surplus linked with a move from staple food production to a more diversified rural sector
- Agriculture to Industry
- Rural to Urban

## **5. Project Description**

### **5.1 Purposes of MMW4P**

The project has two main purposes, to:

1. conduct analytical work on the functioning of markets and the extent to which the poor are able to benefit from them; and
2. build capacity to support pro-poor market development through research activities, networking, and policy dialogue.

### **5.2 Implementation Principles**

In implementing the project we will be guided by the following principles:

- Responsive to the needs of the poor;
- Maintaining a strong linkage to national development priorities
- Promoting local ownership through extensive involvement of local institutions and the “process approach”.
- Ensuring a rigorous approach to research, meeting international quality standards, whilst being objective and unbiased
- Respecting the diversity of stakeholders and promoting diverse means of disseminating project findings

## **6. The research agenda**

### **6.1 Review of international experience in Asian and Transition economies;**

A key piece of background work will be a comparative analysis of other transition experiences to determine what lessons emerge in key areas such as: the critical institutions for promoting market development and growth; the appropriate role of the state; the key context-specific issues; the lessons from both market failure and state failure? An initial contribution is made by Athar Hussain in his paper “*Lessons of Transition for Understanding the Functioning of Markets*”.

We also intend to conduct some quantitative cross-sectional analysis of markets by communes/localities making use of the data available in various GOVN surveys such as the recent Vietnam Household Living Standards Survey (VHLSS).

## 6.2 **Review of Factor Markets**

Following traditional “factors of production” framework, we will produce short background notes on the main factor markets:

- Land
- Labour
- Capital

These initial scoping studies will guide us towards more specific issues to study in greater depth.

## 6.3 **Listening to the poor: markets and livelihoods**

Building on the analysis provided by Dorward and Poole (2003), we will attempt to capture the concerns of the poor themselves in market related areas. In particular we will seek to understand how the livelihoods of the poor interact with markets. Our work will attempt to address the following questions:

- which markets are the most critical for the livelihoods of the poor?
- how well do these markets serve the needs of the poor?
- what relationships exist between these different markets?, and
- what development interventions – or complementary inputs - would make those markets function more effectively for the poor?

## 6.4 **Which groups of the poor?**

Who are the poor that the project should focus on? Broad-based growth in Viet Nam has been remarkably successful at reducing the overall rate of poverty incidence from 58% in 1993 to 29% in 2002. However, recent data published in the Vietnam Development report 2004 shows that poverty incidence is higher (35%) in rural areas – and higher still amongst specific population groups such as ethnic minorities (70%). While food poverty has been almost eliminated in urban areas, it still affects more than forty percent of the population among ethnic minorities, and has shown almost no decline over the last four years. Should the focus be on geographical areas with a greater *incidence and depth of poverty* e.g. Central Highlands (52% poverty incidence) or NW Highlands (70%)? Or should the focus be areas with greater *poverty density*? The two delta areas and the North Central coast account for over half of the poor in Viet Nam. Moreover, market-based interventions may be more effective in these more densely populated areas.

In the first period of the project we will focus on the following sub groups:

1. Ethnic minority households in remote upland areas – as the group with the greatest depth of poverty. Why does this group not benefit proportionally from the overall processes of growth?
2. Unregistered urban migrants – “new” poverty issues. Why is poverty growing in some of the wealthiest and fastest growing parts of the country? The urban poor are not geographically isolated from markets, but participate in them on disadvantageous terms.
3. Household or “micro” enterprises – the engine of future growth and employment. What are the issues associated with the transition from the informal to the formal sector.

## 6.5 Reflecting National Development Priorities and concerns

A number of strategic studies will be initiated that will reflect National priorities in the area of market development. These priorities will be determined in consultation with Government agencies and research institutes and ideally will provide useful inputs to the upcoming national five-year planning process and implementation of the Comprehensive Poverty Reduction and Growth Strategy (CPRGS). Some of the themes that have emerged from discussions so far include:

- Ethnic minority “inclusion” in the general process of growth and development
- Globalisation and implications for Vietnam, particularly in the context of WTO accession and in the agreed frameworks set out in the Bilateral Trade Agreement with the United States and the ASEAN Free Trade Agreement (AFTA)
- Rural urban migration
- Land sale and transfer and the concomitant growth in rural landlessness in the Mekong delta

An initial piece of work has already been conducted on the links between agricultural commodity markets and the poor. Dominic Smith in his paper *The operation of commodity markets and the impact on livelihoods in Vietnam* looks specifically at the experiences of coffee, sugar, rice and tea.

## 7. Capacity Building

A key element of the project is capacity building associated with iterative links between research outputs and a wider policy dialogue on “markets”. We will follow some of the lessons learnt by other research programmes in Vietnam, including those of the Masters in Development Economics programme at the National Economics University where two of the key lessons are:

- (a) Research should not be “too complex” or theoretical. The content and outputs should be relevant and readable (the real R<sup>2</sup>) to real policy makers.
- (b) “Rolling” policy-specific research programmes are best. That is, ones involving various outputs that are discussed over time. This stimulates (informed) debate on the subject over some period rather than as a “one off”.

The project will promote capacity development in the following ways:

(a) Knowledge sharing between Cambodia, Laos and Vietnam (CLV) – and beyond. In addition to regular exchanges between the CLV components, this project will be one of the participants in a wider making markets work global network as described by Albena Melin in her presentation.

(b) learning by doing and the “mentoring” relationship The direct involvement of local institutes in the research work itself will provide useful capacity building through “learning by doing”. Local research institutions will be linked to an international mentor who will provide guidance and support. The international mentor will not actually conduct the research or write the final research papers – that is the job for the local research institution. For some of the subjects it is important that the researchers interact directly with the poor and with ethnic minorities. Such visits outside of the main towns will be encouraged and supported by the project and will form another important dimension of “learning by doing”.

(c) Strengthening research networks: The project, through support for collaborative approaches and use of international mentoring will strengthen research and policy-focussed institutions on an international, regional and national basis.

## 8. Communication

The project will develop its own marketing and communications strategy to guide the formulation of the key project messages and the means of disseminating these key messages. A variety of tools and media will be used – including a regularly maintained project website. But the guiding questions will remain:

- Who is the target audience?
- What type of information do they need?
- What are the key messages? Can they be packaged in a form that meets the needs of the audience?
- What are the best means of reaching the target audience?

Policy dialogue: A better understanding of the processes of policy formulation will need to be developed to identify the target audience and suitable leverage points. The project will support a variety of media formats to support the policy dialogue process. These formats range from conventional workshops and meetings to media articles, press briefings, mail-outs to a targeted audience, and the project website. In addition, for each of the topics a “champion” or primary contact person will be identified from a relevant part of Government. We already have the benefit of strong links with the Prime Minister’s Research Commission and the Central Institute of Economic Management. But we will also forge explicit links with staff in the relevant line ministries or Provincial People’s Committees.

Examples of this are set out in the table below:

Research Topic	Institutional Link to Government and Policy Dialogue
Consultations with the poor	Provincial People’s Committess
Agricultural Value Chains and “commercialisation”	Ministry of Agriculture and Rural Development (MARD)/ICARD
Land Markets	Ministry of Natural Resources and the Environment (MONRE)
Labour Markets/ Labour Exports	Ministry of Labour Invalids and Social Affairs (MOLISA)
Microenterprise development	Ministry of Planning and Investment (MPI) and the Vietnam Chamber of Commerce and Industry (VCCI)
Non-agricultural value chains – the backward linkages of Foreign Direct Investment	Ministry of Planning and Investment (MPI)
Microfinance	State Bank of Vietnam

Policy Briefs. To provide support to the policy dialogue, short policy briefs will be prepared on a number of market-related topics. These short, readable policy briefs will be prepared from existing international and regional literature. The policy briefs will also be a means of disseminating learning from project-supported research.

Some of the potential “leverage points” include inputs to:

- the next five year planning process.
- National Assembly legislative timetable
- CPRGS rollout and progress reviews
- CG meetings
- New market-oriented GOVN or donor projects or programmes

## 9. Implementation process and First Year Work Plan

### Mechanics of implementation

Project implementation will be guided by an advisory committee (AC), comprising ADB staff from the 3 countries, ADB HQ staff and representatives of the ADB Institute; and DFID/UK.

Participating researchers in the studies will be selected from among national research institutes or universities or as individuals on a competitive research proposal basis. The local researchers will carry out the research work in association with an international mentor engaged under the project. Their methodologies, work progress, and findings will be discussed at inception, midterm, and final workshops. Particular attention will be paid to the development of research proposals. There will be annual conferences during project implementation to present the outcome and policy recommendations from the completed research projects.

### **First Year Work Plan**

Potential research topics have been divided into four broad categories:

- (a) "listening to the poor" grassroots consultations looking at the linkages between markets and livelihoods;
- (b) Factor markets
- (c) Globalisation / Product Markets
- (d) Other strategic issues

Research proposals are currently being developed for the grassroots consultations and for a study of the participation of the poor in agricultural value chains under the "product markets and globalisation" category. These proposals should be completed by Jan 04. A bidding process for the first researchers could begin shortly after that. A further two research proposals would be developed during the first quarter of 2004.

For more current information, please visit

[www.markets4poor.org](http://www.markets4poor.org)

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## DISCUSSANT NOTES

**Brahm Prakash**

*Poverty and Social Development Division  
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### **1. Understanding the functioning of markets—general comments**

Lately there have been a number of studies attempting to improve our understanding about how markets function, and how poverty reduction efforts can make better use of these features. This RETA is another such attempt with two additional features. One, that it focuses on the transition economies, and two, it deals with a compact Indo-china region comprising Cambodia, Lao PDR and Viet Nam.

It is inherently a slow, difficult and complex task. (Like cutting steps into a mountain in progression towards the summit except that in this case the shape of mountain itself may be changing due globalization and technological changes while we are in the process of cutting our path.)

ADB is committed to inclusive development, although phasing its implementation is done in close coordination with DMC governments. One possible way of looking at these phases is to emphasize on the following:

- Reduction in absolute levels of poverty
- Reduction in relative poverty, including spatial and vertical mobility of poor
- Moving up the value chain
- Utilizing technological changes, especially information and communication technologies

I wish to emphasize the modular character of the markets. This signifies the role of networking and linkages across the modules, and reinforces the expectation about the convergence to one price, as the product markets mature.

In the current global situations, one has witnessed how the production of the matured products starts relocating to the lower wage economies unless technology intervenes by creating new product or designing alterations. This technology induced differentiation is critical in sustaining the value addition process, and in determining the location choices. The latter is inherently linked with foreign direct investment, productivity increases and growth of developing economies.

In a dynamic context, it is important to note that a significant effort is required to keep running to stay at the same spot (or not loose the ground). This is especially true for the changes that originate globally from far off places and on which one has little control. An obvious example of this kind is changes in the global development/financial architecture that can cause periodic set backs, especially to the poor who are often not in position to protect themselves.

This view point is helpful in understanding the growth process a priori, but for making any poverty reducing interventions one needs to understanding the empirical situation. The latter is a pre-requisite for any planning process for poverty reduction, especially if the interventions relate to knowledge management, financing and skills. This brings me to the Viet Nam Development Report 2004, and I submit a few observations on it.

### **2. Viet Nam Development Report 2004—Some observations**

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First of all I like to thank you providing us excellent documents for the meeting, especially the Viet Nam Development Report (the Report). It is well done, and is an illuminating piece of research. I make a few observations that will, hopefully, help in appreciating the findings of the Report.

Much of the report discusses the findings in the context of Viet Nam economy as a whole. I have a feeling that some of the empirical results would emerge much sharper, if the analysis was carried out by different segments, say, urban and rural areas, and separately for ethnic populations. I am sure you are yourself aware of the segmentations within the economy and that I do not have to labour the point.

The distributional changes in income that are given in the report seemed a bit intriguing and in need of some explanation. I am referring to the fact that income of only the top quintile has increased whereas the share of all other four quintiles have declined. This is a bit unusual. I would have expected that more even gains at least among the top two or three quintiles.

I wonder if the land market behaviour has something to do with this. The findings in the report are suggestive of possible linkage but in my hurried review I didn't quite fathom what was at work and how.

Distributional findings are also somewhat at odds with the way financial markets, especially microfinance seems to be working in Viet Nam. A large number of households are active and using microfinance institutions. Their impact and linkage with the changes in income, if any, needs to be traced and brought out more explicitly.

Likewise, it seems that migration situation within the country is also contributing to some of the distortions in the findings. This is important as it seems there are significant gaps in earning across urban and rural areas.

Finally, it seems that the overlapping of public services and the urban area together accounts for much of the changes in earnings in the Report. It would be interesting to see if this is indeed so.

### **3. Concluding observations**

In conclusion, let me go back to the excellent presentation of Mr. Johnson and his global perspective on making the markets work for the poor. Some of the features that I identified above, also figured in his presentation. Especially noteworthy was his definition of markets and its linkage with the poverty reduction.

Given Mr. Johnson's global perspective, the work under the RETA in the context of Viet Nam is quite promising. I am pleased to be here and to be associated with the RETA, and look forward to its output. Thank you.

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## DISCUSSANT NOTES

**Rana Hasan**

**ADB Headquarters**

It has been mentioned in some of the earlier sessions that Vietnam is one of the most well studied developing countries around. In light of the fact that there are three years to carry out this study and quite a bit of resources, there may be a tendency to want to do a lot and cover a lot of issues. I would caution against this tendency – if it is there, of course. In view of the existence of a lot of research on Vietnam, I think there is a real danger in trying to cover too many areas and thus not adding enough value to the various issues that the project eventually studies. I would therefore go for a more narrow focus which ends up covering a lot of ground than the opposite approach.

Which of the “poor” should the study focus on? Given my feeling that more focus is the order of the day, I would urge the organizers to forego studying the remote areas. Despite the fact that these regions may be where the concentration of poverty is highest, these are areas where the absolute number of poor is not as high. More importantly, the point of this project is to examine the linkages between markets and the poor. The poor in remote areas are cut off from markets (or cannot make the most of existing markets) due to locational aspects combined with weak transportation links. Thus, too much may not be gained on poverty-market linkages by studying a group which is removed from markets due to transportation constraints. It would be more appropriate to focus on those poor who are not geographically isolated, participate in markets, but are somehow not participating on advantageous terms. Understanding what can be done to get this group of poor people to get more from their participation in markets would be very valuable.

The issues of migration and of the development of non-farm opportunities have been raised a number of times in the various sessions. The key issues here are interrelated. At the risk of over-simplification, the issues have to do with getting some farmers to remain “on the farm” but at higher levels of farm productivity and getting the remaining farmers off the farms. Perhaps the RETA study could focus on two locations – one where a significant section of the farming community is contemplating getting off the farm and another where the off-farm employment is expanding. Participatory poverty assessments (PPAs) could be used to examine the key issues for both groups of farmers – those intending to stay on the farms and those trying to get off-farm employment. The PPAs may also throw out issues that could be useful to analyze using quantitative techniques. A useful starting point for a quantitative study on markets and the poor would be the VHLSS 2002. This dataset is a very rich one and includes modules which relate to households and communes. The dataset can be used to address a variety of issues, for example, those relating to the targeting of social safety nets, the types of households that are able to make the most of non-farm opportunities, etc. The types of issues that could be studied are whether certain household characteristics (education and ethnicity, for example) make it easier for a successful transition to non-farm employment. Similarly, the issue of labour regulations and mobility could be examined to see whether there are some impediments to migration and changes in sector of employment.

Another issue that has come up several times in the sessions has been the transition from traditional farming to growing of cash crops. In particular, it has been pointed out that the government’s targeting of coffee as an export cash crop did not take into account the possibility that an increase in the supply of coffee by Vietnamese coffee growers (urged by the government) would put downward pressure on the price of coffee. While this point is well taken, a more general point is that especially in the context of greater openness, certain production decisions will inevitably turn out to be “mistakes” in an ex-post sense. Calls for better coordination and better information systems organized by the government or other

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institutions cannot completely get around the fact that investor herding and the resulting oversupply (whether in the production of coffee or computer chips or cars) is a fact of life. Thus what will be required is a strengthening of social safety nets to protect more vulnerable groups of farmers from downturns in the prices of the commodities they produce.

It will be useful for the project to pay careful attention to political economy issues. In particular, to the extent that the project gets involved in making policy recommendations which entail changes in the shares that, say, the better off farmers and traders get from different types of market exchanges, it will be useful to make an attempt at estimating the costs of the recommended changes to the better off market participants. Ignoring such costs can lead to policy recommendations which would be opposed strongly by elites and likely be difficult to implement. Put differently, it is a good idea to examine who the losers would be from a suggested policy change and have some estimate of the costs of a policy change to the losers.

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**Lessons Learned from the  
Vietnam-Netherlands Masters in Development Economics Programme.  
Hanoi, 1998-2003**

**Adam McCarty**

**Background:**

The Hanoi Masters in Development Economics (MDE) programme starting in 1994, and was fully funded by Dutch ODA for eight years until end-2002. It is a 2-year degree taught in English, now mostly by Vietnamese lecturers. <http://welcome.to/neu-iss>.

The graduation certificate is signed by the Rectors of the Hanoi National Economics University and the Institute for Social Sciences (ISS), The Hague. Funding averaged US\$500,000/year, but was front-loaded to set-up the programme and curriculum.

Each year during 1994-1998, 30 students were chosen from (tough) entrance exams. Since 1999, two more each year were given scholarships by the New Zealand Government. Fees and full-fee students were introduced in 2001, when 22 fee-paying students joined the 32 scholarship students. In the November 2002 intake, there were no more "Dutch scholarships", but still a class a 40 fee-paying students was maintained (with a similar number expected this year). At US\$3,500, the fee is competitive with other (subsidized) foreign-supported Masters programmes, and the programme is financially sustainable.

How is financial sustainability achieved?

- Role of ISS reduced to supervising quality, which requires one visit per year and is funded by giving the ISS US\$600 per student.
- Recruiting of foreign volunteers (Australian, Canadian) to assist programme delivery, including teaching (English), tutoring, administration, marketing.
- Constant searching for donor support (small support has been given by New Zealand, Luxembourg, Ford Foundation).
- Cutting of all running costs to minimum (e.g. project car returned to university)

How is quality maintained?

- ISS annual inspections.
- Tough entrance exam standards maintained.
- Recruiting of foreign teachers around Hanoi, who often volunteer services for free (S.Adams, H.Adams, F.Tarp, P.Auffret, M.Rama, J.Rand).
- Use of best Vietnamese teachers by paying them reasonably (\$50/evening).
- Use of foreign volunteers.

