How Indochina's Economies Took Off

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Favorable structural factors, combined with strong policies, helped Indochina's economies avoid a Soviet-style output collapse in their transition to a market-based system.

FEW ECONOMIES in transition to market-oriented systems have achieved relative macroeconomic stability more quickly than those in Indochina or have matched the strong growth rates these countries recorded during stabilization. In the late 1980s and early 1990s, Vietnam, the Lao People's Democratic Republic (Lao PDR), and Cambodia embarked on rapid disinflation that took them from the edge of hyperinflation to single-digit inflation rates in 1996. Virtually in step with this disinflation, these countries averaged annual GDP growth rates of 6 to 8 percent and strengthened their external positions.

What policies and conditions shaped this remarkable performance, and why has Indochina's path to stabilization differed so markedly from that of other transition economies?

The good stabilization results obtained in the Indochinese countries, as compared with those in other transition economies, reflect, in part, structural factors that allowed Indochina's economies to respond quickly to new policies. The most important of these factors were:

• Differences in economic structure. Unlike the European transition economies, the three economies of Indochina were dominated by private, family-based agriculture, and the state-owned industrial sector was relatively small.

• Although the "shock" of the 1991 disruption in aid from and trade with the Soviet bloc was quite significant for Vietnam and Cambodia, its impact was mitigated, particularly in Vietnam, by the earlier introduction of important economic reforms.

• Geographical location may also have been important. The Indochinese countries benefited from being close to rapidly expanding Asian economies that were eager to invest in neighboring low-wage economies.

• In contrast to many transition countries in Eastern Europe, the Baltics, and the other countries of the FSU, the private sector continued to play a role in Indochina even prior to the reforms, and central planning was, in practice, not fully entrenched.

• Finally, for Vietnam, the coming onstream of domestic oil production and large inflows of foreign direct investment also facilitated a relatively smooth transition.

This is not to argue that all of the initial conditions were favorable. On the contrary, the Indochinese countries were all emerging from extended periods of war and isolation. Each was also faced with extreme poverty, rudimentary infrastructure, and weak administrative capacity. At the outset, the countries attracted very limited international aid and had negligible foreign reserves.

Against this background, the Indochinese countries implemented tough macroeconomic policies that were basically similar. Initially, stabilization policies in all three countries comprised a mix of flexible exchange rates, high interest rates, limitations on state enterprise credit, and government expenditure reduction. This policy mix, in part, reflected the extensive nature of informal markets, which coexisted with the machinery of central planning and which became increasingly important as reforms took hold. Policymakers' recognition of the pervasiveness of informal markets and the need to work with them rather than against them was a key element in the Indochinese countries' success.

Background to reform

Prior to the reforms, the Indochinese countries faced budget deficits similar to (or even larger than) those in other transition countries (see chart). The true extent of these deficits was hidden, as government revenues consisted largely of transfers from state enterprises that themselves benefited from government subsidies, while expenditures were understated by the use of overvalued official exchange rates, arbitrarily low accounting prices, and the practice of paying workers in consumer goods instead of wages. Most of the early reform efforts —including price liberalization, exchange rate devaluation, and monetization of in-kind payments—raised measured budget deficits drastically. The situation was also made worse initially as wages were raised, in part, to monetize fringe benefits. The government wage bill rose rapidly as a share of GDP in Vietnam and Lao PDR until 1989, and in Cambodia well into the 1990s. At the same time, tax systems as such were very rudimentary, and initial reforms led to a deterioration in the financial performance of the state enterprises, reducing their budgetary transfers.

