CUBA AND VIETNAM: ECONOMIC REFORMS AND DEVELOPMENT

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Presentation

This book was written in the framework of the "Program for Training in Economics for Government Officials of the Republic of Cuba", under the Technical Cooperation Agreement between the governments of Uruguay and Cuba, financed by the Swedish International Development Cooperation Agency. It is the result of two seminars that were held in Stockholm, Sweden and Hanoi, Vietnam, and attended by specialists and government officials from Cuba and Vietnam. Specialists from Sweden and Uruguay also took part in those seminars and made a valuable contribution to analyzing economic growth and development experiences in Cuba and Vietnam.

When the "Program for Training in Economics for Government Officials of the Republic of Cuba" first started in Montevideo, Uruguay, in 1996, it did not include plans for research in the field of economics. This research grew from the Cuban participants' progress in accumulating economic knowledge and from various areas of the Cuban economy being identified as priorities for study. The program was run in Montevideo, and since 1996 more than four hundred Cuban officials have attended. It originally consisted of theoretical and practical courses in political economy, with an emphasis on fiscal and monetary policy and on specific subjects in the financial area. It also included postgraduate courses in economics and finance in Cuba, and Cuban researchers studied on the Master of Economics program at the Department of Economics of the University of Uruguay. It

gradually became clear that there was a need to broaden the scope of the teaching both in Cuba and outside it and teachers from Sweden, Chile, Argentina, Spain, Italy, Mexico and Peru joined the program, and this, along with the accumulation of knowledge in Cuban institutions, helped to generate a critical mass in Cuba that made it possible to undertake research in a number of areas of economics.

In my opinion two activities in particular on the "Program for Training in Economics for Government Officials of the Republic of Cuba" stand out for having helped to build this critical mass in economic and scientific production in Cuba. The first is Cuban students doing the Master of Economics Program at the University of Uruguay: five have obtained their Master's degree and are now working in their specialized fields in Cuba, and they are without doubt making a big contribution to the growth of economic knowledge taking place in that country. The second element is that research projects undertaken in cooperation with outstanding international researchers in areas considered by Cuban officials to be strategically important have yielded a wealth of experience.

As was to be expected, these research projects have made an important contribution to the processes of change that are under way in Cuba not only because of their high quality but also because they are pertinent to the situation in that country. What is more, this accumulation of economic research has become a driving force in the sharing of experience that has been taking place, for example, in the seminars on "Economic Restructuring: Cuba and Vietnam".

It seems logical and desirable to publish the results of these research projects not only because the studies are academically important but also because they constitute a useful contribution to meeting the challenge of economic growth. In fact, in the framework of the program, ten books in the field of economics have been published and have been incorporated as resource material on teaching programs in various educational institutions in Cuba.

The seminars on "Economic Restructuring: Cuba and Vietnam" were held in Stockholm, Sweden, in 2002 and in Hanoi, Vietnam, in 2003.

The next will take place in Montevideo, Uruguay, in 2006. The dynamic of these experience-sharing meetings is based on identifying subjects that are important and relevant to development in Cuba and Vietnam, and the studies presented at the meetings deal with these subjects and analyze the experience of these two countries in the area in question. In this way the experience in both countries is presented with its good and bad points and there is discussion and sharing of the lessons learned. This exchange of experience is aimed at helping to strengthen the decision-making process in the area of political economy in both countries.

The first seminar on "Economic Restructuring Cuba and Vietnam" was held in October 2002 at the Stockholm School of Economics of Sweden. The participants at this meeting were four Vietnamese researchers (Dr. Dinh Van An, President of the Central Institute for Economic Management of the Ministry of Planning and Investment of Vietnam (CIEM); Dr. Le Anh Son, Vice-President of CIEM; Dr. Nguyen Quang Thai, Adviser to the Minister of Planning and Investment of Vietnam (MPI) and General Secretary of the Vietnam Economic Association (VEA); and Dr. Le Truong Son, Senior Official of the Department of Foreign Economic Relations of the MPI of Vietnam); two Cuban researchers (Dr. Noel Chaviano, Director of the Institute for Research in Finance of the Ministry of Finance and Prices of Cuba, and Nancy Quiñones MSc., researcher from the National Institute of Economic Research of the Cuban Ministry of Economy and Planning); five officials of the Government of Cuba (Dr. Mirta Villanueva, Vice-minister of the Ministry of Economy and Planning of Cuba; Ana Castellanos (economist), Vice-minister of the Ministry of Finance and Prices of Cuba (MFP); Gilma Rodríguez (economist), Vice-director of the Central Bank of Cuba (BCC); Claudio Vigoa (economist), Director of International Relations of the Ministry of Economy and Planning of Cuba; and Mr. Jorge Payret, Cuban Ambassador to Sweden); Dr. Mats Lundahl and Dr. Ari Kokko, professors at the Stockholm School of Economics; Dr. Renato Aguilar, associate professor at the Department of Economics of the University of Gothenburg of Sweden; Dr. Ruben Tansini, Professor at the Department of Economics of the University of Uruguay and Coordinator of the "Program for Training in Economics for Government Officials of the Republic of Cuba"; and Alejandro Claps,

coordinator of the Seminar. This meeting made it possible for the Cuban and Vietnamese researchers to reach a preliminary agreement about areas for future research, and it was a forum for exchanging experiences and information about the economic reforms under way in both countries.