The general "lessons learned" are:

- Changing the method of teaching is as important, and as difficult, as changing the content of courses (problem: rote learning approach with "teacher as god").
- Course content and teaching method changes are blocked by "old guard" concerned at becoming marginalized (not the case in Business Studies as no "old guard").
- Therefore need to take long-term perspective and build up "new generation" of teachers to deliver courses, but still need "respected professor" for institutional support/umbrella (but one who is "change-friendly").
- Financial autonomy from higher levels essential (but with accountability).
- Operational autonomy also essential, but this requires support from higher levels (University, MOET). [However, MDE seen as "model" and only economics post-graduate training in sea of MBAs].
- Actual subjects delivered requires flexibility depending on available teachers and opportunities presented by foreign volunteer teachers.
- Tough entrance exams reduces numbers of candidates but is quality screening.
- Nevertheless, initial computer and "English for Academic Purposes" subjects needed.

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- Biggest teaching challenge is “Research Methodology” and student thesis writing process. Students totally unfamiliar with arguing academic issues on paper.
  - Success of MDE has had positive externality effects on Economic University and MOET, who begin to see and discuss issues such as use of tutorials, short lectures, group learning techniques, and research methodology.

### **Implications (and advice) for MMW4P program:**

- Beware of academics focused on international publications. They are not really interested in “transfers” of anything.
- Beware of Vietnamese researchers wanting to do vague topics and get paid for research already done, or to do large and not really necessary surveys.
- Development of research proposals must be micro-managed, and lead to very specific research ToRs. I would ask participants to attend a Research Methodology course during which the proposals (including a full literature review) would be developed. Getting to this stage is an important part of the whole research process and should not be rushed.
- Research, however, should not be “too complex”, but kept relevant and readable (the real  $R^2$ ) to real policy makers. Basic and well explained regressions at most.
- “Rolling” policy-specific research programmes are best. That is, ones involving various outputs that are discussed over time (like UNDP-funded Enterprise Law research). This stimulates (informed) debate on the subject over some period rather than “once off”.
- Research is most effective when linked to teaching. It would be great to involve the MMW4P researchers with the MDE programme students doing their theses (over 40 each year).
- Dissemination of outputs needs an explicit marketing strategy: publications, workshops, press releases, direct posting to mailing list of 500 “policy makers”, websites, etc. Similarly, the “bridge to policy makers” needs explicit analysis.

## **TRANSITION TO MARKETS**

## Lessons of Transition for Understanding the Functioning of Markets

Athar Hussain

London School of Economics

### 1. Transition and Transitional Economies

The terms “transition” and “transitional economies” date from the fall of the Berlin wall in 1989, which marked the beginning of a two-part process of fundamental transformation in Eastern Europe (EE) and the former Soviet Union (FSU). One consisted of a change in the political regime, which triggered the second, the replacement of the planned with a market economy. The term “transition” embodied the hope that the economies in question would become well-functioning market economies in the foreseeable future. However, 14 years after the start of the process, the actual outcomes have turned out to be very different from what was originally expected. Upon embarking on the transition almost all of the economies in EE and the FSU experienced a sharp fall in GDP, which was unexpected and remains yet to be fully reversed in some of the economies. In all these economies, inequalities in the living standard have widened and the poverty rate has risen, to catastrophic levels in parts of the FSU. In GDP per head, the transitional economies are far more diverse now than they were at the start of the process. There is a widespread agreement on three lessons from the experiences of the transition in EE and FSU thus far. First, the transition to a well-functioning market economy will take much longer than initially envisaged, even in economies where the process encounters no major impediments. Second, the pace of the transition will vary widely across economies, with some caught in a low income and low or no growth trap for a long time. Third, privatisation and price liberalisation, the two top items on the transition agenda in many economies of EE and FSU, do not immediately result in greater efficiency and higher growth; they need complementary institutions to have the beneficial effects.

Economic reforms in socialist economies have a long history, which in some East European economies and the FSU goes back to the 1960s. Until the early 1990s the aim of such reforms was to improve the functioning of the planned economy rather than to replace it with a market economy. The same was also true of the Chinese economic reforms when they began in 1979 and of the Vietnamese *doi moi* in 1986. Chen Yun, a major member of the Chinese leadership that launched the reform process, suggested that markets should be like a bird in the cage of planning. It is only in the 1990s that a market economy became the desired goal and a planned economy ceased to be regarded as an alternative to a market economy. In China and Vietnam the reforms of the planned economy merge with the transition to a market economy, which in retrospect gives the impression of a continuous evolutionary process. In marked contrast, there is a sharp break between the transition to a market economy and reforms of the planned economy in the constituent parts of the FSU and EE, where the change of political regime started the transition. This introduces a political dimension in the transition process in these two groups of economies, which differentiates it from that in China and Vietnam.

The transitional economies can thus be grouped in the following three categories:

- Ex-planned economies of Eastern Europe (EE)
- Constituent parts of the former Soviet Union (FSU)
- China, Vietnam and Mongolia

The above economies were at different levels of development when they embarked on the transition, and they still are. The economies of EE and FSU ranged from a high to medium level of industrialisation with a bias towards heavy industry, which was a common feature of planned economies. This bias has left most of the transitional economies with a large task of restructuring their heavy industry. Prior to the transition, the first two groups of economies had low economic inequality and also low incidence of poverty, though over time they increasingly fell behind developed market economies in terms of the average living standard. However, compared with their market economy counterparts with a similar GDP per capita, the planned economies fared better in terms of the educational attainment of the population and the public provision of healthcare, housing and social services. In all the economies in the above three groups, the transition has proceeded with widening economic inequality. With two notable exceptions, all have experienced a rise in the poverty rate ranging from substantial to massive. The two notable exceptions are China and Vietnam, which during the course of the transition have experienced a dramatic fall in poverty.

The primary focus of this report is on the three Asian transitional economies of China, Vietnam and Mongolia. The first two share many similarities, but the third is in many ways unique. China and Vietnam seem thus far to be the only transitional economies that have combined significant progress towards a well-functioning market economy with rapid economic growth and also falling poverty. Though these three countries followed the socialist pattern of development with a pronounced bias towards industrialisation, they displayed the characteristic features of developing economies when they embarked on the transition, and still do. The principal features included the following:

- A substantial percentage, if not a majority, of the population dependent on farming and resident in rural areas.
- The central role of households in the organisation of production in the rural economy in the context of the collective ownership of land.
- A low GDP per capita and correlated with it a high incidence of poverty, especially amongst the rural population and a wide gap between the living standards of the rural and the urban population.

Though the three economies, especially China and Vietnam, have undergone massive changes since embarking on economic reforms/transition, the above characteristics still apply to them. All three remain developing economies. According to the World Bank classification of countries by GDP per person, Vietnam, notwithstanding a substantial improvement in its ranking since the early 1990s, has remained a low-income economy. China has only recently graduated to the status of a low-middle income economy and Mongolia has slipped down further amongst low-income economies.

In China and Vietnam reforms in agriculture and the rural economy were the central components of the first phase of their transition. In contrast, in the transitional economies of EE and FSU the primary focus of reforms has been on the transformation of industry and industrial enterprises. The reform of the farming sector inherited from the planned economy period has been comparatively less important and presented issues very similar to those raised in the case of the industrial sector. The developments in Mongolia are in many respects unique because of its two particular features: first, a huge land-locked area relative to a small population of 2.6 million and, second, the overwhelming importance of animal husbandry in the economy.

## **2. Transition and Economic Development**

The transition from a planned to a market economy shares salient similarities with economic development because both involve the building of a new economic system, which in time replaces the old. Among these similarities four are worth noting. First, both are long-term processes and proceed differently across countries. Second, though the broad aim in both cases is clear, the details of the eventual outcome are difficult to predict. The principal reason is that both a developed economy, which is the aim of economic development, and a market economy, which is the aim of the transition, can take very different forms. Third, a radical overhaul of institutions is a central feature of both processes. Related to this, both involve a large-scale re-deployment of labour and present the population with a mixture of opportunities for economic betterment and new risks of deprivation and slipping into poverty. Fourth, government policy plays a crucial role in both processes and both involve a fundamental transformation in the role of the government.

### **2.1. China and Vietnam**

In China and Vietnam the transition towards a market economy has proceeded in tandem with the following three interrelated processes, which usually are the central features of economic development:

- Steady shift of labour out of farming into services and industry
- Correlated changeover from self- to wage employment
- Rising urbanisation and corresponding labour and population emigration out of the countryside and the progressive urbanisation of the rural periphery around cities and towns.

These processes are not particular to China and Vietnam, but they take on particular forms in the two countries because of the transition and the institutions and procedures left over from the planning period. A notable example of mutual influence of the transition and the processes of economic development is provided by the outflow of surplus labour from farming in the two economies. This has proceeded in parallel with a massive reduction of the labour force in the state sector, including the government, enterprises and social organisations, which is a common feature of the transition. In a mere 6 years from 1996 to 2002, the Chinese state units have lost around 40 million jobs, 37% of the total in 1996, which has compounded the problem of creation of jobs in the two economies. With the state sector under pressure to reduce its labour force and surplus labour in farming, the private non-farm sector, especially the services, is the only source of additional jobs in the Chinese and Vietnamese economies, as in other transitional economies. Further, in both countries the land tenure pattern bears a deep imprint of the transition and population migration is strongly affected by the procedures carried over from the planned economy period.

In a striking contrast to the prevalent pattern in developing economies, agricultural land in China and Vietnam is very equally distributed among households, though significant inequalities in the distribution of land still remain. The land tenure pattern is responsible for two notable features of the rural areas in the two countries. First, most rural households have land and accordingly self-employment, usually on the household basis, is the prevalent norm is farming. However, there is in both countries wage labour in farming and there are landless rural households, which have risen in

numbers over time because of the diversion of land for non-farm development and the sale of land lease for a variety of reasons. Distress sale is one of these. However, landlessness and rural poverty are not as closely linked together in the two countries as they are in other developing economies. Most of the rural poor, who form a large majority of the poor population in both countries, have their own land plots. Further, depending on the locality, landless rural households may be comparatively well off. Second, providing rural households with land, as well as generating economic incentives for growth in output, has ensured that income from farming is distributed widely across the rural population, though not equally because of differences in the location and quality of land plots. This has been the principal cause of the dramatic drop in rural poverty seen in the two countries during the transition, which in terms of speed and magnitude ranks amongst the most prominent episodes of the “pro-poor or widely-shared economic growth” recorded in recent history.

However, own land plots have not been sufficient to prevent poverty, not even extreme poverty. Moreover, after a rapid fall in rural poverty over 10 or so years following the decollectivisation, the downward trend in rural poverty has slowed down sharply in both countries. This suggests that much of the possibilities of poverty reduction opened by the decollectivisation have been exhausted. Further reduction in rural poverty and a narrowing of the widening rural-urban gap crucially depends on two factors: first, infrastructural investment, especially in transport and electrification, so as to bring about a further integration of the rural and urban economies. The second is facilitating rural-to-urban migration so as to reduce the labour force engaged in farming. The second is as important as the first. Relative to the rural population, the cultivable area is very limited in both countries. As a result, the average land area per rural household is small. Since the decollectivisation, this average has shrunk because of population growth and the diversion of agricultural land to non-farm uses. The low ratio of land to rural population is a constraint on rural income per head, and the constraint is particularly severe in China and Vietnam compared to many developing economies. It can be pushed back through investment in transport and other infrastructure and though technological upgrading, but cannot be eliminated. The implication is that ultimately a rise in rural incomes depends crucially on a reduction in the farm labour force. The policy challenge is to achieve the reduction without transforming low rural incomes into urban poverty.

Thanks to rapid economic growth and a relaxation of impediments to travel that have accompanied the transition towards a market economy, labour and population migration has risen sharply in both economies, earlier in China than in Vietnam. This trend is expected to continue apace. However, in both economies labour and population flows, especially rural-to-urban, are deeply affected by the procedures carried over from the planning period. Most consequential of these is the household registration system, which in some form existed in all planned economies. Under the system each individual is registered as a resident of a particular locality and classified as “agricultural” or “non-agricultural”. The problem with the registration system is that the recorded place of residence may be different from the actual and does not automatically change with migration<sup>2</sup>, even after a long period. Changes in the usual place of residence in the household register remains subject to official discretion and do not reflect population movement. In both countries, the result is a large number of individuals living and working over a long period in a locality other than the one recorded as the place of residence in the household register and thus treated as “outsiders”. These individuals constitute a heterogeneous group. They differ in the length of stay and their official status. A percentage of them hold temporary registration, which gives them the right to stay but not the full status of a

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<sup>2</sup> In both China and Vietnam six months is the dividing line between “visitors” and “migrants”.

permanent resident. But many remain unregistered and subsist at the margins of the society and the economy. Depending on their official status and socio-economic position, the migrants are caught in a web of disadvantages, which particularly affect low-income migrants. These disadvantages include restriction to jobs and occupations that are not attractive to local residents and, more important, limited or barred access to public facilities, such as housing and schools. The latter impedes the absorption of migrants in urban areas and creates a poverty trap, which makes it difficult for migrants to improve their social and economic position. Various forms of restrictions upon migrants' children's access to schools are particularly objectionable because these perpetuate the disadvantageous position of migrants across generations.

In recent years in China, population and labour migration have increasingly come to be seen as permanent and irreversible, instead of as transitory movements. The policy focus has shifted away from encouraging the outflow of labour from farming without out-migration to cities via the development of rural industry, or town and village enterprises (TVEs). The objective of the current policy is the promotion of urbanisation, with special emphasis on the development of small and medium-size towns. Migration to small or medium size towns has been freed in the sense that migrants can obtain a change of status and thus treated as permanent residents. Moreover, the last few years have also seen the introduction of assisted migration out of rural localities with little or no prospect of emerging out of poverty. Further, the household registration system that has been the principal instrument for controlling migration is undergoing a radical transformation and looks likely to disappear as an instrument of migration control in most of the country except perhaps in some major cities. This will put an end to the inequitable status division between urban and rural areas that has been an abiding feature of Chinese society since the early 1950s and bring to the fore the issue of the integration of rural migrants in the urban population. The ongoing changes in the household registration system are long overdue and reflect the widespread recognition that labour and population migration is an integral part of the process of economic development.

## **2.2. Underdevelopment in Mongolia**

Since embarking on a transition path towards a market economy in 1990, Mongolia has undergone changes that are the opposite of those observed in China and Vietnam and the exact reverse of those associated with economic development. GDP in 2001 was about the same as 12 years earlier; it fell by almost a quarter over the first four years of reform (1989-1993) and then took the subsequent eight years (1993-2001) to regain its starting level. With the urban population constituting 57% of the total, the economy in 1989 was predominantly urban, more urban than the present-day China and Vietnam. The economic crisis that accompanied the transition forced many urban people to flee to the countryside and retreat into subsistence herding. Thus paradoxically the transition to a market economy has substantially raised the number of households who mostly consume what they produce and engage in market transactions only sporadically. By 1998 the urban population percentage had dropped to 49.6%, 13 per cent lower than in 1989. Correspondingly, the composition of GDP shifted away from industry and the GDP share of agriculture more than doubled from 16% in 1989 to 33% in 2000. With a population growth rate 1.4% per year while GDP was falling, GDP per head in 2001 was 15% lower than in 1989. The end result of the first 12 or so years of the transition is not a comparatively efficient and a growing economy, as originally hoped, but an economy with a lower GDP per head and a historically high poverty rate.

### **3. Transitional Economies**

When they embarked on the transition, the planned economies shared some salient similarities and also differed in some major respects. The similarities arose from the fact that these economies were realisations of a common ideology and were in various degrees influenced by the institutional architecture of the first planned economy (the former Soviet Union (FSU)) and its experience of industrialisation. These similarities are important because they constitute the core features of the planned economies and have therefore been prime candidates for transformation during the transition. The differences at the start of the transition, which are discussed below, help to partly explain variations in the experiences of the transition.

#### **3.1. Similarities**

Looked at from the perspective of well-functioning market economies, the planned economies presented the following common features, which had been causes or symptoms of their comparatively poor performance:

1. Predominance of state-ownership and limitations on private ownership.
2. Economy-wide production planning and, correlated with it, an excessive centralisation of economic decision-making in the hands of the government.
3. Arbitrary prices and rudimentary or non-existent market infrastructure
4. Pervasive shortages of goods and, associated with it, rationing (including queues) and a limited range of goods.
5. Soft budget constraint whereby enterprises continued operating and investing regardless of profit or loss.
6. Absence of labour lay-offs, low labour mobility and a compressed wage structure.

Leaving aside goods and services that are of social and political concern, such as education and policing, much of the evidence from market economies shows that private enterprises<sup>3</sup> are on average more efficient than are state-owned enterprises (SOEs). However, the reason is not that private enterprises are intrinsically more efficient than SOEs, but that in general private enterprises are more likely to operate under conditions that are conducive to efficiency. These include, compared with SOEs,

- greater exposure to competition;
- harder budget constraint implying higher sensitivity to profit and loss in operation and choice of investment because of greater difficulty in covering losses;
- relatively free of the political pressure to pursue objectives that detract from efficiency such as maintaining a larger than required number of employees or charging a low price.

The implication is that the comparative efficiency of private enterprises depends crucially on the environment in which they operate not on the form of ownership as such. They can be as inefficient as SOEs when the above conditions are not satisfied. Market economies provide numerous examples of inefficient private enterprises when sheltered from competition. Evidence that a change to private ownership does not automatically result in greater efficiency is provided by the mass

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<sup>3</sup> "Private enterprises" is understood to cover a diverse range, including owner-managed enterprises, companies managed by salaried employees with equity held by individuals or institutions, partnerships and cooperatives.

privatisation in Russia, which quickly created private enterprises but no more efficient than the SOEs they were suppose to surpass in efficiency. The policy implication is that the governments need to introduce measures conducive to efficiency, as well transforming the ownership of enterprises.

It is generally accepted that the complementary combination of economy-wide production planning, the predominance of state ownership and the concentration of economic decision-making in the hands of the government was responsible for much of inefficiency in planned economies. The problem lay not with planning as such but its economy-wide coverage. This forced planning in planned economies to be based on insufficient and unreliable information. Planning is common in market economies, but the difference is that it is local: limited to the activities of the firm making the plan and largely based on information it collects during the course of its activities. An essential component of the transition is a decentralisation of economic decision making mainly from the government to enterprises. This is comparatively easy to achieve and has usually been among the first policy measures in the transition. The eventual outcome of the transfer of the decision-making is a complete phasing-out of economy-wide production planning.