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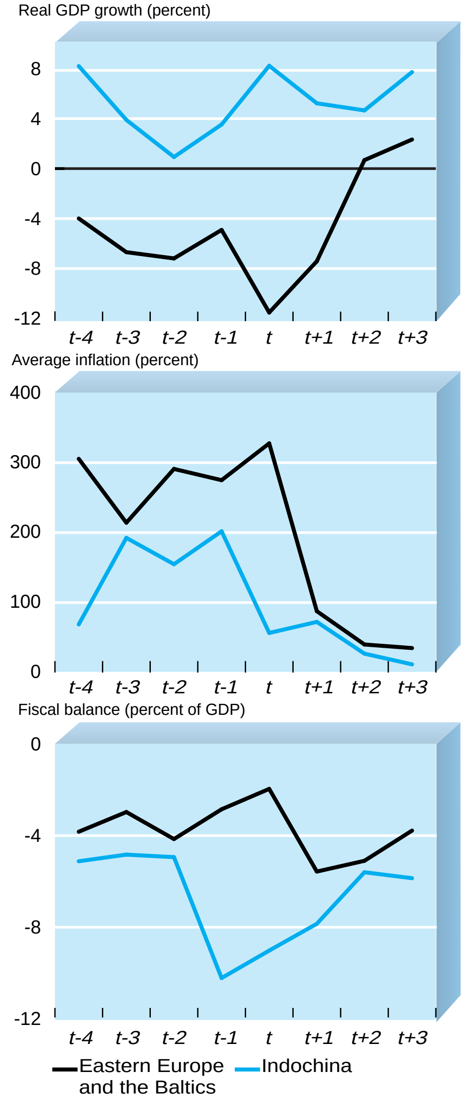
With the withdrawal and eventual termination of external assistance from the Council for Mutual Economic Assistance (CMEA) countries, the resulting large deficits were financed mainly through the printing press, and inflation escalated to triple-digit levels in each of the countries. High inflation gave a further push to informal markets and worsened the situation in the official sectors. The banking systems that existed in each of the countries had never been well established, and the lack of trust in domestic currency was reflected in flight to foreign currency and gold, and in minimal use of commercial bank accounts.

Stabilization and growth

There are two distinct phases of stabilization policies in the Indochinese experience. The immediate policies to bring down inflation from very high levels were based on flexible exchange rate regimes combined with drastic reductions in government outlays and high real interest rates. After dealing with inflation, each country entered a second stage with policies aimed at achieving exchange rate stability, although none of the three has yet adopted a pegged exchange rate. In this second stage, greater emphasis has been placed on mobilizing revenue and rebuilding government current and capital outlays. Measures are also being taken to develop the banking system and encourage the use of domestic currency.

The early phase. The initial conditions of high inflation, increasing dollarization, low international reserves, and limited international assistance severely constrained the scope for action. The marked decline in individuals' willingness to hold domestic currency progressively narrowed the base of the inflation tax, and this made the inflationary impact of the growing fiscal deficits worse. Inflation, in turn, contributed to further overvaluation of official exchange rates, and there was an increased diversion of foreign exchange receipts into the parallel market. Because administration was weak, foreign exchange controls could not be enforced and both the public and private sectors met the bulk of their foreign exchange needs from the parallel market. While fiscal measures were clearly needed, there was no dependable tax base, and budgetary adjustment was necessarily focused on cuts in expenditure, including curtailment of subsidies to state enterprises and reduction in real public sector wages.

Indochina avoided an output collapse[1]



Source: John D. Dodsworth, Ajai Chopra, Chi D. Pham, and Hisanobu Shishido, 1996, "Macroeconomic Experience of the Transition Economies in Indochina," IMF Working Paper 96/112 (Washington: International Monetary Fund).
[1] Period *t* is the starting year for comprehensive stabilization programs. This year is 1989 for Vietnam and the Lao People's Democratic Republic and 1992 for Cambodia. Initial price liberalization measures were actually carried out in these countries before period *t*. The data for Eastern Europe and the Baltics are an unweighted average, as calculated in Stanley Fischer, Ratna Sahay, and Carlos Végh, 1996, "Stabilization and Growth in Transition Economies: The Early Experience," IMF Working Paper 96/31 (Washington: International Monetary Fund).

These actions were supplemented by curbs on public services and capital spending.