The second seminar on "Economic Restructuring: Cuba and Vietnam" took place on 22-24 August 2003 in Hanoi, Vietnam. The participants at this meeting were four Cuban researchers (Lazara Blanco (economist), Director of the Foreign Trade Division of the MEP; Dr. Noel Chaviano, Director of the Institute for Financial Studies of the MFP; Isis Mañalich MSc, researcher at the National Institute of Economic Research of the MEP; and Guillermo Gil (economist), researcher from the Monetary Policy Area of the BCC); eleven Vietnamese researchers (Dr. Nguyen Quang Thai, Adviser to the Vietnamese Minister of Planning and Investment (MPI) and General Secretary of the Vietnam Economic Association (VEA); Dr. Dinh Van An, President of the Central Institute for Economic Management of the Ministry of Planning and Investment (CIEM); Dr. Le Anh Son, Vice-President of the CIEM; Dr. Bui Ha, General Director of the Department of Monetary-Finance at the MPI; Dr. Ho Quang Minh, General Director of the Department of Trade and Services of the MPI; Mr. Vu Ngoc Duy, Deputy General Director of the Department for Banking Development Strategy of the Central Bank; Mr. Duong Xuan Hoi, Deputy General Director of the Tourism Department of the Vietnam National Tourist Administration; Mr. Tran Nguyen Nam, head of the Department of Financial Markets of the Financial Research Institute at the Ministry of Finance; Dr. Le Truong Son, senior official of the Department of Foreign Economic Relations of the MPI; Mr. Nguyen Viet Ha, official of the Department of Foreign Economic Relations of the MPI; Mr. Nguyen Hoangh Linh, official of the Department of Foreign Economic Relations at the MPI; and Mrs. Tran Thu Hang, Deputy General Director of the Trade and Price Department of the General Statistics Office of Vietnam); two Swedish researchers (Dr. Mats Lundahl and Dr. Ari Kokko, professors at the Stockholm School of Economics); Dr. Ruben Tansini, professor at the Department of Economics of the University of Uruguay and coordinator of the "Program for Training in Economics for Government Officials

of the Republic of Cuba" and Alejandro Claps, coordinator of the seminar. There were also special guests: Mr. Phan Quang Trung, Vice-Minister of Planning and Investment of Vietnam; Mr. Bui Liem, Deputy Director of the Department of Foreign Economic Relations of the MPI of Vietnam; Mr. Chu Van Oanh, Vice-Director of the Vietnam Investment Review of the MPI; Mrs. Helena Sangelang, chargé d'affaires of the Swedish Embassy in Hanoi; Mr. Fredesman Turro, Cuban Ambassador in Hanoi; and Dr. Martín Rama of the World Bank Office in Hanoi, Vietnam.

This book is made up of seven chapters each of which is a separate article. The first, by Ari Kokko and Mats Lundhal[1], is a review of economic growth and development experience with a special emphasis on a discussion of how a national economy can become integrated into the world economy, a question which is especially important for countries' economic progress.

The rest of the book consists of three articles about the Cuban economy and three about the Vietnamese economy.

The first is "The Cuban Economy: Transformation and Challenges" by Nancy Quiñones[2] and Lázara Blanco[3], which analyzes the experiences and changes in the Cuban economy, especially those that were initiated in the 1990s, and the challenges involved. The second article, "Cuban Competitiveness and Export Performance in the 1990s" by Isis Mañalich[4], presents an evaluation of the changes in Cuba's insertion in the international economy in the 1990s and the challenges the country is facing in the sphere of trade. The third article about Cuba, "Fiscal Policy in Cuba: 1994 – 2002" by Noel Chaviano[5], is an analysis of the changes in fiscal policy in the 1990s and the contribution that this made to overcoming the economic crisis

1 Professors at the Stockholm School of Economics of Sweden.

2 Researcher at the National Institute of Economic Research (INIE) of the Ministry of Economy and Planning of Cuba.

3 Director of the Department of Foreign Trade of the Cuban Ministry of Economy and Planning.

4 Researcher at the National Institute of Economic Research of the Cuban Ministry of Economy and Planning.

5 Director of the Institute for Research in Finances of the Cuban Ministry of Finances and Prices.

that Cuba went through at the start of that decade, in the wake of the collapse of the USSR.