As for the transformation of the ownership pattern inherited from the planned economy period, privatisation is an inappropriate term to describe the transformation because the alternatives to the state ownership of the type prevalent in planned economies cover a broad range. Ownership patterns vary across market economies and a variety of ownership forms are compatible with efficiency. Broadly, there are two ways of transforming the ownership structure in transitional economies: first, the transformation of the ownership of existing enterprises through privatisation and corporatisation and, second, the emergence of new enterprises with an ownership structure different from the traditional state ownership. Although the first has received much attention in the large literature on privatisation in EE and FSU, the second is as important and has played a crucial role in economies where the transition has proceeded in tandem with economic growth, such as China and Poland. Ownership transformation and decentralisation of economic decision-making are not ends but means to enhance efficiency and stimulate growth and whether or not they actually have these effect depends crucially on an effective framework for good “corporate governance”, which strikes a balance between allowing managers to take initiatives conducive to efficiency and preventing them from misusing their authority for their own gain. The risk of such misuse is greater in transitional economies where managers may acquire greater decision-making power before checks against misuse, such as independent accounting and auditing, are fully in place. To a greater or lesser degree every transitional economy provides examples of such misuse. Also important is a system of regulation to keep in check monopoly and other forms of market power, which most of the transitional economies have yet to introduce.

During their planning phase, the transitional economies did have a price system in the sense that most goods had a price and money was used as the medium of accounting and exchange. Restricted markets existed for consumer goods and, except in some planned economies, also for labour. But producer goods were allocated by the government not by the market. The system differed from that in market economies in two fundamental respects. First, apart from a few used for small transactions, all prices were set by government agencies and buyers and sellers had no role in the process. The prices of consumer goods regarded as essential, housing and public utilities were set very low<sup>4</sup> and prices of other commodities were, in

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<sup>4</sup> Low has to be understood “relative to the average income”.

principle, fixed so as to cover production cost and a mark-up. But, as prices, once set, stayed fixed for long periods despite changes in production costs, the principle remained far from fully realised. Second, paying the set price was not sufficient to obtain the good. Many consumer goods were rationed; a licence or a ration ticket as well as money was needed to purchase many goods<sup>5</sup>. Even when not rationed, consumer goods could not be purchased easily; queues to purchase goods were a common sight in many planned economies. Similarly, the allocated quantities of producer goods often fell short of what enterprises wanted. The other side of queues to purchase consumer goods was households having more cash than they would have if goods were easily available. This excess cash would later become a source of inflation during price liberalisation as part of the transition.

Thus pervasive shortages of goods and a limited range and comparatively poor quality were characteristic features of planned economies. Consumers had little option but to accept the goods on offer. This is the exact opposite of the situation in well-functioning market economies where buyers can purchase additional quantities of most commodities at the going prices and sellers are eager to sell. Compared with market economies another feature of planned economies was an underdeveloped commercial sector with fewer shops and less consumer friendly. There were two reasons for this, first, shortages, which made it unnecessary to cater to the convenience of buyers, and, second, the ideological bias against commerce on the grounds of being an unproductive activity. As a result, all transitional economies started off with a smaller services sector than those in comparable market economies.

The justification for underpricing essential consumer goods was that this helped to ensure that everyone had at least the basic necessities of life. How convincing is this justification? Paradoxically, the underpricing (or subsidisation) of necessities has a stronger justification in a market than in a planned economy. In the former, household incomes are determined by factors over which the government has little or no control, such as wage and salary rates and the unemployment rate. Given such a situation, the cost effective way of ensuring each household can afford the basic necessities is to pay a cash allowance equal to the difference between the cost of the necessities and actual household income. However, this is only feasible if the government can ascertain household incomes reliably without incurring a huge cost. In case this is not possible, the next best alternative is to subsidise the prices of selected necessities and ration the quantity each individual or household can purchase, which is the usual form of rationing. But this justification cannot be valid for a planned economy in which the government determines wages and salaries and transfer payments, and can therefore ascertain household incomes comparatively easily. The case for the underpricing of necessities is further weakened by two common phenomena in planned economies. First, at least some of the underpriced necessities were not always available. A notable example of this was urban housing, which was heavily subsidised but only available after a long wait. In the interim, households had to endure poor and crowded housing. A low price is of no help to low-income households if the good is not available. Second, the low prices charged for food items in urban areas were partially passed on as low purchasing prices to farmers, who on average had a much lower average income than urban inhabitants, as in China, for example. However, there is a strong case on social welfare grounds for supplying rations of basic necessities at low prices during the process of price liberalisation, which in almost all transitional economies has been accompanied by high to hyper inflation.

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<sup>5</sup> In China until the first half of the 1980s many of the daily consumer goods were rationed. These included grain, cooking oil, meat, eggs and cotton cloth.

In a market economy the price system is the key determinant of the profit/loss balance sheet, which in turn determines the behaviour of enterprises (including what and how much to produce) and ultimately their survival and closure. Given competitive conditions, the role of the price system in guiding enterprises and in selecting them for survival or closure serves as the engine of improvement in efficiency and of innovations. In contrast, in planned economies the profit/loss balance sheet generated by government-set prices, given their arbitrariness, were of little or no value in the assessment of enterprise performance or in deciding on survival or closure. Once established, enterprises in planned economies were kept operating even when making a loss continuously. The other side of the immortality of enterprises was the absence of labour lay-offs even when the enterprise had a surplus of employees. An associated phenomenon was lifetime employment: i.e. most employees had the option of keeping their existing job for life. The twin combination of arbitrary prices and the soft budget constraint in planned economies impeded incentives to raise efficiency. Thus, in addition to the decentralisation of economic decision-making and a transformation of the ownership structure, the two essential components of the transition have been:

- Price liberalisation, which, with some exceptions, consists in the transfer of the power to set prices from the government to the buyers and sellers of commodities. The exceptions concern those goods whose prices have to be regulated because of monopoly and other market imperfections.
- Hardening the budget constraint facing enterprises so that profit/loss balance sheet becomes the key factor in decisions concerning current operation, investment and ultimately survival.

Both these pose hard choices for the governments of transitional economies. In practice, price liberalisation in transitional economies has not been a simple process of adjustment in relative prices: a rise in the prices of “under-priced” goods, many of which are necessities, and a reduction in the prices of “over-priced” goods, many of which are consumer durables. Such a relative price change affects low-income households adversely and high-income households favourably. But this is in part compensated for by an easy availability of goods and an end to queuing. In all transitional economies, because of the “excess cash” in the hands of households, the adjustment of relative prices has been accompanied by a surge in inflation, in many with the inflation rates well in excess of 100% lasting over several years. Moreover and most consequential, with a few notable exceptions, price liberalisation also went together with a sharp fall in production, which further fuelled inflation. Among the notable exceptions are China and Vietnam, which went through price liberalisation with economic growth, though both experienced inflation. In the transitional economies experiencing a substantial output decline, price liberalisation has been associated with a widening in economic inequality and a sharp increase in the poverty rate. The reason is that the impact of output decline was not evenly spread across the whole population but heavily concentrated on one section.

Similar to price liberalisation, the hardening of the budget constraint facing enterprises has had an adverse impact on economic inequality and poverty. Given the soft budget constraint in the planning period, many enterprises entered the transitional period with a much larger labour force than needed. As a consequence, one reaction of enterprises to a hardening of the budget constraint was to reduce their labour forces and the reaction was further amplified in case of a reduction in output. The overall impact of the transition on employment depended crucially on whether the economy was growing and creating new jobs so as to at least partially offset the job losses in state-owned enterprises inherited from the planning period,

most of which were state-owned. In EE and parts of the FSU, except Poland and Slovenia, all economies experienced a negative growth rate over the 10 years from 1989 and 1998. The same is true of Mongolia. As in market economies, the cost of unemployment in transitional economies has fallen heavily on a comparatively small section of the labour force.

The market for labour existed in all economies of EE and FSU when they embarked on the transition. Then most of these economies had low or negligible open unemployment, which the governments set out to eliminate. However, disguised unemployment was common and substantial. That is, many enterprises and employment units could shed a significant percentage of their employees while maintaining the current level of activity, as they later did during the course of the transition. The situation in labour surplus economies such as China and Vietnam was different. There an overwhelming majority of the labour force was in rural areas and excluded from the labour market through strict control on migration. Wage employment was largely confined to the small percentage of the labour force in urban areas. Open unemployment in urban areas was kept low by a mixture of strict control of rural-to-urban migration and also disguised unemployment. Those fortunate enough to be urban residents had lifetime job security, a security that would later disappear during the course of the transition. As it were the planned economies maintained low or negligible open unemployment at the cost of substantial disguised unemployment<sup>6</sup> and a low average wage. Although committed to high employment, planned economies failed to make use of some major opportunities for wage or self-employment because of biases of their economic ideology. Two of these were particularly consequential. One was the bias against private enterprises, including small-scale household enterprises, which kept their numbers small and confined them to particular branches of economic activity. The other was the denigration of services, including commerce, as unproductive activities; hence their stunted development in planned economies. The impact of these biases can be gauged from the fact that in the same economies during their transitional phase private enterprises in the services sector have been the most important source of new jobs.

As with goods prices, the government determined wages and salaries centrally, though enterprises had some discretion to vary set wages. Labour remuneration in planned economies had two notable features. First, compared with market economies, differences in cash wages of various grades of workers were very low, as was the average wage rate. In particular, the gap between the average wage of the highest and of the lowest grade was very narrow compared to those in market economies. Second a substantial percentage of labour remuneration was in the form of a broad range of benefits in kind, the most valuable of which was heavily subsidised housing. Besides, social security benefits such as old-age pension, healthcare and disability compensation were administered by enterprises. This included record keeping, payment of benefits and provision of medical care. The benefits in kind and enterprise-based social security tied workers to their employment unit and acted as impediments to labour mobility. A radical reform of the labour market has been high on the transition agenda and has generally consisted of the following:

- End to lifetime job guarantee, which has resulted in a reduction in disguised unemployment and a corresponding increase in open unemployment.
- Decentralisation of wage determination, which has led to an increase in wage inequality.

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<sup>6</sup> It is important to emphasise that open unemployment is not equivalent to disguised unemployment. The conversion of the latter is invariably accompanied with an increase in economic inequality.

- Sharp reduction in labour remuneration in kind, principally as a result of the phasing out of subsidised housing.
- Transfer of the administration of social security schemes from employment units to a specialised social security organisation, and the modification of the social safety net to taken account of open unemployment.
- In China and Vietnam, the economies with a large surplus of labour in farming, the transition has proceeded with a lowering of impediments to rural-to-urban migration.

What has been the net impact of the labour market reforms during the transition on income inequality and the incidence of poverty? As far as income inequality is concerned, this has risen in all transitional economies without exception. Focusing on urban areas, the principal causes have been the following three. One is the widening of differences between the wages of manual workers and those skilled workers and professional employees. The second is the lay-offs in the state sector of the employees surplus to requirements. During the planned economy phased these employees would have remained on the payroll of the employment unit, but after the labour reform they would receive no more than unemployment benefit or poverty relief, less than either the wage rate in employment or the minimum wage. If we regard disguised unemployment (or lifetime employment) during the planning period as equivalent to a very generous unemployment insurance then the change consists in a substantial reduction of unemployment benefit. The third is the appearance of personal income from property, which was insignificant during the planning period. The picture of the incidence of poverty is mixed. In EE and FSU almost without exception the poverty rate rose, sharply in some, following the start of the transition and remains higher than it was during the planning period. The principal cause has been the sharp fall in GDP and the subsequent rise in unemployment that accompanied the transition, which in many economies of EE and FSU remains yet to be fully reversed. Most of the new poor in these economies have been urban citizens. In contrast, the transition in China and Vietnam has been accompanied with a dramatic fall in poverty, almost all of it in rural areas. The reform of the state sector in both these economies has gone together with a rise in urban unemployment, which is partially mitigated by the creation of jobs as a result as a result of a high GDP growth rate.

### **3.2. Differences**

Although the items on reform agenda are very similar across transitional economies, the sequence, the strategy and the pace of reforms differ widely across the transitional economies, as do the outcomes over the 14 or so years since 1989. These differences can be explained in terms of various factors, which can be grouped as follows:

- Structure of the planned economy (the initial conditions)
- Transition strategy: the nature, speed and sequence of reforms
- Political conditions.

Under the first heading, the following three features have been of special importance in influencing the transition path taken by an economy:

- Sectoral division of GDP and of the labour force, particularly between industry and agriculture.
- Form of planning.
- Pattern of external economic relations

The importance of the first consists in the fact that a large GDP and employment share of agriculture went together with significant differences between the organisation of the rural economy and the urban industrial economy, as for example in the planned economies of China and Vietnam. In these economies, whereas the urban industrial economy was more or less completely governed by planning, the rural economy was largely occupied with subsistence production. Its relation to planning was limited, largely confined to the delivery of a quota of agricultural produce, mostly grain, at government-set prices. Such differences made it possible to separate the transformation of the rural-agricultural economy from that of the urban industrial economy, as has happened in China and Vietnam.

There are two features of planning that have been particularly relevant for determining the transition path. These are, first, the scope of planning and, second, the degree of centralisation or decentralisation. In respect to these two features, China and the FSU provide extreme examples. In the FSU planning was comprehensive and centralised. All but a few productive activities were controlled by the plan and most of the details of the economic plans were decided at the centre. The FSU economy went for a high degree of regional specialisation, with each regional economy heavily dependent on goods produced in other regions. In contrast, the Chinese planning was highly selective; the plans covered a comparatively small number of commodities regarded as essential. The economy consisted of loosely connected regional economies, each self-sufficient in a wide range of agricultural and industrial commodities and many decisions concerning production were made at the sub-national level. This pattern, which still survives in a modified form, was associated with the duplication of industries, some of which was highly wasteful. But it gave the economy resilience against shocks. That is, disruption in one region had little or no impact on other regions. It also made it possible to try out reforms in selected localities without disrupting the whole economy, which has been the hallmark of the transition in the Chinese economy. The Soviet planned economy avoided the wasteful duplication of the Chinese planned economy, but it was premised on a close coordination between enterprises and regions which made it highly sensitive to shocks. Disruption in one region or even one factory affected the whole economy. The over-specialisation and integration of the planned economy magnified the costs of the transition in terms of disruptions.

As for external events and shocks, for many of the transitional economies the most consequential were two, first, the break-up of the Former Soviet Union (FSU) and, second, the collapse of COMECON<sup>7</sup>, the trade and economic cooperation alliance between the FSU, EE and some other economies. Mongolia and Vietnam were particularly seriously affected by these two events because of their close economic ties with the FSU and EE. But China, which was not a member of COMECON, remained unaffected. In Mongolia assistance from the Soviet Union, which at its height accounted for almost one third of Mongolian GDP, began declining in the 1980s and ended abruptly with the break up of the FSU in 1990-91. In Vietnam the *doi moi*, which was initially intended as a package of reforms to improve the command economy, later on transformed into a full-scale transition to a market economy. This transformation was in part hastened by economic changes in EE and FSU in the late 1980s that culminated into the collapse of COMECON and the FSU. Up to the end of the end of the 1980s, all but a small percentage of Vietnam's foreign trade was with the FSU and EE. In contrast, external factors seemed to have played a comparatively minor role in the dynamics of the Chinese reforms, which have been mostly driven by internal factors.

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<sup>7</sup> Same as CMEA: the Council of Mutual Economic Assistance.

The transition is not only an economic but also a political process because the planned economy is founded on a political ideology, socialism. In EE, FSU and Mongolia the transition to a market economy was triggered by a change in the political regime, a change that has varied in form and outcome across countries. In some countries of EE, such as Poland, Hungary and the former Czechoslovakia, there was a smooth changeover from the old to a new multi-party political regime. As important, the state apparatus remained intact and in functioning order and was available for use by the new political regime. In contrast, the regime change in the FSU was a long drawn-out process accompanied by the disintegration of the Union and a weakening of the state apparatus in Russia and other constituent republics of the FSU. Progress in the transition has been comparatively rapid in those countries where the political change has been orderly and the state apparatus has continued to function, which points to the importance of political stability. It has been slow in those countries where the political change has created an institutional vacuum and has increased uncertainty about the future.

In contrast to EE and FSU, in both China and Vietnam the transition to a market economy has been taking place without any fundamental change in the political structure. In both countries, the Communist Party retains its leadership role in politics and society. However, both countries have experienced far-reaching political change in the form of the acceptance of a market economy and the shift of emphasis away from state control and exclusive reliance on public ownership of means of production to diverse forms of economic organisation and of property. This calls into question the once widely held assumption that the transition from a planned to a well-functioning market economy is neither possible in a piecemeal fashion nor without a complete transformation of the political regime.

### **3.3. Transition Strategies and Assessment**

Following the collapse of Communist regimes in EE and FSU, many of the economies in the group opted for the transition to a market economy in one great leap. In early 1990s this strategy was generally commended by outside observers and Western economists. During a visit to Vietnam in 1995 the then US Secretary of State advised the Vietnamese to “look at economic reform as a passage over a ravine” and went on to suggest “You cannot do it by taking several little steps; only one giant leap will get you across.” Vietnam apparently did not accept the advice and, like China, persisted with the strategy of piecemeal reforms while retaining features of the planned economy. In the two economies the transition started with piecemeal reforms focused mainly on agriculture with the initial aim of improving the performance of the planned economy. It was the unexpected success of these piecemeal reforms that prompted the leadership to widen the scope of the reforms. Building a market economy became the explicit policy goal only in the 1990s, more than a decade after the start of the first round of reforms. In Mongolia, the transition was set in motion in 1990 by the twin shocks of the dissolution of close economic links with the FSU followed by the break up of the FSU itself, which triggered a change in the political regime in the country. In contrast to China and Vietnam, Mongolia went for a total transformation of the economy in one giant leap.

In the literature on EE & FSU the common wisdom has been that grafting elements of a market economy to the planned economy would not only fail to deal with the fundamental problems of the latter but also create new problems. There are three arguments in favour of the total reform – the transition in one leap.

- Interdependence or complementarity: the success of reform in one area depends crucially on complementary reform in other areas. For example, the privatisation of enterprises and a hardening of the budget constraint may fail to enhance efficiency without a rationalisation of prices.
- Reversibility: Piecemeal reforms run a greater risk of being reversed than do comprehensive reforms.
- Adverse Effects: Piecemeal reforms may create vested interest in the maintenance of the partially reformed structure.