Using the exchange rate as an anchor to bring down inflation—as tried in many transition economies—was not considered a feasible option in the Indochinese countries. The parallel market exchange rate was recognized as the main operational rate within the economy, and the governments of the Indochinese countries could not hope to establish a credible fixed exchange rate that would eliminate parallel market premiums and anchor their policies. Indeed, any attempt to fix the official exchange rate was thought likely to have an immediate adverse impact on foreign exchange receipts in the official market, in part because it would raise expectations of renewed foreign exchange restrictions. Without adequate reserves, the governments would be unable to defend the official rate and would lose policy credibility once the parallel market premium reemerged.

Instead, a flexible exchange rate policy was adopted that accepted the parallel rate as the dominant rate in the economy and linked the official exchange rate to it. Policy focused initially on narrowing the gap between the official and parallel rates by devaluing the official rate in response to depreciation in the parallel market. The rate of depreciation of the parallel rate was, in turn, taken as the main indicator of whether financial policies were sufficiently tight. Thus, the main burden of inflation reduction rested on fiscal and public enterprise adjustment. At the same time, there were few, if any, indexation mechanisms working in the Indochinese economies, and, by holding in check the public sector wage bill, the governments (particularly Vietnam) were able to effect an overall decline in real wages.

The policy of following the parallel market was one of the few practical alternatives available, given the limited institutional capabilities, negligible reserve levels, and the tremendous changes taking place as these countries moved to more market-oriented systems. Underlying the policy was the assumption that the parallel market rate would provide a reasonable guide to a real equilibrium rate for the economy and would not itself be a source of additional inflationary shocks. In the Indochinese countries, once initial stabilization policies took hold, the parallel market exchange rate tended to be relatively stable, reflecting the extensive nature of these markets. An important complementary measure in this respect was the relaxation, early in the reform process, of foreign exchange controls, which made transactions easier and reduced the distortive effects of risk premiums.

A further crucial policy element during the first stage of stabilization was the adoption of positive real interest rates during periods of high inflation. This policy was important in curbing further currency substitution in Lao PDR and Vietnam, but it was not relevant in Cambodia, where domestic currency was used almost entirely for cash transactions and no domestic deposit base developed. With high domestic interest rates, time and savings deposits denominated in domestic currency increased rapidly. The use of a high interest rate policy, together with the introduction of popular treasury savings certificates, also facilitated a switch from bank to nonbank financing of the budget deficit. As inflation began to subside, the governments reacted relatively quickly by reducing nominal interest rates, which smoothed the adverse impact of excessively high real rates on enterprise profitability. The countries also avoided any massive build-up of unrecoverable debts in the banking system, though the profitability of the state-owned banks did suffer from the combined effect of high lending rates and enterprise closures.

As in other transition economies, government revenues declined at the outset of reforms as the countries moved toward a modern tax system instead of relying on transfers from state enterprises. Thus, the only course open to the Indochinese countries to achieve fiscal adjustment was to cut expenditures, mainly by lowering real labor costs, eliminating subsidies for consumers and state enterprises, and reducing capital outlays. Even though public sector layoffs were significant, the budgetary impact of severance packages was small, since state enterprises carried out most of the layoffs (notably in Vietnam) and, unlike European transition economies, neither the government nor state enterprises offered much in the way of social services. As for subsidies, in Vietnam, practically all subsidies for consumers and exporters (about 5 percent of GDP) were eliminated in 1989 in the context of price and exchange rate liberalization. A similar policy was adopted in Lao PDR, where all current budgetary subsidies were eliminated beginning in March 1988. Fiscal adjustment was supported by stricter control of bank credit to the state enterprises. This approach included allowing unprofitable enterprises to shed labor, close down, or merge with more profitable ones.

Fiscal stringency initially hit spending on public investment and social services hard. Capital expenditures fell to extremely low levels (1–3 percent of GDP) in both Cambodia and Vietnam. In Lao PDR, however, although there was also a decline, assistance from OECD countries had begun at an earlier stage, and capital outlays were maintained at 5–6 percent of GDP. Social services—including basic education and health care—also suffered. For example, annual spending per capita on health and education in Vietnam was suppressed to about 5,000 dong in 1989 prices (about $1) from the late 1980s until 1991. The quantity and quality of services thus regrettably deteriorated, undoing a good part of the impressive progress Vietnam had made previously. This deterioration was, fortunately, short-lived. In subsequent years, Vietnam's expenditures on education and health services increased, financed by sharp improvements in revenue performance and higher fees for public services. After the 1990–92 shock, improvements in education and the delivery of health care were documented at the grassroots level.