Next come the three articles about Vietnam. The first, "Overview of the Vietnamese economy in the 21st century" by Nguyen Quang Thai[6], offers an analysis of the structural changes in Vietnam's economy, especially the transition from a centrally-planned economy to a market system and the challenges involved with respect to the well-being of the population. The second article, "Vietnam's Economic Reform and Development: Achievements and Issues"[7], analyzes the country's economy and political economy in the 1975-2003 period and focuses in particular on the 1990s and on the challenges to be faced between now and 2010. The third article, "Vietnam's Export Integration and the Competitive Strength of Key Export Products" by Ho Quang Minh[8], analyzes the changes in Vietnam's trade policy with special attention to the situation of export products that are now, or soon will be, of critical importance for Vietnam's insertion in the international economy.

Lastly, as editor of this book, I would like to take this opportunity to express my thanks to Rosario Domingo (economist) from the Department of Economics of the University of Uruguay, who has contributed not only to editing this book but also to quite a number of others in the framework of the "Program for Training in Economics for Government Officials of the Republic of Cuba", and who has been closely involved in setting up and running this program. I would also like to express my gratitude to Alejandro Claps from Sweden, who most efficiently coordinated the two seminars on "Economic Restructuring: Cuba and Vietnam" that were held in Stockholm, Sweden, and Hanoi, Vietnam. In addition I should like to thank all those who took part in those seminars and in particular professors Mats Lundhal and Ari Kokko from the Stockholm School of Economics in Sweden who contributed commentaries on the papers that were presented and on the articles published in this book. Last but not

6 Senior Economic Advisor to the Ministry of Planning and Investment of Vietnam.

7 This paper was written by a research group at the Central Institute for Economic Management of the Vietnamese Ministry of Planning and Investment.

8 General Director of the Department of Trade and Services of the Vietnamese Ministry of Planning and Investment.

least I should thank Dr. Adriana Cassoni and Carlos Casacuberta MSc, from the Department of Economics of the University of Uruguay and Professor Hugo Schwartz, who patiently read the articles in this book and made very enlightening comments to the authors.

Dr. Ruben Tansini (PhD)

Coordinator of the Program for Training in
Economics for High Government Officials
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CUBA AND VIETNAM: ECONOMIC REFORMS AND DEVELOPMENT

Chapter I

ARE THERE RECIPES FOR ECONOMIC DEVELOPMENT?*

Ari Kokko
Mats Lundahl[1]

Introduction

Is it possible to identify in an operational way the main factors that make the economies of some countries grow and develop, or is the development process so complex that it defies such efforts? The answer to this question probably lies somewhere in between, in the sense that it is possible to distinguish a number of necessary conditions that must be met if a country is to be economically successful, while claims that it is possible to know the sufficient conditions for success should be greeted with a large dose of skepticism. Fools rush in where wise men fear to tread, as the saying goes, and we will try to avoid doing that, and instead pursue a somewhat more modest goal: to offer a review of some of the most common factors involved in the process of economic development. In addition to a brief survey of the main development fundamentals, we will also discuss one specific policy choice that has become increasingly important for economic progress: how a national economy decides to manage its integration into the world economy. Primarily, this amounts to deciding whether development should be inward or outward oriented. Somewhat simplistically, this decision has often been presented as a choice between import substitution and export orientation.

* The chapter was written when Mats Lundahl was a fellow at the Swedish Collegium for Advanced Study in the Social Sciences at Uppsala in 2003-04. This support is gratefully acknowledged.

1 Researchers of the Stockholm School of Economics.

1. THE STARTING POINT

A possible starting point for our review is the decade when development economics began to take shape: the 1950s. That was an "easy" decade, because everybody agreed on some "central facts" (see Lundahl, 1979, for an overview). First, there was near consensus that economic development was the same as economic growth. Whatever their positions were in the political spectrum, the development economists of the 1950s did not worry too much about distribution issues. Either it was argued that growth had to come first and that distributional issues had to wait until a high and sustained growth rate had been ensured, or it was naïvely assumed that the fruits of growth would "trickle down" to the poorer strata of society as well.

Of course, it did not take too long to discover that the naïve concentration only on growth was a mistake. As more data became available and there were not just time series from more economically advanced nations but also data on income and wealth distribution in countries that were developing, it became clear that distribution would not take care of itself and that the question warranted immediate concern (see Bigsten, 1983). The gaps between rich and poor that the statistics showed were too large for the issue to be postponed. At the same time it was demonstrated that large population segments lived on income levels that were too low for them to meet even their most basic needs.