The first provides the strongest argument in favour of a package of complementary reforms. However, the extent of complementarity varies between reforms and the appropriate reform package may cover only particular aspects of the transition. The second, reversibility, is not necessarily a disadvantage; outcomes of reform are uncertain and reversibility allows unsuccessful reforms to be undone or altered. The risk posed by vested interests is always high and applies as much to the stages leading to total reform as it does to step-by-step reform.

The major arguments in favour of piecemeal and step-by-step reforms include the following:

- Most major reforms have unforeseen consequences; and the step-by-step approach provides the possibility of adaptation and revision in the light of experience.
- The capacity of governments to implement reforms successfully is limited, especially in the initial stages of the transition. The piecemeal strategy provides the possibility of tailoring the reform package to the capacity of the government.
- Radical institutional changes such as the replacement of the planned with a market economy require major adaptation on the part of the population. Such adaptations require time and affects the outcome of reforms.

The above are theoretical arguments in favour of a particular reform strategy; they are not sufficient to assess a reform package. Such an assessment requires empirical details and also a detailed analysis of reforms in the following three dimensions:

- Coverage: the areas of the economy covered by the reform package
- Pace: the time it would take for the reform to be implemented
- Depth: the radicalism of the reform, the difference between the situation before and after the completion of the reform.

In terms of these dimensions, most actual reform packages do not neatly divide into two categories: “total” and “partial” reforms. Instead they present a varied range with a diverse combination of characteristics.

It is open to question how much of the transition path that an economy has followed was due to policy choice, including advice from foreign experts, and how much was due to the force of circumstances. Both factors have played some role in determining the transition path an economy happens to have followed; the split in terms of relative importance between the two varies between economies and the specific policy. The force of circumstances seems to have been the decisive factor in policies to control high or hyperinflation rates, which Vietnam faced between 1987 and 1991 and Mongolia between 1990 and 1993. In such situations, speed is an essential condition for policy effectiveness; and a gradual and piecemeal policy may worsen and prolong instability. But the answer may be the reverse when it comes to

the transformation of state enterprises, including privatisation. Most, if not all, of the transition economies have had at least some choice between the strategies of transforming the institutions of the planned economy and of creating new institutions. Mass and quick privatisation of state enterprises as carried out in Russia and the Czech Republic, and of animal herds and pastures in Mongolia, was due mostly to a deliberate choice. Some observers argue that there were other alternatives to quick mass privatisation, such as a reorganisation of enterprises prior to their privatisation, as Poland did for example.

How should one assess the transition in an economy? There are two approaches to an assessment and these are complementary rather than alternatives. One approach is in terms of the principal requirements of the conversion of planned economy into a market economy. To select a few, these include:

- Privatisation or the transformation of the ownership of enterprises.
- Price liberalisation: leaving markets to determine prices.
- Transfer of economic decision making from the government to enterprises or individuals.

Indices such as these are used by the European Bank (EBRD) to assess progress in the transitional economies of EE. Although valuable in focusing attention on the steps that need to be taken, they suffer two major limitations: first, the approach tends to neglect performance such as the growth rate and, second, it completely overlooks the aspects that concern the welfare and well-being of the population. Thus the second approach oriented towards economic performance and welfare uses indices such as the following for an assessment:

- Growth rates of GDP and GDP per capita
- Inflation rate
- Changes in economic inequality
- Incidence of poverty and unemployment

The two approaches give very different answers. For example, several economies do well in terms the first group of indices but poorly in terms of the second. Russia provides a particularly clear example of such a contrast.

### **Mongolian Experience of the Transition**

As parts of one grand policy package, commodity prices were rapidly liberalised; the exchange rate was left to be determined by market forces; restrictions on international trade and flows of foreign capital were abruptly lifted; state owned enterprises were privatised, initially by a free distribution of vouchers to the entire population and later through direct sales to domestic and foreign buyers; and the size of government activities was greatly reduced. Most consequential of the measures, the animal herds and the pastures that formed the foundation of the rural economy were at one stroke privatised, which created massive inequalities, on the one hand, and cut the ground from underneath the traditional systems of insurance against natural hazards and for ensuring the sustainability of pastures.

The interesting question is, why did the division of land and assets among rural households, which brought dramatically beneficial results in China and Vietnam, turn out to be a disaster in Mongolia? The division of herds and pastures in Mongolia was not carried out in isolation but simultaneously with a complete price liberalisation. This produced a set of relative prices that suddenly made a substantial part of the industrial urban sector unprofitable. Given the absence of a social safety net, letting such enterprises go bankrupt forced large numbers of unemployed workers to flee to the countryside to find succour in subsistence herding, which became a reservoir of the poor while meanwhile the ecological balance between the number of animals and the sustainability of pastures was disrupted.

The high human cost of the first decade or so of the transition in Mongolia raises the question of how far it was due to the avoidable decision to implement all major reforms quickly and simultaneously. Given their crucial importance to the Mongolian economy, the stoppage of financial assistance from the FSU and the collapse of the COMECON would have had a large adverse impact on the economy, regardless of the transition strategy. The shock was similar to that to the Vietnamese economy. A substantial reduction in government expenditure, including subsidies, a severe downturn in exports oriented industries and a sharp depreciation in the exchange rate and thus a high inflation were to a degree unavoidable. But the wholesale privatisation through the distribution of vouchers and the abrupt opening of the economy to international trade were not only unnecessary but also added to the disarray in the economy.

#### **4. Lessons from the experiences of transition**

The collapse of economy-wide planning reaffirms the efficacy of markets over central planning in supplying products, satisfying a wide range of wants and in promoting technical progress. However, the first decade and half of the transition has also brought out the limitations of price liberalisation and privatisation in restructuring state enterprises and generating momentum for recovery and eventually growth. The actual experiences of the transition have diverged markedly from the vision that was vigorously promoted in the 1990s by international financial organisations and many Western economists. This vision has been labelled as the “Washington Consensus” by Joseph Stiglitz, Nobel laureate in economics and ex-Chief economist of the World Bank. The consensus rests on the following three policy prescriptions:

- Macroeconomic stabilisation through a tight monetary (or bank credit) policy and a balanced government budget
- Swift and comprehensive price liberalisation
- Quick and complete privatisation of state enterprises

Of the above three, arguably the first has been necessary and also successful in bringing under control high rates of inflation, which a number of transitional economies, including Vietnam and Mongolia, experienced during the initial stages of the transition. But the experiences of the transition over 15 or so years cast serious doubts on the benefits claimed for the last two and generally for the transition in one big leap.

One of the two major surprises of the experiences of the transition has been a massive fall in GDP following a quick price liberalisation and a stringent macroeconomic stabilisation in EE, FSU and Mongolia. In a number of these economies, the falls ranged between 25 to 75%. Historically falls of such magnitude have not been experienced since the Great Depression of the 1930s the Second World War. Further, many of the economies have yet to resume positive growth and remained stuck with a GDP far lower than the level they had in 1989. These adverse outcomes raise two questions: first, why were the output falls so huge and, second, why have the affected economies been so slow or unable to achieve positive growth? Price liberalisation had two aims first, to soak up excess cash carried over from the planning period and, second, to change relative prices in the form of some prices rising more than others. The second was supposed to lead to increased efficiency through a reallocation of resources between industries and enterprises. Both aims were justified. However, what was overlooked was the disruptive impact of price liberalisation on the supply network between enterprises and a rise in uncertainty about the future. These would lead enterprises to reduce output and postpone investment. As it turned out, these two negative effects far outweighed any positive effect of the relative price change. For example, in Mongolia the rapid price liberalisation rendered many of the enterprises unprofitable without giving them any time to adapt. But, contrary to the hopes, it did not succeed in encouraging extra output from the enterprises which, in principle, gained from the price liberalisation. In fact, almost all enterprises sharply reduced output, including those benefiting from the relative price change. As for the delay in achieving positive growth, a plausible explanation is that the initial fall output adversely affected the emergence of new institutions and prompted enterprises and households to adopt defensive strategies that have prolonged the initial decline in output.

The other side of the surprise at the magnitude of the fall in GDP and the length of time it has persisted is that the initial visions of the transition grossly underestimated the adverse impact of the recommended transition strategies on poverty and economic inequality. The rise in poverty due to unemployment and the breakdown of mechanisms of income support and the increase in economic inequality in most of the transitional economies have far exceeded what was expected. China and Vietnam stand out as the only transitional economies which now have a substantially lower poverty rate than they did when they embarked on the transition. However, both have experienced a sharp rise in equality. The human cost of the transition has to be taken seriously because it is not only important in its own right but also it has an impact on efficiency.

The other major surprise of the experiences of the transition has been the disappointing impact of rapid and mass privatisation in improving the efficiency of state enterprises. Economists who advocated a rapid privatisation believed that private property rights alone would provide incentives to create the legal foundations and institutions required for a vibrant market economy. What this perspective overlooks is that the dynamism of a market economy depends crucially on competition, on the one hand, and good corporate governance. In the absence of competition, private enterprises can be content to be inefficient monopolists. With the hindsight of more than

a decade long experience of the transition, it is widely accepted that privatising state-owned enterprises by itself does not lead to enterprise governance conducive to efficiency. Such governance requires prudential regulation and a mechanism for the oversight of managers. In cases where the privatised enterprises are shareholding companies, an institutional arrangement for protecting the rights of minority shareholders is also needed. None of these and other requisites of good governance automatically follow from private ownership. Sometimes these have to be created in the face of opposition from principal owners of privatised enterprises.

## **Annex 1**

### **A Case Study in Transition - China**

Given the remarkable performance of the Chinese economy since 1978 (when the reforms started), it is instructive to examine the Chinese experience of the transition in terms of answers to the following three questions:

- In what respects have the Chinese reforms succeeded?
- What are the principal causes of their success?
- What are the main items on the list of necessary reforms?

#### **1 Success of the Reforms**

Taking a well-functioning market economy as their eventual goal, the Chinese economic reforms have succeeded on the following four counts:

- Rapid economic growth with a reasonable degree of macroeconomic stability;
- Large and sustained improvement in the living standard of the population;
- Dramatic rise in foreign trade and inward foreign investment;
- Structural transformation of the economy.

The first three are indices of economic performance and the fourth is the index of the shift from a command to a market economy. The first three are discussed below and the fourth is discussed together with the causes of success in Section 2.

#### **Economic Growth**

In the 24 years from 1978 to 2002 Chinese GDP has grown by around 9.3% per year and the 2003 rate is estimated to be hefty 8.8%. Given the annual population growth rate of around 1% over the period, the annual growth rate of per capita income comes to around massive 8%, which means that it has since 1978 risen six-fold. These statistics suffer from problems such as inadequate adjustment for inflation and exaggeration, which give grounds to suspect an upward bias. Nevertheless, even if revised downwards, the post-1978 growth would still stand out in comparison to the following:

- the growth in the pre-1978 period, which was not low;
- the growth rates in other populous developing economies such as India;
- a sharp fall in GDP in and FSU and a slow resumption of positive growth.

To illustrate the implication of the third, in 1989 China's GDP was less than half that of Russia, ten years' later in 1999 it was more than double.

The rapid growth rate of the Chinese economy raises the question of how it has managed to grow so rapidly despite its semi-reformed structure? There is little doubt that the Chinese economy is some way off from being a well-functioning market economy; the soft budget constraint is still common, the banking system is laden with non-performing debt, the financial markets have yet to develop fully and government intervention, although diminished, remains pervasive. However, rapid growth in an economy with such ills appears puzzling only if China is compared with the transitional economies of EE and FSU where their elimination has generally been assumed to be a precondition for the resumption of growth. But it does not when China is compared with East Asian economies. Neither South Korea nor Taiwan was free of these ills when they were growing at very high rates. In East Asia, and in many of today's developed market economies in the past, a well-functioning market economy, instead of

preceding, has followed a period of rapid growth and even that gradually. The argument is that the relationship between a well-functioning market economy and growth depends crucially on the stage of development. A well-functioning market economy may be necessary for growth when that is completely driven by improvements in technology, as in developed economies, but not in developing economies where shift of labour and capital from low-productivity to high productivity sectors and "catching-up" may be sufficient to propel growth for sometime. There has been a two-way relationship between the economic reforms and economic growth. The reforms have contributed to the acceleration of the growth rate since 1978 by adopting the "open door policy" and creating conditions for the proliferation of new enterprises, both of which have raised the efficiency of investment. The rapid growth has, in turn, facilitated the reform process in two ways, first, by creating a strong constituency in favour of reforms, second, by making it easier for the government to partially compensate losers from reforms.

Another question of interest is, whether the Chinese economy would in the near future (say over the next 10 or 20 years) maintain a growth rate similar to the average rate since 1978? One way of answering the question is to examine whether the causes of the rapid growth up to 2003 are likely to persist and what the barriers to a rapid growth in the near future might be. One point is clear: the rapid growth from 1978 to 2003 has lasted too long to be explained away simply in terms of contingent circumstances. The three part combination of a high savings rate, a steady shift of surplus labour out of agriculture and reforms conducive to "catching-up" with best-practice technology and organization would seem to be sufficient to sustain a high growth rate in the near future as they have since 1978 been. The likely barriers to a rapid growth in the short-run would be spiralling inflation and an unsustainable balance of payments deficit. Inflation has been a major problem since 1980, but it is important to point out that inflationary spirals have set in only at growth rates of between 10 to 14%. Moreover, the inflation rate has been very low over the last five or so years. Thanks to the rapid growth of exports, massive inflow of foreign capital (discussed below) and now huge foreign exchange reserves, a balance of payments deficit no longer poses a significant problem. The implication is that neither inflation nor the balance of payments is likely to be a constraint on a high growth rate in the near future.

### **Rise in Living Standard & Reduction in Poverty**

Breaking from the pattern in the two decades up to 1978 of a very slow rise in the consumption level interspersed by a deadly famine in 1959-61, the economic reforms have brought a large and sustained rise in the living standards of both the urban and rural population. Measured in terms of per capita personal income, the living standard has risen five-fold between 1978 and 2002. In the first eight years of the reform period (1978-86) alone, the rise equalled that in the 26 years between 1952-1978. The losers from the reforms in the absolute sense would appear to be few, if any. The large and sustained rise in per capita consumption has been accompanied and helped by a declining fertility rate, which began in the early 1970s.

The reform period has seen a massive reduction in the poverty-stricken population. The official headcount of the rural poor dropped from about 250 millions in 1978 to 125 millions in 1985. A notable feature of this reduction was that it was due entirely to the acceleration in the economic growth rate caused by the replacement of collective by household farming and the proliferation of rural enterprises. Little of the reduction can be directly attributed to poverty alleviation policies. In the subsequent 7 years from 1985 and 1992 the poor headcount dropped by another 45 million taking the total down to 80 million (8.8% of the rural population)<sup>8</sup>. By the beginning of the 1990s, poverty decline, although still continuing, had slowed down substantially. It was becoming apparent that economic growth alone was not sufficient to sustain the downward trend in the poor headcount. Notwithstanding the dramatic reduction in poverty, rural poverty is far from eliminated. Further, with the rising

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<sup>8</sup> The poverty on which these figures are based is reckoned to be too low. Using a higher poverty line raises the numbers below the poverty line but does not affect the downward trend.

urbanisation rate and labour lay-offs in the state sector, urban poverty has emerged as a significant problem.

The steep reduction in rural poverty and, by international standards, a low incidence of urban poverty over much of the reform period has depended crucially on the following three features:

- all rural households having a claim to a parcel of collectively-owned land, which is equivalent to an income-maintenance scheme;
- the growth of non-agricultural employment in rural areas and the easing of restrictions on migration to cities;
- high urban wage-labour participation (amongst the highest in the world) and low unemployment rates.

But these have been losing some of their importance. Given that the cultivated land area is slightly less than a mere fifth of a hectare (0.19) per rural inhabitant the first is increasingly inadequate to generate sufficient income for rural households. Since the mid 1980s, the growth of rural incomes has depended crucially on the expansion of non-agricultural employment in rural areas, but that has slowed down sharply since the second half of the 1990s. Rural-to-urban migration, the other source of non-agricultural employment, has risen sharply since the early 1990s; but it is still impeded by the rules and regulation carried over from the planning period. More important, these rules and regulation hinder the integration of migrants in urban areas. The result is a growing numbers of people in urban areas who are in various degrees disadvantaged by virtue of their status as migrants. Finally, the third has eroded in recent years because of a rise in urban unemployment due to the retrenchment of surplus labour in the state sector. The implication, which has been evident for some time, is that to maintain the trend of poverty reduction the Chinese economy has to create enough jobs in the non-state sector so as to absorb laid-off workers from the state sector and new entrants to the labour force, as well as progressively reduce surplus labour in farming.

### **Open-door policy**

As remarkable as the rapid growth of its GDP, has been the opening wide of the Chinese economy to international trade and foreign capital flows. From 1978 to 2002 Chinese exports (in dollar terms) have grown at annual rate of 16%, lifting the ratio of exports to GDP ratio from less than 5% to around 26%. The pattern of increase in imports has been similar to that of exports. With the ratio of exports and imports to GDP equal to 49%, the Chinese economy is more open to international markets than are the Japanese and the US economies, though obviously still not in terms of tariff and non-tariff barriers to international trade. Such wide exposure to international commodity markets has three facets. The first is providing access to a wide range of technologies in the form of machinery, plants and production goods. Second, it signifies that Chinese enterprises face a high competitive pressure in both the domestic and foreign markets.

Third, it has narrowed the divergence between domestic and international prices and has therefore had the same effect as price liberalisation. In parallel with foreign trade, inward foreign direct investment (FDI) has risen sharply; the inflow between 1979 and 2002 totalled \$446 billion. Around 95.7% of this (\$427billion) flowed in 1991 to 2002, after 12 years' of economic reform when a market economy as the goal of economic reforms was widely accepted. Over the 3 years from 2001 to 2003, China displaced US as the largest destination of FDI in the world. There is a two-way relationship between market-oriented reforms and FDI. Significant and sustained inflows of FDI depend crucially on progress in instituting the basic structure of a market economy, and can therefore be regarded as an important index of such progress. On the other hand, FDI directly contributes to the transformation of the economy inherited from the planning period through a diversification of the ownership structure and the introduction of

management techniques and organisation conducive to efficiency. To give an idea of the impact of FDI on the economic structure, enterprises with foreign investment accounted for almost 26% of value added in Chinese industry in 2002<sup>9</sup>.