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Consolidation

As inflation was gradually brought under control and parallel market premiums were eliminated, the policy mix was changed, although maintaining financial stability—especially keeping inflation low—while sustaining rapid economic growth was still the main goal. The policy emphasis in the second stage has been on achieving exchange rate stability through tight financial policies. Fiscal policies, while still emphasizing avoidance of domestic bank financing, have focused on raising revenues in order to rebuild social services and expand capital outlays. Monetary conditions have generally been kept tight, and policies have increasingly focused on promoting the use of domestic currency, particularly in Vietnam and Lao PDR.

In many respects, the experience of the countries during this second stage has become more disparate, reflecting their varying degrees of success in fiscal adjustment and in moving away from parallel market activities. At one extreme, in Cambodia, the development of a tax base is still in its early stages, and little headway has been made in reducing currency substitution. In Lao PDR, the conduct of monetary policy also continues to be complicated by the impact of dollarization on the stability of the measured demand for money. Furthermore, the foreign exchange market in Lao PDR is less formalized than in Vietnam, where an interbank foreign exchange market has developed rapidly over the past two years. Although Vietnam has made the most progress in moving toward formal markets, informal activity is still strong—there is still a large parallel foreign exchange market; foreign currency bank notes are still widely used; smuggling and border trade adversely affect tax collections; and there is a thriving informal credit network.

Foreign exchange markets. After the initial period of following the parallel market, the official and parallel markets were unified in all three Indochinese countries. Official rates have generally been kept within 1 percent of the parallel market exchange rate, and liberalization of controls on the use of foreign exchange has significantly reduced the incentive to channel foreign exchange into the parallel market. Moreover, all three countries have generally been able to maintain a remarkably stable nominal exchange rate vis-à-vis the US dollar in both the parallel and official markets. Thus, although the exchange rate was not used as an explicit anchor during 1992–95 in Indochina, stable rates have been used as a guide for gauging the effectiveness (and recalibrating) of financial policies.

New institutional arrangements have also been important in promoting the use of the official foreign exchange market. Specifically, the exchange system in Vietnam moved closer to a market regime with the introduction of trading floors for foreign exchange in November 1991, followed by the establishment of an interbank foreign exchange market in October 1994. As the official market expanded and captured a greater proportion of foreign exchange receipts, the official rate has more closely reflected underlying market conditions. In Lao PDR, an increasing number of banks and foreign exchange bureaus authorized to deal in foreign exchange have also helped bring a larger share of transactions into the official market. Despite these reforms, however, the parallel market still attracts the bulk of remittances and some export receipts, making it difficult to formally peg the exchange rate. Indeed, an attempt to peg the exchange rate in Lao

PDR in 1995 led to increased diversion of foreign exchange receipts to the parallel market and forced an eventual devaluation of the official rate.

Fiscal consolidation. In contrast, with the first phase of adjustment, the emphasis in the second phase has been on strong revenue performance while containing current expenditure (Cambodia and Lao PDR), or even increasing spending for social purposes (Vietnam) and capital outlays (Lao PDR and Vietnam). The buoyant revenue performance mainly reflects sustained efforts to install modern tax systems and improve tax administration, coupled with the dynamic output growth, the rapid expansion of foreign trade, and financial improvement of the public enterprise sector.

Credit policy. Tight monetary policies have continued during the second stabilization phase in the Indochinese countries. Moderate growth rates of the money supply, broadly defined, have been achieved mainly through the virtual cessation of government budget financing, continued hard budget constraints on state enterprises, and keeping real interest rates at positive levels. However, all three countries continue to face problems arising from the effects of currency substitution on the stability of the measured demand for money and a general lack of monetary policy instruments with which to control increasingly sophisticated banking systems.