China's open-door policy, consisting of lowering impediments to imports and FDI and promoting exports, has already left deep imprints on the economy and has been a motor of reforms. Large segments of the Chinese economy are heavily dependent on international trade; and tourism and foreign-invested enterprises are a significant source of employment in urban areas, not only in Southern China but also increasingly in other coastal provinces. Loans from international organizations have been an important conduit for outside influence on the design and the course of Chinese reforms. Since 1978 some of the important reforms have been directly prompted by the aim of increasing FDI and trade. These include the acceptance of ownership forms other than the traditional state and collective ownership, the establishment of the land market, the institution of a market in foreign exchange and a reduction in the monopoly of state foreign trade companies. China's accession to the WTO in December 2001 comes with a list of stringent commitments to further lower the barriers to imports and FDI. The most consequential of these is the commitment to completely open the financial sector to foreign institutions with 5 years. This has forced the government to deal with a large problem of non-performing loans by re-capitalising state-owned commercial banks.

Thus far engagement with globalisation has brought China ample benefits, many of them immediate, and very few problems. Unlike many developing countries, China has faced no major balance of payments problem or a currency crisis. Nor has it experienced a serious foreign debt burden. It has been outstandingly successful in increasing its exports and in changing their composition away from primary (agricultural goods, minerals and oil) to manufactured goods, increasingly electronic goods. These developments strongly suggest that it is able to adapt and thrive in the face of foreign competition. Contrary to fears, thus far it has managed to meet the stringent conditions of WTO entry without any difficulty. However, the benefits of foreign trade and FDI are very unequally distributed. Guangdong province in the South-East alone accounted for 41% of total exports in 2002. Similarly, during the year almost 80% of FDI flowed to just 8 coastal provinces. The pattern is unlikely to change in the near future, which calls for a redistributive policy in favour of poorer provinces.

## **2 Causes of the Success**

The salient features that have shaped the transition in the Chinese economy can be grouped under three headings:

- Decentralisation
- The Rural Economy
- Proliferation of New Enterprises.

Each feature is crucial to an understanding of how and why China has been able to advance towards a market economy without the upheaval of the kind experienced in EE and FSU and also maintain a high growth rate. Decentralisation, in its many facets, allowed experimentation and change without massive dislocation. The very large rural sector provided both the possibilities of decentralisation and productivity growth in the early stages of transition and served as the reservoir of labour for the growth of industry and services. In turn the decentralisation and the rural economy provided the foundations for the emergence of the new, initially largely collective and increasingly private, enterprises that have been one of the principal drivers of China's growth from the mid-1980s.

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<sup>9</sup> Foreign invested enterprises include fully owned foreign enterprises and joint ventures.

## Decentralisation

The heading “decentralisation” covers the following two features of the Chinese economy at the start of the reforms that have played a crucial role in shaping the transition in the non-farm sector.

- The division of the economy into loosely connected and fairly self-contained geographical units: provinces and cities.
- The co-existence of plan and off-plan transactions.

The first gave the economy resilience against disruption and made it possible for the leadership to follow a strategy of geographically selective experimental reforms, which has been the hallmark of the transition in China. The examples include the establishment of special economic zones free of many of the controls and allowing selected coastal cities to experiment with reforms. A central feature of the decentralisation was the dispersed ownership of most of state enterprises (including control and cash-flow rights)<sup>10</sup> among sub-central governments. This was caused by two factors that gained in strength with the start of the reforms in 1979: first, the transfer of enterprise ownership from the central government to lower government tiers of cities and provinces and, second, the ability of all government tiers to undertake investment projects, including the establishment of new enterprises. The first began as early as the late 1950s and accelerated with the start of economic reforms. The second gave lower government tiers a large economic stake in the development of the local economy and encouraged entrepreneurship on the part of territorial governments. They sought out promising investment opportunities, branched into new activities and took risks. The result has been a proliferation of new public enterprises, divided into state- and collectively-owned.<sup>11</sup> Of particular importance amongst the new enterprises have been rural enterprises, which began multiplying rapidly from the 1980s.

There is one important difference between public (both state and collective) ownership at the local level and at the national level: that is competition, both actual and “yardstick<sup>12</sup>.” The typical criticism of public enterprises is that the power of taxation that a government has enables them to be inefficient because losses can be covered through revenue from taxes. Moreover, by closing markets to imports, governments can force consumers to subsidise inefficient public enterprises. These adverse features lose at least some of their force when public enterprises are established by numerous local governments, because with each aiming to promote development in their respective locality they end up with too many public enterprises. The proliferation of public enterprises diminishes the degree of protection these enterprises can enjoy. With their limited capacity to levy taxes, local governments have restricted revenue to subsidise their public enterprises. Further, though local governments in China impede the sale of products produced outside their locality, such local protection is far less effective than that provided by barriers against foreign imports. The end-result of the proliferation is product market competition, which, though imperfect, exerts discipline. Such competition has become more vigorous with the appearance of excess capacity in many industries since the second half of the 1990s. The reverse side of enterprise proliferation is a wasteful diversification at the local level and a duplication of enterprises. Many industries

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<sup>10</sup> “Control rights” cover decisions concerning the following:

- products and inputs including labour;
- terms of sale and purchase contracts;
- use of retained profit including for investment;
- internal and external structure of the enterprise;
- the capital side of the enterprise balance sheet.

“Cash flow rights” refer to the appropriation of enterprise profit.

<sup>11</sup> Collective enterprises, which can be urban or rural, are owned by lower government or quasi government tiers such as townships or villages. They differ from state-owned enterprises in that certain rules and regulations do not apply to them. In particular these include regulations concerning terms and conditions of employment.

<sup>12</sup> Yardstick competition refers to the use of the performance of successful enterprises as the benchmark for the assessment of their close competitors.

have far too numerous enterprises to be compatible with the utilisation of the economies of scale. This is particularly the case in the consumer durables and vehicles industries.

Concerning the second feature of decentralisation, compared with the FSU, in China co-ordination through the central plan had a limited remit. The implication is that decentralisation that is a central characteristic of a market economy was already present in some form in the Chinese planned economy. From the mid-1980s, the scope for off-plan transactions was greatly enlarged with the introduction of the two-track pricing system, which allowed the opening of a market track in parallel with plan-mediated transactions. The system addressed a key problem facing an economy at the beginning of the transition. That is, how to go from prevailing government-determined prices to market prices. The former are distorted and impede efficiency, but the population and enterprises are adapted to them. The latter are conducive to efficiency and growth but are not known; they have to be discovered through a process of trial and error that may last over a long period. Further, their introduction may involve a substantial redistribution across households and enterprises, benefiting some and hurting others. The problem facing a transitional economy is how to go from the first configuration of prices to the second without a huge disruption in the economy, which may cause a sharp drop in GDP as experienced in Mongolia, EE and FSU. The Chinese solution was to keep the old prices for the "plan quota" production, but allow market prices for over-the quota production, which exceeded plan prices by a wide margin. This allowed market prices to be established through trial and error and let such prices to prevail at the margin, thus determine economic incentives. Plan quotas were fixed in absolute terms; as a result they accounted for a decreasing percentage of enterprise output as it grew. Because of the rapid growth, which was fuelled by market track, the plan track became increasingly unimportant overtime. The two-track system did give rise to widespread corruption but provided a reasonable solution to a key problem of the transition, how to let markets determine prices without incurring a high cost in disruption and a sharp drop in GDP. Within 15 years of the formal introduction of the two-track system, by the end of the 1990s the plan-track had almost completely disappeared.

## Rural Economy and the Transition

On the eve of the economic reforms, around 80% of the Chinese labour force was rural, with most of them (around 90%) engaged in farming. Some rural localities, especially in East China (the region around Shanghai), had comparatively developed industry. Though the cropping pattern and remuneration were determined by collective units, in most localities households were responsible for particular tasks. The level of mechanisation was low, and still is. Given that rural communes were formalised only in 1962, collective farming had been in operation for just 17 years in 1979, household farming was an immediately feasible alternative. Indeed, during the commune period rural cadres had to struggle constantly to stop spontaneous reversion to household farming. The salient feature of the rural economy was not the size of its labour force but that it was organised very differently from the urban industrial economy. As a result, the de-collectivisation of farming, once allowed, was swift and remarkably free of any major disruption. It yielded a dramatic growth in agricultural output and provided impetus for further reform.

### ***Decollectivisation of Farming***

The reform consisted of two components, first the distribution of collectively owned agricultural land to rural households and, second, giving the households power to decide what to grow. The distribution of land took place at the grassroots level of villages. As a result, the average area of land plot per household varied across villages, as did the quality of land. Land plots were transferred not in perpetuity but leased for a definite period (twenty or thirty years) on a renewable basis. In formal legal terms, land remained in collective ownership with the village as the owner, which limited the rights of landholders in various ways. The distribution of land was not once-and-for-all action but subject to modifications to take account of population growth and migration, which introduced an element of uncertainty on the part of households and has adversely affected fixed investment. The land leases could be inherited and sold, in principle freely, but in practice subject to restrictions. The market in land, more accurately land use rights, has been heavily affected by the collective ownership of land and the limited lease period. Generally most of the proceeds from the sale of land use rights accrue to the village. Land plots cannot be used as collateral, which impedes investment in land and diversification into non-farm activities. The general implication is that the distribution of land to households shares only some aspects of privatisation but is far from synonymous with that. In practice, the ownership of land is neither fully private nor collective but a combination of the two. It has evolved over time in the sense that the rights of households have been extended and clarified, but they are still surrounded by ambiguity and uncertainty. The important point is that, notwithstanding the limited rights of rural households and residual uncertainty, the division of land in combination with allowing households some power over the cropping pattern in both China and Vietnam resulted in a massive increase in agricultural output.

An apparently paradoxical feature of the post-1978 rural economy in China has been that the de-collectivisation of farming went together with an explosive growth of rural collective industry. As a result, whilst farming has for many years been largely private, rural industry, with a rising share in rural income, has until recently been predominantly collective. Thus, in industrialised rural counties the local economy was until the late 1990s no less collective than it was in 1978, although the focus of collective activity had changed. The mix between collective and private enterprises varied widely across rural localities and has in recent years rapidly shifting towards the latter. Many of the rural enterprises that were previously collectively-owned are now private. Rural industry is not a post-1978 development. Though promoted during the plan economy period, it differed from state industry and marked a significant departure from the planned economy. For the most part, rural enterprises had to be financed from local resources and their growth depended crucially on local initiative. Compared to state industry, rural industry always has had a pronounced regional dimension, with a heavy concentration

of rural enterprises in a few regions. For example, in 2002, only 5 out of 31 provinces accounted for almost 52% of the total value added of rural industry. The reasons for the uneven geographical distribution of rural industry lay in favourable local factors and had little to do with government policies at higher levels. Amongst these, three characteristics of the locality have been of special importance in providing a favourable environment for the growth of rural industry: first, a high population density, second, a comparatively high household income per head and, third, a relatively high level of education.

This institutional combination of household farming and collective industry might seem anachronistic in the transition context but has in fact contributed strongly to the pace of evolution toward a market economy. In farming, the disincentive effects of collective organisation of economic activity far outweighed whatever beneficial scale effect it may have had. But in industry there was, at least to begin with, no alternative to collective organisation. Non-existent capital markets meant that rural households lacked capital; further they were also without the organisational capacity to undertake industrial activities beyond simple processing and handicrafts, which do not depend on long chains of co-ordination. Collective ownership provided an institution that could offer a partial substitute for non-existent markets, including for credit and land, and thus opened up possibilities that were not available under private ownership. In this sense collective ownership has served as a mechanism for overcoming a problem of collective action associated with market failure.

Rural townships (the lowest government tiers) and villages (quasi-governmental units) have been the midwives of township and village enterprises, or TVEs. They marshalled necessary capital and procured land for the establishment of TVEs and have also provided them with a degree of insurance from market risks. Without this “governmental entrepreneurship,” rural industrialisation in China would not have progressed beyond the rudimentary level. There is no developing economy, including high performance economies in Asia that approaches China in the scale and depth of rural industrialisation. TVEs were, in turn, obligated to finance local public goods and give preference to local inhabitants in labour recruitment. The distinction between “insiders” and “outsiders” runs deep in the TVEs and represents one of the challenges in moving China towards an efficient market economy. Further, the growth of collective rural enterprises, instead of crowding out household enterprises, has facilitated their proliferation – a classic example of the effects of forward and backward linkages.

### **Proliferation of New Enterprises**

The success of the Chinese reforms lies not in reforming its state sector, especially large state-owned units, but in spawning the growth of new enterprises in industry and in services. The transformation of the state industrial sector has been hesitant. In a marked contrast to reforms in the rural economy and to the opening of the Chinese economy to international trade and direct investment where outcomes far exceeded initial expectations, reforms in the state sector, especially of large enterprises, have moved only slowly and delivered far less than expected.

The reform of large state enterprises in China presents problems very similar to those encountered in FSU and the EE. Indeed, because of the continuity of the one-party state, political and ideological impediments to a transformation of state enterprises have been, in some respects, greater in China than in other transitional economies. Amongst these, of particular significance is that large and medium state enterprises in China are not only economic but also political units. For example, the party has an important say in the appointment of managers of medium and large enterprises and their selection depends not only on performance and managerial competence but also on political reliability. As a result, the depoliticisation of ownership and of management has been a slower process in China than in, for example, Czech Republic and Poland. In all transitional economies the transformation of the governance structure of state and privatised enterprises has turned out to be more intractable

than many envisaged. The big difference in China is that a strong new sector has developed, which facilitates the restructuring of old enterprises. Not only do new enterprises provide competition to old enterprises, but also in some cases they merge with or take over the older and less efficient enterprises.

The share of non-state enterprises in gross industrial output has risen from 22% in 1978 to 59% in 2002, and most of this rise is accounted for by new enterprises. The significance of new economic establishments does not lie in the creation of a substantial private sector, though that has flourished in recent years. Whilst there are many jointly-held enterprises, private units and foreign ventures, public ownership permeates most new establishments. Rural enterprises are partly collective and partly private. The government (central or territorial) is the sole or the majority shareholder in most share-holding enterprises. Similarly, the government is the majority shareholder in many of the large and medium enterprises with foreign investment. In terms of ownership, new economic establishments are more mutations of public enterprises than an entirely new species.

The new enterprises are, however, different from traditional state enterprises in two important respects. First, their labour contracts are different from those of state enterprises. Compared to state enterprises, they are less constrained in choosing forms and scale of remuneration and the terms of employment. They have greater freedom to lay off employees, restrictions on which constitute a principal barrier in restructuring state enterprises. Second, their relation to the government is in various ways different from that of traditional state enterprises. They tend to face a harder budget constraint. Further they put a stronger weight on profitability in setting objectives than the traditional state enterprises do. This also holds for large state enterprises that have been transformed into corporations. It is no longer true that all state enterprises face soft budget constraints.

The new enterprises in China in some key respects resemble new firms in Poland and Hungary, two examples of successful transition in EE. But the difference is that the transition in the non-farming sector in China has been spearheaded by public enterprises and government entrepreneurship. Further, unlike in EE and the FSU, output planning in China did not collapse but instead was gradually made obsolete by the development of the market track. Recent years have seen both privatisation and the growth of private enterprises in China. But these have followed rather than preceded the development of a market economy. Private entrepreneurship in China has grown from, and on the basis of, market development and government entrepreneurship. The emergence of private enterprises has created a set of firms with the managerial skills and capital to take over the pre-existing state enterprises, improve their management and restructure them. Hungary accomplished the same thing by inviting in foreign firms. But Russia privatised domestically – and had neither real capital nor managerial skills to draw upon.<sup>13</sup> With the growing integration of markets, internal competition has risen and led to three developments that are of crucial importance for the future evolution of the industrial structure. The first is a widening differentiation between leading and lagging enterprises in a broad range of industries, which is a first step in a market selection process. The second is the falling trend in general profitability in industry, especially in the state sector. This drop has raised the cost to territorial governments of keeping lagging enterprises in business. The third is the process of organisational re-structuring whereby more profitable and efficient enterprises take over the laggards, a process which is far from completed.

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<sup>13</sup> The privatisation typically occurred with heavily borrowed funds, and thus the “entrepreneurs” had little to lose from mismanagement.

### 3 Challenges in the Coming Years

In recent years, the Chinese economy has moved into a different era. Some of the major reforms and developments that sustained the high growth rate in the past, such as the decollectivisation of farming and the proliferation of TVEs, have lost much of their force. Further, with massive changes over the reform period new problems have come to the fore and some of the old ones have grown in magnitude. Finally, with the fundamental transformation of the economy the reform agenda has changed. Establishing missing markets, liberalising prices and diversifying the forms of ownership are no longer top issues. Instead, the top items on the current reform agenda include the creation of jobs, narrowing glaring inequalities and removal of market imperfections. This section discusses the challenges facing the Chinese economy and the reforms they call for with reference to three problems.

#### **Unemployment Problem**

China faces a serious unemployment problem. The sectors that created jobs over the period 1980-95 have been since then losing jobs. There are sectors which are creating new jobs but as yet not in large enough numbers. Historically, the state sector and the urban collective enterprises (the public sector) have been the principal sources of employment for the urban labour force. But in the late 1990s the sector not only failed to provide jobs to fresh entrants to the labour force but also began reducing its labour force. In just 7 years from 1995 to 2002, the public sector has lost around 61 million jobs, 43% of the total in 1995. The trend is expected to continue for some years. On the other hand, the non-public sector (comprising foreign-invested, private and household enterprises) has been increasing its labour force and thus its share of urban employment. This shift of employment into the non-public sector fits in with the transition from a planned to a market economy. But the problem is that there have been not enough new jobs to prevent a rise in urban unemployment in recent years.

Adding to the problem in urban areas is the massive number of surplus labourers in rural areas. Until the mid 1990s out-migration and employment in rural town and village enterprises (TVEs)<sup>14</sup> were the two outlets for the surplus labour. The first still remains important, but is constrained by the limited opportunities of wage- or self-employment in urban areas and by the institutional impediments to rural-to-urban migration. But the role of TVEs as a vent for surplus labour has changed radically. Over the 18 years from 1978 to 1996 employment in TVEs increased almost five-fold from 28 to 135 million. But in the subsequent 6 years (1996-2002) the TVE labour force first fell sharply and then rose, but ending up still 2% short of the level in 1996.

The implications of the trends are clear. The non-public sector in urban areas, especially private enterprises in the services, looks likely to be the only major source of new jobs in the Chinese economy. In the case of TVEs, the likely prospect is little or no change in the total employment in the near future. As a result, rural-to-urban migration coupled with the absorption of migrants in urban areas seems to be the only feasible way for reducing surplus labour in farming. The implications for reform are straightforward and as follows:

- A package of measures to facilitate the establishment and growth of private enterprises.
- Elimination of all forms of discrimination against migrants in the urban labour market.
- Adoption of a package of positive measures to facilitate the integration of migrants in urban areas, including providing them full access to housing, education and healthcare.

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<sup>14</sup> TVEs include private and household units as well as collectively-owned enterprises.

## **Rising inequalities**

As generally recognised, economic inequalities in several dimensions have risen over the reform period. As measured by the ratio of average household per capita incomes, the income gap between urban and rural areas, which narrowed substantially between 1978 and 84, has since been widening and is almost back to the level in 1978. Added to this, inter-personal income inequality in both rural and urban areas has also risen, particularly sharply since the early 1990s. China started the process of economic reforms in 1978 with, by international standards, a very low-income inequality within rural and within urban areas, though with a high rural-urban inequality. After 24 years of reform both intra-rural and intra-urban inequality in household income or consumption per capita are high by international standards. Finally, regional inequality between the coastal and interior provinces, as measured by the ratio of GDP per capita has also risen, which suggests a regional polarisation. The rising trend in economic inequalities is a potential source of social discontent and may act a brake on the growth rate.

The principal measures for arresting the trend and eventually reversing it include the following:

- A reform of inter-governmental finances to counteract regional inequality by means of transfers and central government expenditure in favour of poorer localities. To an extent this is being done through regional development initiatives such as that for the 12 Western provinces. However, the extent of redistribution from richer to poorer localities in China is low by international standards, which calls for an overhaul of inter-governmental finances.
- Increased subsidisation of the cost of essential services, such as education and healthcare, for low-income household. The costs of education and of healthcare have risen sharply over the reform period forcing low-income households to cut on necessary healthcare and on the education of children. The problem is recognised by the government and there are measures to deal with the problem but these do not add up to a coherent package.
- Income maintenance schemes to prevent deprivation. The urban population already benefits from a two-layered social safety net consisting of unemployment insurance and the Minimum Living Standard Assistance; the latter is available to all urban residents with a per capita household income less than the local poverty line. In contrast, the social safety net in rural areas is grossly inadequate. A Minimum Living Standard Assistance Scheme for the rural population, similar to the one for the urban population is needed but remains yet to be introduced.

## **Removing Market Imperfections**

Much of the basic requirements of a full-fledged market economy are already in place in China. However, market imperfections are pervasive; and two salient examples of it are as follows. First, the distinction between permanent residents and migrants implied by the household registration system segments the labour market. The effects of the segmentation include migrants being restricted to particular jobs and receiving a lower pay than permanent residents for the same work. Such discriminatory treatments detract from efficiency and are particularly inequitable in that they adversely affect the poorer sections of the society. Ultimately the solution lies in the transformation of the household registration system, which is the root cause of the labour market segmentation. Other areas where monopolistic abuses are common are healthcare and education. Examples of abuse include charging arbitrarily high fees and prescribing unnecessary medical treatment in order to raise charges. Although all sections of society suffer from these abuses, poorer sections fare worse because of their weaker bargaining position. The remedy lies in two groups of measures: first, an effective

regulation of fee and service delivery and fee and, second, adequate government funding for education and healthcare. The first does not make much sense without the second because it was the shortfall in government funding for health and education that prompted educational and health institutions to explore ways of closing the funding gap.

## **GLOBAL ECONOMIC INTEGRATION**

# **The operation of commodity markets and their impacts on livelihoods in Viet Nam**

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## **1. Introduction**

The development of commodity markets that are pro-poor in their orientation is a vital component in reducing poverty, increasing growth and opportunities and empowering the poor. This is especially the case for the rural poor, who rely on commodity markets not only as a source of their basic requirements, but also as an outlet for at least a portion of their production.

Viet Nam is a primarily rural country, with around 80 percent of the population living in the countryside. There are around 10 million farm families at various levels of livelihood in Viet Nam, and the majority of these are linked in some way to commodity markets for their produce. For many households, selling commodities produced on farm is their only source of cash income. Improvements in the operations of markets and pro-poor commodity market development may have the potential to have a positive impact on the lives of the rural poor.

This paper aims to give some background to the discussion about making commodity markets work better for the poor by first presenting a review of relevant literature relating to commodity markets and livelihoods in Viet Nam, and secondly by examining the livelihood impact of commodity markets in Viet Nam for four commodity types:

- a. Rice
- b. Coffee
- c. Tea
- d. Sugar

These commodity types have been chosen because they represent a wide range of product characteristics, levels of market development and poverty profiles of farmers.

## **2. Commodity Markets in Viet Nam**

Prior to 1986, the agricultural sector in Viet Nam was characterised by central control over production decision making, and central control over marketing systems for production. Households had little or no control over the decision making process in regards to what products to produce or how or where to sell any excess production.

After 1986, the process of *doi moi* meant that state control over the agriculture sector was gradually relaxed in many facets. The process of reform included the granting of long-term land use rights, the affirmation of the household as the basic unit of decision-making, reform of controls on import and export of products, the gradual withdrawal of the state from distribution and procurement systems and (with a lowering of concern about food security) relaxation of restrictions in transforming rice production land to other agricultural and non-agricultural uses.

The results of this process on the agriculture sector in Viet Nam are well known. Following *doi moi*, productivity of agriculture increased dramatically and planted areas and production levels of various staple and non-staple food products increased rapidly. The initial gains

made through the process of assigning land use rights and devolving production responsibility were supplemented by further reforms in the late 1990s, including the removal of rice export quotas, and the lowering of almost all export tariffs for agricultural products to zero percent.

Food security ceased to be a major concern of the Vietnamese government and Viet Nam moved from a position as a net importer of rice in the 1980s to become one of the world's major exporters of rice by the end of the 1990s. How far Viet Nam has come can be illustrated by the fact that in 2003, a mere 2 years after the World Food Program ceased operations in Viet Nam; Viet Nam participated in the WFP as a donor of rice.

The opening up and market orientation of the rural sector, and the subsequent increases in productivity and production levels in the sector, have had a dramatic effect on the incidence of poverty in Viet Nam, and in particular the incidence of rural poverty. According to the Viet Nam Living Standards Surveys, the incidence of poverty fell from 58 percent in 1993 to less than 37 percent in 1998. Although the results of the 2002 Viet Nam Household living standards survey have not been released yet, it is likely that the poverty rate in Viet Nam now has fallen to less than 30 percent.

Despite these achievements, poverty remains a major problem in Viet Nam. Poverty is also a largely rural phenomenon, with the majority of the poor living in rural areas. Reduction of the levels of poverty in the rural areas is a high priority of the Government of Viet Nam, and this direction is underlined in the Comprehensive Poverty Reduction and Growth Strategy (CPRGS) released in 2002.

While market liberalisation policy reforms were sufficient in the past to foster significant growth in the rural sector and have a substantial impact on the levels of poverty it is unlikely that in the future, further liberalizations and market orientation will have a significant poverty reduction impact. There is strong evidence that the boost to the sector by market oriented reforms is already beginning to wane, with the annual growth rate of the agricultural sector (not including fisheries and forestry) declining to around 2 percent per year, compared with close to 15 percent growth for industry, and the proportion of GDP contributed by the agriculture, forestry and fisheries sector declining to a current level of around 23 percent by 2002.

The low potential impact of policy reforms for market orientation is due largely to the fact that for almost all commodities – especially rice – the major policy reforms in regard to market orientation have already been undertaken and were largely in place by the late 1990s. In order to maintain the gains made on poverty alleviation and to assist households who did not reap significant benefits from the previous policy reforms, new types of commodity market development should concentrate on improvements in information availability, planning processes and in the development of efficient organizational structures. This type of market development implies a holistic approach to market systems, and also implies that development of market systems should aim for maximum inclusiveness of stakeholders in the rural area, including the poor.

The following sections review the development of commodity marketing systems for four commodities in Viet Nam, with a focus on the impact of the development of the marketing systems on the livelihoods of the poor. The commodities are rice, coffee, sugar and tea. These commodities have been chosen because of the diversity of product characteristics, levels of market development and poverty profiles of farmers.

**Rice** is the staple crop of Viet Nam. Government reforms in the fields of land use rights, production decision making, tariffs and quotas have all had a major impact on production levels and productivity. Rice production is still subject to government guidance, but the involvement of the state in the sector is declining. Viet Nam now produces a surplus of rice, which is exported.

**Coffee** production in Viet Nam has expanded rapidly since the mid 1990s, with much of the development of coffee production being undertaken in the Central Highlands by smallholders. The development of the coffee industry was initially driven by government promotion of the crop, due to suitable production conditions and a strong world price of coffee. Subsequently, many smallholders took up coffee production, and the levels of production and export of coffee boomed. Since the late 1990s (due in part to Vietnamese overproduction) the world price of coffee has collapsed and many coffee producers in Viet Nam are facing significant financial hardship.

**Sugar** production has developed rapidly in Viet Nam since the mid 1990s, in line with the government's plan to produce "1 million tons of sugar by 2000". The industry has been strongly promoted by the government as a vehicle for poverty reduction, with the government subsidising both the construction of sugar cane mills and the production of cane by smallholders. By necessity, an intricate marketing system has developed between smallholder farmers and the mills. However, the development of the sugar industry has been undertaken under extremely high levels protection from imported products, and at significantly high cost to the government.

**Tea** production has developed strongly in the 1990s, with the area, yields and production volumes all increasing over this period. However, the increases have not been as dramatic as those for the coffee industry, and unlike the sugar industry they have not occurred under high protective barriers or strongly subsidized production systems. While the state still has a dominant portion of the production and processing sector (particularly through VINATEA and its subsidiaries and Lam Dong Tea Company and subsidiaries), a significant proportion of tea production is in the hands of smallholders. The development of tea production and the domestic and international markets for Vietnamese tea has had a positive outcome for poverty reduction, both through the inclusion of smallholder producers in the production system, but also through the generation of employment in labor intensive activities such as tea picking.

### **3. Rice**

Rice is the staple crop of Viet Nam. Government reforms in the fields of land use rights, production decision making, tariffs and quotas have all had a major impact on production levels and productivity. Rice production is still subject to government guidance, but the involvement of the state in the sector is declining. Viet Nam now produces a surplus of rice, which is exported. The impact of policy reforms on rice production and welfare has been reported by many authors, including Minot and Goletti (1997) and Nielsen (2003).

Prior to doi moi, rice production and marketing systems were closely controlled by the government. Production was largely collectivised and collection, processing and distribution of rice was the responsibility of the state. The reforms of doi moi, and in particular Resolution 10 of 1988 [devolving production responsibility] and the revision of the Land Law in 1993 [assigning long-term land use rights] had a profound impact on the quality, quantity and efficiency of rice production in Vietnam.

According to Cuc (1999), prior to 1988 Vietnam suffered significant food shortages and had to import up to a million tons of rice per year to feed the population. In some years, this food shortage was severe (for example, Cuc reports that in 1988 9.4 million people in 21 Northern Provinces of Vietnam experienced significant periods of lack of food).

The initial reforms in production responsibility and land use rights generated significant increases in rice production areas, yields and output. The growth rate of output of paddy (6-7% per year) outstripped the population growth rate (2% per year) and Vietnam began to produce surplus output of rice.

In the mid 1990s it was realized that further reforms of rice policy toward a more market oriented position with a lowering of government involvement might be required in order to further develop the marketing systems and accelerate poverty alleviation. However, lingering concerns over food security issues meant that the decision to reduce state involvement in the systems was one that would not be taken lightly.

In order to study the potential impacts of the liberalization of rice marketing systems IFPRI built a spatial price equilibrium model (International Food Policy Research Institute, 1996). The model was used to estimate the impacts on income distribution and poverty of the removal of the quota on rice exports and liberalizing of internal trade in rice. As reported by Minot and Goletti (1998), the results of the simulation indicated that liberalization of the market systems and the removal of the rice export quota could have substantial positive effects on national welfare, increase incomes in rural areas and decrease the incidence of poverty.

The results of this study (see for example Goletti, 1998, Goletti and Rich, 1998 and Minot, 1998) contributed to the subsequent decision by the Government of Vietnam to eliminate the quota on rice exports and liberalize internal rice distribution systems. The impact of this study was assessed by Ryan (2002), who concluded that the work by IFPRI resulted in the government relaxing export quotas and internal distribution earlier than would have otherwise been the case and resulted in a net benefit to Vietnam of \$222 million by 2000 and \$966 million by 2020.

The strong position of Vietnam in the rice export market is likely to continue under international trade liberalization regimes. International Support Group of MARD (2002a) concludes that under the implementation of CEPT (Common Effective Preferential Tariffs) of AFTA (ASEAN Free Trade Area), Vietnam's rice production would still enjoy a comparative advantage over rice production from trading partners in ASEAN, and that export levels might increase. In further research, International Support Group of MARD (2002b) concluded that a reduction of average world tariff rates on rice by 50 percent would result in an increase in Vietnam's rice price of around 6.2 percent and an increase in the level of rice exports by 16.3 percent.

The potential for further substantial poverty reduction as a result of market liberalization and export orientation of rice is less clear. The Center For Rural Progress and ActionAid Vietnam (2001), in a study of globalization and its impact on poverty amongst households in An Giang Province, concluded that while trade liberalization in rice had a substantial positive impact on the economy of the province as a whole, the benefits largely accrued to wealthier households, while the poor households did not reap significant benefits. The reasons cited in the study are that the poor lack key resources that enable them to participate in high margin activities such as producing rice for export. The key assets lacked by poor farmers are land, educational attainment and capital/access to credit. The main asset that they possess is labor, which is in oversupply.

In a study for the World Bank, Agrifood Consulting International examined the value chain for rice in Vietnam in order to ascertain if further improvements in efficiency of the value chain and marketing systems could have significant poverty alleviation impacts (Agrifood Consulting International, 2002). The analysis suggested that improvements in the marketing chain and the development of higher quality rice could benefit Vietnam in entering higher value niche markets for rice exports. The analysis also concluded that the previous gains made in productivity improved the livelihoods of many of the poor, through increased household food security. However, the report also noted that rice may not be a vehicle for widespread poverty alleviation in the future, as poor households in rice growing areas generally have small areas of land, and have limited access to capital and credit. One implication from the study is that diversification of production away from rice monoculture into production of higher value products should be further developed.

#### **4. Coffee**

Coffee production in Viet Nam has expanded rapidly since the mid 1990s, with much of the development of coffee production being undertaken in the Central Highlands by smallholders. The development of the coffee industry was initially driven by government promotion of the crop, due to suitable production conditions and a strong world price of coffee. Subsequently, many smallholders took up coffee production, and the levels of production and export of coffee boomed. Since the late 1990s (due in part to Vietnamese overproduction) the world price of coffee has collapsed and many coffee producers in Viet Nam are facing significant financial hardship.

The total coffee area planted to coffee increased in absolute terms between 1995 and 2002. Area under coffee production was 186,400 hectares in 1995 and increased to 535,100 hectares by 2002. This enlargement in coffee area happened in two main phases. The first phase was during 1996-7, immediately after the Brazilian frost, when the high coffee price gave farmers a strong incentive to expand production; the second period was between 1999 and 2000. The total level of coffee production increased from 1995, until it reached a peak level in 2001. These increases in production were mostly used for the export market, as the domestic market size remained static. Export coffee accounted for around 97 percent of output. By the late 1990s, Vietnam had become the second largest producer and exporter of coffee in the world.

A number of factors contributed to the rapid expansion of the coffee industry in Vietnam. Jones (2002) highlights the three main factors contributing to the development of the industry in the 1990s. These were migration to the Central Highlands region, the impact of doi moi reforms and active government promotion of coffee production and export orientation. Government promotion of the sector included granting of preferential credit and a range of subsidies on inputs.

The granting of long term land use rights, the devolution of production decision making to the household and liberalization of input and output markets, coupled with strong government promotion of the sector development meant that the production characteristics of coffee changed rapidly. In the mid 1980s, State farms were responsible for more than 75 percent of total production area. By 2000, only 15 percent of production area was under SOE control, of which two thirds was under the control of VINACAFE. While private enterprises were allowed to process coffee, international marketing of coffee was under government control until 1999, with only state approved enterprises being allowed to export.

The initial impact on livelihoods of the expansion of the coffee industry in the Central Highlands was positive. This positive effect came from both increased earnings of smallholder farmers and the absorption of labor by the coffee industry. Smallholder incomes increased rapidly, because at the time of the initial expansion of the industry, the world price of coffee was relatively high, due mainly to the Brazilian frost of 1995. Labor intensity is also high, with the industry estimated to employ around 600,000 workers, rising to a peak of 800,000 at the busiest time of the season.

The poverty alleviation impact of the development of the coffee industry is harder to ascertain. As a high value industrial crop, with a relatively long lag between planting and production of coffee berries, coffee may not be a viable cropping option for the poor. The Center for Rural Progress and ActionAid Vietnam (2000b) conducted an analysis of the impact of coffee development on poor households in Dak Lak province (the largest coffee producing province). Their findings revealed that while there were significant benefits for the province as a whole, and that many households had been beneficiaries of the development of the industry, these benefits had not accrued equally between poor and non-poor

households. The poor households surveyed for the study indicated that they did not have access to sufficient land or capital, and therefore were unable to participate in coffee production.

The vulnerability of the development of the coffee industry and the fragile nature of the benefits accruing to smallholders involved in coffee production have become increasingly apparent in the period since 1999. Since this time the world price of coffee, and in particular robusta coffee has collapsed, and is now at a 30 year low. Despite increases in export volumes between 1999 and 2001, the value of coffee exports fell over this period. The lowering of the world price has had a direct and significant impact on the livelihoods of smallholder producers of coffee, as the purchase price of coffee has fallen to below the cost of production in many cases.

It has been argued by many (including Oxfam, 2001) that the decline in producer prices world wide is due to the international market being dominated by multi-national roasting companies. However, it is difficult to ignore the fact that the decline in world prices has accompanied an overproduction of robusta coffee, due mostly to the recovery of Brazilian production after the frost of 1995 and the substantial increases in Vietnamese production.

The Vietnamese coffee industry is now in a situation where reforms to government policy on land use, production decision making and domestic and international market access have been undertaken. According to a number of analyses (including International Support Group of MARD, 2002a), Vietnamese coffee production enjoys a strong comparative advantage in production, due to favourable soil and climatic conditions. Despite these positive conditions, the industry is now facing difficulties, due in part to a lack of good information about appropriate varieties and about world market conditions.