The rapid expansion of commercial banks—evidenced by the opening of a large number of joint venture banks and branches of foreign banks—and increased public confidence in the banking system have led to a significant degree of financial deepening, which is generally measured by the share of broad money in GDP. This share has risen significantly in Vietnam and Lao PDR since 1991. The beginning of a similar trend has been observed in Cambodia since 1993. However, currency substitution, once it has taken place, is extremely difficult to reverse. Thus, despite the moderation of inflation, continued positive real interest rates, and stable exchange rates, only partial progress has been made toward de-dollarization.

De-dollarization. The future pace of de-dollarization is critical for the formulation of stabilization policies. This reflects the fact that, while the overall demand for money may be expected to change only gradually over time, there may be sharp changes in the measured demand for money as domestic money replaces dollar currency holdings. The progress of de-dollarization is difficult to project, since it shows up only indirectly as an increase in the foreign assets of the banking system and an increase in measured broad money. Although the shift from dollar notes to domestic money would not affect the balance of the overall demand for and supply of money, from a practical viewpoint, such shifts mean that a planned increase in the money supply can become tighter than anticipated if de-dollarization from currency notes occurs. On the other hand, if there is a reverse shift from domestic money to dollar currency holdings—which may have been the case in Lao PDR in 1995—then the monetary program becomes looser than originally intended.

This has practical implications for exchange rate policies. As indicated above, the Indochinese countries retain market-based exchange rate systems with financial policies aimed at achieving relative stability of the exchange rate. In this context, their governments may need to be ready with a variety of policy responses if, for instance, international reserves are accumulating at the current exchange rate at a faster pace than planned. If the increase is assumed to result from de-dollarization, then the recommendation would be to accumulate additional reserves and allow additional monetary expansion as this would not have inflationary consequences. This appears to have been the situation that developed in Cambodia in 1995, when international reserves rose strongly, causing measured broad money to increase by 45 percent while prices rose by only 3–4 percent.

Among the three countries, only in Vietnam does there appear to be a reasonably firm relationship between measured broad money and prices. In the other two countries, substantial shifts from dollar currency holdings to domestic money (or in the reverse direction) can be expected to take place.

In addition to the complications of formulating and quantifying monetary policy, the Indochinese countries need to develop new monetary policy instruments. With private sector credit becoming increasingly important, and with banking systems becoming more extensive and diversified, reliance on instruments such as central bank refinancing and moral suasion has proved insufficient to control overall credit expansion. For this reason, explicit bank-by-bank credit ceilings were adopted by Vietnam in early 1994 and by Lao PDR in June 1995. Using such direct instruments, however, has led to a buildup of excess reserves in the commercial banks and spurred fresh disintermediation from the banking system. Efforts to put in place more efficient indirect instruments of monetary management have therefore been given priority. In each of these countries, initiatives are under way to strengthen government securities markets and to relax administrative controls over interest rates.

Next steps

Since the initial periods of rapid disinflation, each of the Indochinese countries has done well in keeping inflation under control and maintaining relatively stable exchange rates. Tight financial policies have been helped by successful efforts toward revenue mobilization through revamped tax systems, and fiscal deficits have been covered mainly in a non-inflationary way, by drawing on external assistance and nonbank domestic sources. Monetary policies have also been restrained, with the notable exception of Lao PDR in 1995, when attempts to expand credit and hold the exchange rate stable immediately gave rise to the reemergence of dollarization and a parallel market premium.

Although reforms are far from complete, the experiences of the Indochinese economies should not be interpreted as supporting a "gradualist approach" to adjustment. On the contrary, the countries adopted comprehensive adjustment policies, which helped achieve both favorable growth and disinflation results within a relatively short period, thus challenging the view, held by some observers of the experience of the transition economies, that gradual liberalization is necessary to avoid an output collapse.

For the future, stabilization policies in the Indochinese countries will have to come to grips with a new environment that will require different policy responses and the development of more efficient and sophisticated policy tools. In particular, the countries will have to deal with the overheating problems that accompany strong growth; at the same time, they will have to take into account substantial inflows of external assistance and foreign capital, uncertainties over de-dollarization, and increasing integration into the world economy. F&D

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