## **5. Sugar**

Sugar production has developed rapidly in Viet Nam since the mid 1990s, in line with the government's plan to produce "1 million tons of sugar by 2000". The industry has been strongly promoted by the government as a vehicle for poverty reduction, with the government subsidising both the construction of sugar cane mills and the production of cane by smallholders. By necessity, an intricate marketing system has developed between smallholder farmers and the mills. However, the development of the sugar industry has been undertaken under extremely high levels protection from imported products, and at significantly high cost to the government.

Sugarcane production in Vietnam is characterized by government policy toward self-sufficiency. In 1995 the government announced its plan to support the development of the domestic sugarcane industry in order to achieve the goal of producing 1 million tons of sugar annually by 2000. In order to achieve this goal the government invested heavily in the industry, through such measures as providing credit for the construction of 32 new sugar cane mills (increasing the total number of mills to 44), providing input subsidies and incentives for production and investing heavily in infrastructure development to support the industry. In order to assist in the development of the industry the government also enacted protective measures against imports of sugar, including high tariff levels and the effective banning of sugar imports through placing sugar on the list of commodities subject to import licensing restrictions by the Ministry of Trade.

The impact of the government promotion of the industry has been substantial. The area planted to sugarcane in Vietnam has increased by around 30 percent since 1995. In addition, between 1995 and 2002 there was a significant shift in location of production. Production areas in the Mekong River Delta region decreased by around 22 percent, while the sugarcane production areas in the North Central Coast and the Central Highlands

regions increased by 31 percent and 13 percent respectively. Total sugar output levels increased by 36 percent between 1995 and 2002. In parallel with the shift in production locations, the sugar production levels of the North Central Coast and Central Highlands regions increased significantly during this period. Almost all of the increases in production were as a result of increases in production areas, as yields per hectare remained relatively constant at around 49 tons between 1995 and 2002.

The promotion of the sugar industry has been targeted regionally and has had a higher level of concentration on the North Central Coast and Central Highlands Regions. The impact in terms of creating jobs in mills and transportation and in development of smallholder cane production systems contracting production activities with mills has been significant.

It is estimated (Center for International Economics, 2002) that the development of the industry has created opportunities in smallholder production, transportation and mill work for around 200,000 rural households, many of them in poor districts and communes. The sugar industry is often cited as a successful model of rural industrialization, with many smallholder producers grouped around a “nucleus” mill in an integrated production and processing system.

However, these gains in production and poverty alleviation have come at significant cost. Poor climatic and soil conditions, combined with low efficiency of production and processing lead to a low level of productivity in terms of tons of cane per hectare, and the yield of sugar per ton of cane. This has meant that the government has had to maintain support to the industry through subsidized inputs and through restrictive trade practices.

The analysis of Goletti and Rich (1998) argued that the restrictive trade policies imposed costs on Vietnam as a whole. They estimated that if trade were liberalized, sugar prices to consumers would fall by 22 percent and the real income of the country would increase by \$92 million. The analysis suggested that removal of trade restrictions would lead to a restructuring of the industry, with production being restricted to regions where there is a comparative advantage in production.

In addition to the costs of restrictive trade practices, the costs of investments in mill capacity and associated infrastructure as well as subsidized inputs are high. Center for International Economics (2002) estimates that the total cost of the sugar program in Vietnam from 1995 to 2002 has exceeded \$US1 billion, consisting of \$US750 million on milling capacity and \$US350 million on infrastructure and capital.

It is widely accepted that the sugar industry is facing a crisis. The world price of sugar has fallen sharply, and Vietnam’s commitments to AFTA and the concessions that it is likely to have to make in order to gain WTO accession mean that it is unlikely to be able to maintain the current high levels of protection. In addition, the high cost of supporting the industry is not sustainable in the long run. Using a spatial price equilibrium model, the International Support Group of MARD (2002b) argued that if the government removed all trade barriers and support for sugar mills then sugar production would decrease significantly and all small mills would close. Even with a 40 percent tariff on imports in place (such as that discussed by Center for Rural Progress and ActionAid Vietnam (2000) and removal of support to mills, the small mills will close, while the larger mills will expand capacity. However, in order to maintain the current level of self sufficiency, the tariff would have to remain in place indefinitely, resulting in an increase in the domestic price of sugar by around 40 percent.

Goletti and Rich (1998) advocated a removal of trade restrictions and a rationalization of production locations and mill capacity. Center for International Economics (2002) also advocated the closure of small mills and a rationalization of capacity, accompanied by a reduction in domestic support and trade barriers.

The implications of the current choices facing the sugar industry for poverty alleviation are relatively serious, especially on a regional basis. As mentioned above, the development of the industry has resulted in production and employment opportunities for around 200,000 households. If small mills are to close, then the producers and workers in those mills will potentially be adversely affected. Center for International Economics (2002) estimates that around 10,000 mill workers in small mills will lose employment. Many commentators have used the poverty alleviation aspect as an argument for continued support of the industry. However, as shown in a number of analyses, including Goletti and Rich (1998) and Center for International Economics (2002), the overall gains to the economy far outweigh the losses incurred as a result of decreased levels of support. Even if direct income support is given to those adversely affected by the discontinued support, the net outcome would still be positive (Center for International Economics, 2002).

In summary, the development of the sugar industry has had some positive implications for regional poverty alleviation and the development of marketing channels for commodities. However, these positive developments are likely to be unsustainable in the long-run, because they have taken place under an environment of high levels of domestic support and international trade restrictions.

## **6. Tea**

Tea production has developed strongly in the 1990s, with the area, yields and production volumes all increasing over this period. However, the increases have not been as dramatic as those for the coffee industry, and unlike the sugar industry they have not occurred under strongly subsidized production systems. While the state still has a dominant portion of the processing sector (particularly through VINATEA and its subsidiaries and Lam Dong Tea Company and subsidiaries), a significant proportion of tea production is in the hands of smallholders and contract farmers.

The development of tea production and the domestic and international markets for Vietnamese tea has had a positive outcome for poverty reduction, both through the inclusion of smallholder producers in the production system, but also through the generation of employment in labor intensive activities such as tea picking.

Areas planted to tea in Vietnam have expanded since 1995, although the rate of expansion has been steady compared to the rate of expansion of coffee production areas. During this period the yield per hectare has also increased, and therefore there have been significant increases in total production of tea for the country as a whole. In 2002, the area of productive tea land was 77,800 hectares, and the production of dry bud tea was 402,100 tons.

Trade liberalization is likely to have a positive effect on the tea industry. The International Support Group of MARD (2002b) analyzed the potential impact of AFTA tariff reductions and reductions in world tariff barriers on tea exports and production. The study concluded that AFTA tariff reductions and reductions in average world tariffs on tea would have a positive effect on both the producer price and the level of exports.

Tea production has developed with a system of smallholder farmers and contract farmers linked with (generally state-owned) processing factories. Tea production and exports have increased over the 1990s. Unlike coffee, the increase in production and exports has not been too rapid, and Vietnamese tea production and export still does not have a major effect on the world price of tea. Tea provides a good example of a steady, relatively controlled increase in production of a commodity where Vietnam has a relative comparative advantage. Tea also provides an example of organization of smallholder producers and larger processors and exporters in a value chain.

## 7. Pro-poor commodity market developments for the future

If commodity marketing systems development in the future is to be inclusive and have a pro-poor orientation then it should have a focus on improving information systems and planning processes, the development of efficient organizational structures, the strengthening of the enabling environment and enabling the poor to participate in networks and value chains.

**Information Systems** are a vital tool in the empowerment of the rural poor in the marketplace. Lack of knowledge of the situation in the market and potential opportunities in the marketplace limits the ability of the poor to participate equitably in markets. An increase in the knowledge of the rural poor through the provision of accurate, relevant and timely information could lead to increases in their marketing power and ability.

Provision of information to the rural poor implies more than merely providing information on price levels. Merely providing price information does not necessarily increase the market power of the rural poor if there is a lack of competition in purchasing their products. Relevant information that could be supplied includes demand levels for particular commodities, seasonal price fluctuation characteristics and other information that would allow producers to take informed production and marketing decisions in the time dimension.

The development of information collection and dissemination networks in the rural sector in Viet Nam has commenced with the Agro Viet network set up by the Informatics Centre of MARD (formerly the Information Centre for Agriculture and Rural Development) and a trial information collation and delivery system set up in An Giang Province. Under the current ADB Agriculture Sector Development Program loan, a national information network under the Informatics Centre will be developed, initially covering 10 provinces and then being expanded to nationwide coverage. The UNDP project on Public Administration Reform in MARD is about to commence a feasibility study on the development of rural telecenters to collate and provide information in 10 pilot provinces nationwide.

**Planning Processes** are an important element in the production and marketing systems for agricultural products in Viet Nam. Despite the devolution of decision making responsibility to the household level, in practice many of the overall policy directions that impact on production and marketing systems are made by the central or provincial governments under the framework of short, medium or long term plans for development of commodities.

In many cases, the initial planned development is followed by "spontaneous" development by other stakeholders who wish to become involved in production and marketing of commodities. An example of this is the case of coffee, where the initial movement into coffee production by farmers was a result of promotion of coffee production by the government, but subsequent large-scale development was undertaken by producers who had observed the success of the initial plan and wished to participate in what was seen as a successful sector.

In order to ensure the success of the planning process and the achievement of desired pro-poor outcomes, it is essential that the planning process is undertaken with access to the best possible information. Planning processes should also be undertaken in a holistic manner, taking into account demand characteristics, marketing systems as well as production capabilities.

**Organizational structures** are also an important element in the development of pro-poor market outcomes. High population densities mean that the average household farm size in Viet Nam is very small. Poor households tend to have more members (Minot and Baluch, 2002) and have relatively smaller farm size per household.

The small size of landholdings per household means that an individual household does not have a high degree of market power when dealing with collectors, traders or end-users, as

the volume of product that they are selling represents only a very small proportion of the total product demanded. Through a process of organization and linking together, groups of small-scale households can increase their market power and achieve better outcomes.

The Government has been actively promoting the organization of producers through the vehicle of “new co-operatives” since the introduction of the Cooperatives Law in 1997. The promotion of new co-operatives came about after a realization that after de-collectivisation, there was a period where there was very little formal organization of producers, which resulted was not conducive to pro-poor outcomes. The new cooperatives form can include production cooperatives, input purchasing cooperatives, marketing cooperatives and specialized cooperatives (such as seed production cooperatives). The majority of new cooperatives are involved in production and marketing.

Other forms of organizations that have developed include farmer clubs and groups and extension clubs. Some of these organization forms are formal, and others are informally based.

**The enabling environment** with regard to commodity markets should also be improved in order to strengthen pro-poor outcomes. Improvements in the enabling environment can come from activities such as strengthening of the enforceability of contracts, improving the research and extension systems and developing a workable framework for intellectual property rights.

The lack of enforceability of contracts has negative impacts on pro-poor outcomes for two main reasons. First, the poor can be disadvantaged when purchasers break contracts or renegotiate prices for products supplied by households. The low level of bargaining power of the poor households means that they are vulnerable to these outcomes. Secondly, the lack of contract enforceability means that purchasers may be less willing to enter into contracts with the poor, or with co-operatives consisting of poor households, based on the perception that the poor may not honour contracts if the market price increases above the contract price.

As discussed in Agrifood Consulting International (2003), restructuring and refocusing of the agricultural research and extension systems in Viet Nam is a necessary step in order to develop the sector further and to promote agricultural diversification from food crops to high value crops, livestock, and fisheries, and to make quality improvements comparable with neighboring countries and trade competitors. Policy makers and stakeholders in the agriculture sector in Viet Nam have identified a number of features of improved research and extension systems that will provide a strong background for development of the sector.

Agricultural research systems should include research targeted towards the needs of poor households as well as commercial farms, the involvement of the private sector in research provision should increase, research should aim at the development of a competitive, internationally linked and commercially oriented value chain in agriculture and research efforts should be linked with extension.

The public extension service should move to become more focused on the needs of poor households, while private extension services should develop in order to meet the needs of more commercially oriented enterprises. The extension system should become more participatory, and offer a comprehensive advisory service, not just concentrating on production of commodities. Extension services should become more adaptable and flexible.

In order to develop effective marketing systems for high value products, it is important to have a system of protection of intellectual property rights and trademarks. The development of branded, recognizable processed agricultural products for the domestic and international market has been hindered, because of uncertainty surrounding the security of brand names and trademarks for these products.

### Enabling the Poor to Participate in Networks and Value Chains

As discussed by Goletti et. al. (2003), development of the agriculture sector in the future will be characterized by higher degrees of commercialization, and a focus on the development of marketing networks, rather than the current focus on production and marketing of commodities.

In order to capture higher levels of value added and target more lucrative markets, the agricultural system will have to move from merely producing primary commodities and selling through a chain, to a position of having integrated networks (for example of producers, processors, other input suppliers, marketers and exporters) producing higher value products for the domestic and world market.

In order to benefit from increased levels of commercialization and business orientation of agriculture it is vital that the poor are included in the development of value chains and networks. Participation in these value chains and networks can benefit the poor, both as producers of commodities to supply to the value chain and also as suppliers of labor. This implies that the other conditions described here, such as information availability, organization and enabling environments are also in place.

The importance of linkages and formation of networks in the development of the rural sector has been recognized by the Government. In particular Decision 80/TTg of June 24, 2002 regulates mechanisms and policies for promoting contracts between smallholder farmers and agricultural enterprises. Since the implementation of the Decision, a number of contracts for production of rice, sugarcane, pineapples and cotton have been entered into under the framework of the Decision. However, according to Ngo (2003), there are still a number of problems with the system that need to be overcome. These include contract violations and the lack of an enforceable framework to deal with contract violations.

The Ministry of Agriculture and Rural Development is also promoting linkages in the rural sector through the development of a network of "The Four Subjects in Agricultural Production and Consumption". These are farmers, scientists, enterprises and the state. According to Ngo (2003), these linkages are the subject of a joint communique issued by MARD, Farmers Association, Vietnam Union of Science and Technology Associations and the State Bank of Vietnam. The aim of promoting coordination between the four subjects is to facilitate the development of efficient networks linking all subjects and domestic and international markets.

## **8. Conclusion**

The experience of the doi moi era has shown that policy reforms leading to increased market orientation can result in significant increases in production and productivity, and also to have significant poverty alleviation effects. The challenge now facing the agricultural sector is how to build on the gains made from the initial reforms and develop a system that enables the poor to benefit from production and marketing systems of high-value products that are able to be produced efficiently in Vietnam, and also have a strong level of demand, both locally and in the international market.

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**1. Context:**

Key elements related to the policy context for examining globalism and poverty in Vietnam includes the following:

**a) The population bubble, political legitimacy, and the need to create jobs**, all of which point toward the need to promote an export-led development strategy aimed at expanding labor-intensive exports -- Much like Vietnam's neighbors in the 1980s, Vietnam in the 1990s and 2000s are in the middle of a demographic bubble, where 50 percent of the population are younger than 25. This yields an estimated 1.5 million new young entrants to the labor force each year for decades into the future. This comes on top of an existing situation where a substantial proportion of the "older" population is underemployed and living in rural areas with incomes around the poverty level. Furthermore, the Vietnamese government understands clearly that unemployment and poverty contribute to social instability, leading to a clearly stated policy of working to improve the standard of living of all its people and in particular reducing the number of those living in poverty. All of this leads to a fundamental need to create large number of jobs, both for young new entrants and older underemployed rural residents.

How can a country like Vietnam boost job creation significantly and on a sustained basis? Lessons from its more developed East Asian neighbors are straightforward. Economic development led by a rapidly growing private sector and labor-intensive export growth has proven to deliver time after time a rapid expansion in employment opportunities, leading to relative broad-based, sustained growth and eventual pressure to increase real wages. Thus, to maintain social stability, Vietnam really has no choice except to internationalize, expand their private sector and promote investment and labor-intensive exports. The policy mix required for Vietnam to do this must, of course, be tailored to the specific characteristics of Vietnam, but the lessons from its neighbors over the last 30 years have provided a relatively clear set of policy options.

**b) Vietnam is just moving out of a pre-industrial stage of development** - This means that for Vietnam to develop rapidly and to create the large number of jobs needed to reduce underemployment and to eventually raise real wages, both critical steps to reduce substantially the number of people living in poverty, a large amount of investment will be required to support industrialization and closely related improvements in physical and social infrastructure. How will such a large amount of investment be financed? Again, the lessons of its neighbors are clear. The core foundation for such investment must be from high levels of domestic savings, supplemented by foreign investment and donor inflows. This focuses attention in particular on the weak financial system in Vietnam, which both limits formal savings opportunities and reduces the efficiency of formal intermediation between savers and investors, and the relatively weak tax system, especially a weak value-added tax system. And, it focuses attention as well on the immature private sector in Vietnam as a basis for expanding investment. In Vietnam, many savers do not deposit their funds in banks or other financial intermediaries, and there are few domestic private firms large enough to make substantial investments in factories and infrastructure to boost the industrialization process. Furthermore, due to the limited attractiveness of partnering with state-owned firms and limited privately-owned potential partners, most foreign direct investment is now 100%

foreign owned, potentially raising in a political economy sense concerns of foreign domination that would be less with FDI working through joint ventures with local partners.<sup>15</sup>

**c) Trade anomalies** - Until the passage of the US-Vietnam Bilateral Trade Agreement (BTA), Vietnam's trade flows were highly distorted. Unlike all other rapidly developing, labor-intensive East Asian economies, until 2002, Vietnam's exports were dominated by non-manufactured commodities exported to countries other than the United States. For a labor-intensive economy like Vietnam, this is major anomaly compared to its neighbor. In this regard, the pre-2002 U.S. policy of treating Vietnam as a non-MFN economy was a major tax on Vietnam's development. The U.S. market has always been the key engine of growth for developing economies in East Asia and, in fact, developing economies throughout the world.

In a remarkably short period of time, however, the U.S. extension of MFN treatment to Vietnam as a core element of the BTA has reversed this anomaly. By the end of 2003, the U.S. is Vietnam's largest export market and manufacturing exports, particularly labor-intensive manufacturing exports, now dominate overall exports. This impressive response to the new market opportunities opened up by the BTA illustrates clearly the potential for Vietnam to expand exports substantially well into the future.

**d) Economic restructuring and internal labor migration** -Shifting toward a private-sector-led, outward-oriented development strategy will increase demand substantially for labor-intensive manufacturing and will tend to create jobs close to urban areas and related infrastructure. A key element of the market forces leading to reducing poverty on a sustainable basis for a country like Vietnam, then, will involve the migration of rural residents to jobs in urban areas, combined with efforts to increase the productivity of those remaining in the less dynamic rural areas. This tendency toward urbanization as industrialization and internationalisation advances, of course, raises a further set of development issues. I should make clear that a market-based dynamic does not solve all problems, and clearly targeted poverty programs, especially for those in disadvantaged rural areas, will be required to help out the most hard core poor. Covering the costs of such targeted poverty reduction policies should be made easier as a result of higher levels of growth resulting from export-led dynamics, which should contribute to higher government revenues that can be used to finance such re-distributive policies.

## **2. Industrialization and Global Economic Integration**

This development policy context leads to an emphasis on how Vietnam industrializes and internationalizes its economy, that is, how it advances industrialization, private sector growth and increased foreign trade and investment. In this regard, the context for Vietnam is somewhat different from its neighbors. From the 1960s to the early 1990s, a relatively weak international framework for governing international trade -- the GATT and relatively passive bilateral policies - allowed developing economies considerable flexibility in developing export-led growth strategies. Typically, Vietnam's East Asian economies used a "parallel" trade policy, concurrently promoting exports while protecting sensitive domestic, import-sensitive sectors. All neighboring countries promoted an expansion of their private sector, although some emphasized domestic investment while others encouraged a strong mix of domestic and foreign investment. Furthermore, since developing countries did not play a major role in multilateral GATT negotiations, most trade and investment policy reforms were promulgated on an "unilateral" basis driven largely by domestic objectives.

The international policy environment for Vietnam in the 2000s is considerably different. Whereas Vietnam made a number of "unilateral" reforms in the late 1980s and throughout the 1990s, the next step to gain access to the U.S. market, to participate in AFTA, and to

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<sup>15</sup> In this regard, I fully favor 100-percent foreign ownership, but I note the political economic problem of limited number of joint ventures.

accede to the WTO had to be done through trade negotiations that will limit the range of trade and investment policies available, and that will bind Vietnam's policies once negotiated so that they cannot be reversed in the future. Therefore, whereas Vietnam will gain major benefits in terms of access to foreign markets, the range of trade and investment policies opened to Vietnam will be significantly limited by bilateral (the BTA), regional (AFTA) and multilateral (WTO) treaties and trade arrangements, especially compared to the early stages of development of its neighbors. Tariffs will be bound at levels around 10 to 20 percent (0-5 percent for AFTA), quantitative restrictions must be eliminated, performance requirements for investment will not be allowed, and so on. Vietnam essentially will not be able to use traditional import substitution processes to promote industrialization and domestic development while simultaneously promoting exports, as its neighbors did in the past.

Furthermore, Vietnam's capacity to provide financial subsidies to support domestic development, which in some parts could be WTO legal, will nevertheless be severely limited by limited tax revenues and demands to use such revenues on infrastructure, education, health and targeted poverty programs, rather than subsidizing industries. (Note import protection through tariffs and quotas provides major subsidies for domestic industries, but the cost of these subsidies are paid primarily by domestic consumers through higher prices rather than by the government.)

Therefore, Vietnam's industrialization process will need to be done in a much more open market environment, which in fact most economists think is optimal, but it nevertheless raises new issues for dealing with adjustment and market imperfection issues than were faced by earlier developers. For Vietnam, led by a Communist Party with a Socialist orientation with an economy with a large state-owned sector and a relatively small private sector, developing a strongly market-oriented, private-sector-led industrial strategy with substantial 100% foreign-owned investment will raise many contradictions in fundamental Vietnam's approaches to development and in its link between development and politics.

### **3. The US Bilateral Trade Agreement**

Next, I have been asked to look more closely at the BTA as a kind of case study on the internationalization process for Vietnam, with an eye on poverty alleviation.

The BTA does four major things:

- a) It extends MFN treatment by the US to Vietnam, which reduces tariffs on Vietnamese exports to the U.S. from an average of over 40 percent to around 3-5 percent. This is critical for opening up export opportunities for Vietnam into the huge and relatively developing-country receptive U.S. market. Essentially, the BTA removes a major tax on Vietnam's export-led development process.
- b) It requires that Vietnam adjust its legal and institutional structures to conform to a wide range of international norms, laid out primarily in the WTO. This particularly important for issues related to dispute settlement and the court system, transparency, intellectual property protection, various administrative regulations, and customs and licensing procedures. All of this is critical for raising the confidence of domestic and foreign investors. As well, the BTA was designed to mirror in large part the WTO, and thus serves as a key stepping stone toward complying with WTO standards.
- c) It requires Vietnam to provide greater market access for U.S. firms, most importantly in service sectors. In fact, the BTA has a limited impact on market access for goods, since it requires tariff reductions only on around 250 tariffs lines, and since Vietnam has already eliminated almost all import quotas as part of World Bank/IMF agreements. And, most market access commitments are phased in over 3 to 10 years after the coming into effect of the BTA (Dec. 10, 2001). Note that the AFTA will have a much greater impact than the BTA in terms of increasing competition from imports in the goods sector, as will the WTO accession.

- d) The BTA does have strong investment commitments, in many cases which go beyond the WTO, and these restrictions will in particular eliminate the use of performance requirements for foreign investment. This includes a phased in prohibition of domestic content and export performance requirements, both of which are in common use now by Vietnam and were used by neighboring countries in early stages of development.

The economic response to the BTA reforms has been profound. Vietnamese exports have surged to the U.S., growing from around \$1 billion in 2001 to \$2.4 billion in 2002 and to around \$4.5 billion in 2003. Much of this growth has been in labor-intensive manufacturing exports, especially clothing. Strong export growth has also occurred in natural-resource based sectors that are nevertheless labor-intensive, especially seafood and furniture. Although we estimate that a small proportion of this export growth resulted from diversion of exports from other countries, most of this surge in export growth has come from new output, which translates directly into more jobs.

A continuation of such growth in exports will depend critically on new investment, both domestic and foreign, in labor-intensive exports. A substantial amount of the clothing exports in 2002 and 2003, for example, was generated by more fully utilizing existing plant and equipment. Future growth in all sectors, however, is now supply constrained and will require new investment in plant and equipment. This focuses attention on policies that encourage investment and facilitate business related to labor-intensive exports.

In this context, exports from East Asia increasingly are managed within the context of production networks, where firms specialize in organizing production in a number of countries to produce a final product at the lowest possible price. In particular for Vietnam to expand into higher value added export sectors, it will need to specialize in various products used as inputs to produce other products, for example importantly in household and IT electronics, or to serve as a processing center for final goods using imported inputs. Much of these production networks involve competitive private firms working on a contract manufacturing basis, which is with strong commercial relationships with buyers and suppliers, but no equity (or investment) relationship. This calls all the more for Vietnam to develop private firms that are able to enter into highly competitive contract manufacturing relationships.

The response to the BTA by the Vietnamese government to conform to the international standards in the BTA has moved along solidly, but much work remains. Key areas where the government is moving forward to meeting international standards (in terms both of having its laws conform to such standards and effectively implementing and enforcing those new laws and regulations) include the following: a) customs; b) dispute settlement in terms of commercial arbitration, investment disputes and the right to appeal administrative actions; c) intellectual property right protection; d) basic rule of law issues, including the civil procedure code for the court system, the commercial law, and the improved capacity and effectiveness of the courts; e) transparency in terms of publishing rules and regulations, data, and providing the opportunity for public comment on draft laws; f) improving licensing procedures and eliminating dual pricing; g) conforming administrative regulations to international standards, such as for sanitary and phyto-sanitary standards in agriculture and technical standards for industrial goods.

This long list of commitments appears daunting, but we have found that Vietnam had been advancing reforms in many of these areas well before the BTA was brought into law. The BTA, however, added considerable focus and urgency, which is reinforced all the more by the push to accede to the WTO by 2005. In most regards, Vietnam is making solid progress in implementing the BTA, and in preparing for entry into the WTO.

#### **4. The Gradualism Tax**

Lastly, let me comment on what I call the gradualism tax, which has a direct bearing on the impact of economic growth on poverty alleviation. Clearly, Vietnam has grown solidly over the last decade, averaging roughly 7 percent per year for a decade. If one looks, however, at the growth rates of neighboring countries at their early stages of development, which typically centered more around 9-10 percent growth per year (20-25 percent for Guangdong Province in China, for example, a province with many similarities in terms of size and economic structure with Vietnam), Vietnam's "potential" growth appears to higher than 7 percent.

Who pays the cost for this more "cautious" or "gradual" growth rate? A more rapid growth rate in the 9-10 percent level would almost surely add substantially higher demand for low-skilled workers and farmers who tend to hover around poverty levels. In this sense, it is the working poor and the underemployed who pay a "tax" in the form of weaker demand for labor as a result of the solid but less than robust 7 percent growth rate in Vietnam. Presuming that the higher growth rates resulting from market oriented production, which in turn would be labor-intensive in nature, a shift up in the growth levels to 9-10 percent would probably provide the most immediate and broad-based positive impact on reducing poverty levels in Vietnam.

I wanted to address a question that come my way during the discussion, since I think its important for the argument laid out above. I was asked whether export growth based on low-value added exports such as apparel really provide much positive economic impact. Most manufacturing exports in developing economies at early stages of export-led growth such as Vietnam, for example, involve relatively labor-intensive, lower-wage processing that use substantial imported inputs and often with domestic value added levels in the 10-20 percent range.

My response to that, again based on the experience of Vietnam's neighbors, is that such exports build upon Vietnam's comparative advantage – at early stages of export growth for labor intensive economies, its much easier to try to expand exports in sectors where you have the strongest comparative and competitive advantage. As well, such low-value-added exports still involve building critical capacities for exporting, including moving goods in and out of customs and ports, implementing duty draw back systems, developing transport networks to ports, building financial, legal and insurance services related to exports, building the connections and market networks to develop and fulfill export contracts, developing confidence in the government and among business that they can compete in international markets, and so on. This is a critical step, building the foundation for moving into higher value added export sectors. You have to learn to walk before you run. There is little chance that an economy with Vietnam's dynamics will get caught in a low-wage, low-value export trap, where it finds it hard to move into higher value added sectors. Again, looking to its neighbors that have a relatively well educated labor force, a shift toward export-led growth tends to increase demand of labor that surprisingly quickly leads to pressure to increase real wages, which is a key to reducing poverty. To make this sustainable, continuing reforms, growth and investments in physical and social infrastructure typically facilitate a movement into higher value added exports, which accommodates higher real wages (matched by higher skill levels) and further increases standards of living and used market forces to reduce poverty levels.

## **FACTOR MARKETS**

# **DISCUSSANT NOTES**

## **Comments on Issues of Labor Market and the Poor**

**Vo Tri Thanh**

*CIEM*

### **1. Understanding labor market in VN**

- Very young population (about 60% under 30; Ages 20-25 highest among unemployment)
- Public sector vs. non-public sector (in terms of employment stability and competition pressure, insurance, access to public services)
- Mismatches (gaps) between demand and supply (by sector and skills). Abundant labors from rural areas have been largely absorbed by low productivity / low value added services sectors (in recent years partly also by garment and footwear industry)

### **2. New/important issues**

- Rural-urban migration and urbanization (this process is accelerated) and industrialization
- Cross-border (international) migration (both legal and illegal)
- Poverty in ethnic minority groups (Difficulties in reducing poverty incidence in Central High Land; reasons for uneven performance in poverty reducing in the North Mountain and Central High Land?; people mobility and possible conflict between majority and minority)
- Impact on WTO accession and regional integration on labour market and poverty (channels: changes in relative prices; production factor market; budget revenues; and institutions, incl. institutions supporting the poor)
- Insurance for non-public and farmers

#### ***Some other comments***

- Land problems:
  - Land concentration (in broader sense, efficiency in using land) and social equity
  - Real estate/housing market and the poor (in urban areas)
  - Land clearing for infrastructure development and compensation (in kind, in cash, reallocation, training, ....)
- Financial market:
  - Overall environment and Gov't intervention
  - Institutions and transaction costs (effective interest rate)
  - Best practice for Bank for Social Policy?
- Understanding the emergence of middle class and the faces of the rich?

## DISCUSSANT NOTES

### Research Issues relating to financial markets and poverty reduction

William Smith

#### 1. Financial markets and the national economy

The operation of financial markets clearly has a significant impact on the overall strength of a national economy and therefore, indirectly, on poverty reduction. There are a wide range of issues worthy of research regarding how Vietnam's financial markets effect macro-economic development: the extent of bad debt within the state owned commercial banking sector, the allocation of resources between state-owned and private enterprises, the openness of Vietnamese markets to foreign capital investment, the development of Vietnam's stock market etc. In turn, all of these issues will have a hugely important impact on poverty.

#### 2. Poor people's participation in financial markets

There are also a range of research issues regarding how the operation of financial markets impacts directly on the situation of poor people. Given the scope of 'Making markets work for the poor' project, it is suggested that it may be more practical and feasible to focus in particular on these issues.

##### 2.1 *Issues for research:*

##### The impact of government intervention in financial markets 'in favour' of the poor

This is an issue of universal concern in relation to financial markets and poverty and is also relevant in Vietnam, in particular with reference to the Vietnam Social Policy Bank. Government intervention is evident in terms of: interest rate ceilings (VSPB), compulsory interest rate reductions (VBARD), directed lending towards households on HEPR lists etc. It is important to look at the impact of this policy in terms of: mobilising resources for lending, cost recovery, outreach, product development, market distortion effects on other service providers etc. It may also be instructive to analyse the political interests and mechanisms which underlie current policies in this area.

##### Regulatory environment:

This issue also relates to government intervention in financial markets but to the more neutral role of regulation and supervision of market activity. It would be useful to examine the extent to which the current regulatory environment encourages or impedes the entry of potential new service providers as well as the operations of existing organisations providing services to poor people. Areas of particular interest may include: rules on loan guarantees, capital requirements for establishment of local credit co-operatives and organisations, opportunities for legal registration of microfinance organisations etc. Moreover, the quality of supervision of the financial market can have a huge impact on poor people's access to services (e.g. 1989-90 co-operative collapse in Vietnam, pyramid schemes etc.)

##### Institutional development

In some cases, constraints on provision of financial services for the poor may result less from the regulatory environment than from the institutional characteristics of current providers. For example, donor microfinance initiatives have been promoted primarily through non-specialist mass associations. Commercial companies may also have limited experience in more difficult

areas of service provision e.g. health and property insurance in rural areas. The origins and institutional history of state-owned commercial banks like the Vietnam Bank of Agriculture are also likely to have major impact on current provision of services to poor people. It may be instructive to analyse the institutional strengths and weaknesses of some of the main providers.

### Market conditions

Whatever the regulatory and institutional environment, there may be local market conditions which have a major impact on financial service markets and the poor. For example, it is evident that interest rates in the private market in rural areas in Southern Vietnam are considerably higher than, for example, in the Red River Delta. It would be useful to understand the underlying reasons for some of these variations.

### Cultural and social environment

In some circumstances, there may be social and cultural constraints to poor people participating in financial markets. This may be particularly the case for ethnic minorities interacting with a Kinh dominated banking system and private traders. Internal social dynamics of various ethnic groups may also have an important impact- it is noted, for example, that while ROSCA's and other indigenous financial service mechanisms are very common in Vietnam's rural areas, there does not appear to be documented evidence of such activity within ethnic minority groups.

## **2.2 Research approaches**

It may be helpful to follow a variety of approaches:

### Institutional analysis

It may be instructive to conduct in-depth research studies into the issues and constraints faced by a number of current service providers in offering services to poor people. For example:

- A district branch of VBARD in a mountainous area.
- The Prudential Insurance Company's operations in one rural province.
- A People's Credit Fund.

### Household analysis

It is not easy to generate an accurate picture of poor people's participation in financial markets and their need for financial services. Traditional interviews tend to result in responses focusing on borrowing for productive investment. One useful method to gain a more comprehensive picture has been to guide a sample of poor households to maintain financial diaries in which detailed records are kept of income and expenditure flows as well as existing household financial management mechanisms used (e.g. piggy banks, neighbour loans, purchases on credit etc.). Such information can help to give a clear picture of types of financial service required, issues related to existing services on offer and gaps in current service provision.

### Market analysis

It would be useful to conduct an economic analysis of financial markets for poor people, investigating the determinants of interest rates in the private market in a variety of areas and the extent to which these determining factors effect poor people's access to services.

## **DISCUSSANT NOTES**

**Nguyen Hanh Nam**

*MPDF*

IFC/MPDF selected the topic of draft land law for its first issue of Business Issue Bulletin launched in September, a bi-monthly publication that provides a compact analysis on a particular business environment issue and exposure with different opinions held by various stakeholders. (Hard copies were distributed and are available at request, soft copy can be downloaded from website [www.mpdf.org](http://www.mpdf.org)) Very much to our happiness and also surprise, we received a lot of feedbacks from readers, all show keen interest in the Bulletin.

### **Experiences that we want to share are:**

Most private businesses show continuous concerns over land as a major constraint, in all aspects of availability, price, lease tenure, secured legal rights and transferability. Although the revised Land Law has just been approved, much of the current businesses concerns are yet to be answered and subject to to-be-issued implementing regulations; (Examples are capital gain tax, repossession of land by the State, mechanisms to determine the price of Land Use Right (LUR) etc.)

Through interviews with stakeholders including private businesses, it seems that law interpretation and implementation seem to vary from central to local levels and between different local authorities and it's the implementation rather than the law itself seem to create constraint for private business sector

The wide circulation and short, concise and by-issue presentation of the Bulletin seemed to have worked very well. It fits well with our objective to raise the awareness of business issues among National Assembly delegates and local governmental official – who have the influence over the law making and implementation respectively but lacks information or even the basic good understanding of the background. The feedbacks we've got from these people all show keen interest in the Bulletin and solicit for wider circulation and further topics to talk about.

In our viewpoint, when talking about private sector in Vietnam, we are talking about small and micro businesses who create jobs and income for millions of people, and in that sense the private sector business issues that we have shared above are much linked to the poverty reduction by making the market works better for the poor, not by granting subsidies.

### **Recommended further research ideas:**

In relevance to the MMW4P, land as the most important assets is not yet efficiently used to maximize return and the land market is still a highly regulated market, so how this regulated market is operating to benefit the poor is a big question and certainly serves well a good topic for further in-depth research.

While the revised land law has been officially ratified, it could be worthwhile to undertake further discussion on how implementing sub-law regulations are to be drafted.

A survey of land and property market after a year of revised land law implementation could be also meaningful to help see back what has worked well and what has not.