The pendulum had begun to swing. Development strategies were devised that dealt directly with distribution and poverty[2] and the definition of economic development began to change. It should be said at once that there is no single "best" definition of economic development, but even so, there are three elements that in one way or another tend to be present in most of them. The members of the development economics profession by and large agree on a definition that may be formulated more or less as follows: "economic development is a process of sustained long-run growth in real Gross Domestic Product (GDP) or real Gross National Product (GNP) per capita,

2 Notably Chenery *et al.* (1974) and Streeten *et al.* (1981).

while at the same time the distribution of income does not become more uneven and the number of people with a standard of living below what may be considered absolute poverty does not increase" (Meier, 1976). In other similar definitions, distribution and/or poverty receive even more emphasis. In recent years the trend has been more and more in the direction of poverty eradication, a trend that has made itself felt not least among the major multilateral donor organizations.

In addition, economic development has been viewed as a process of structural change[3]. When economists began to address development questions in the early 1940s, one of their first empirical observations was that, as per capita income levels rose, there was a tendency for the importance of the primary sectors of the economy to be reduced while secondary and tertiary activities came to the forefront, both in terms of output and of employment (Clark, 1940).

2. FROM GRAND THEORY TO COMPLEX VIEW

The 1950s was an "easy" decade in a second sense as well. Most development economists agreed that one factor was more important than others when it came to generating growth, namely capital. The theory of economic growth began to be developed in the 1940s and 1950s and the vast majority of growth models concentrated on capital formation. Such models, in turn, were adopted and adapted by development economists. Capital formation was central not only in the Harrod-Domar (Harrod, 1939 and Domar, 1946) and Solow (1956) models, but also in the theory of dualistic growth originated by Lewis (1954), in the notorious stage theory of growth concocted by Rostow (1960) and in the balanced growth argument developed by Rosenstein-Rodan (1943) and Nurkse (1953). The argument that made capital the central factor in economic development was accepted by practitioners as well. It provided the rationale for the foreign aid that began to flow from developed to less developed economies, and development plans paid considerable attention to capital, both in their technical parts, which abounded with capital-output ratios and the like, and in the sections that dealt with aid.

3 See Syrquin (1988).

Exactly as in the case of the definition of development, however, reality caught up with the panacea. The human factor, education in particular, started to attract more attention [4]. Development began to be seen not as a process of accumulation of physical capital but as a "general" accumulation process involving "human capital" as well. Planners turned to education, calculating rates of return on schooling at all levels and devising methods for manpower planning.

The attack on the view that held physical capital formation as central did not come only from the human capital side. As data became available that allowed the construction of statistical time series related to different aspects of the development process, it gradually became clear that this process was many-faceted and complex. Little by little single-factor explanations of economic development got out of fashion. The works of Kuznets (1966) and later that of Chenery and his group of researchers at the World Bank (Chenery and Syrquin, 1975) in an inductive fashion pointed out that a lot of things happen as the income and living standard of the citizens of a country increase. Accumulation processes only tell part of the story, and processes on the micro level tend to be as important as the macro aspects. Economic development is also a story about decision making, i.e. if we are to understand it we must introduce political factors and institutions into the analysis as well. To put it simply and bluntly, economic development is a process that operates on each and every level of society and which is conditioned by a large number of factors, not all of them economic, and all of those factors have to be studied.

3. RESOURCE ALLOCATION

By and large, the early models of economic growth and development concentrated on accumulation aspects while the role of resource allocation was pushed into the background. Emphasis was on the outward displacement of the production possibility curve rather than on the choice of production point on the curve. The assumption was that it was easier to achieve growth by increasing the production

4 The triggering article was Schultz (1961).

possibilities of the economy than by ensuring the most efficient use of its resource endowment. Accumulation and efficiency were viewed as if they were independent of each other.

Again the analysis proceeded on false assumptions. As growth theory was gradually refined it began to bring the interplay between resource allocation and growth into the picture (Dorfman, Samuelson and Solow, 1958). In development economics the connection was made between resource allocation and structural change. Rostow (1960) had hypothesized that there were "leading" sectors in economic development, and the statistical analysis of comparative development patterns indicated that different sequences tended to yield different outcomes in terms of growth and distribution. As a result resource allocation became an interesting area of study. Development economists began to examine more closely the different individual sectors of the economies of developing countries.

The most important sector in most developing economies was of course agriculture, especially at lower per capita income levels, and in the resource allocation discussion agriculture was frequently viewed as the "backward" or "traditional" sector *par excellence*. The view proved limited, however. The early analysis often tended to view farmers in developing countries as governed by a different mentality than their counterparts elsewhere in the world. "Cultural" or "non-economic" factors were assumed to govern their behaviour, which was believed to be a far cry from the "rational" behaviour of the textbooks "economic man". Governments based their policy interventions on the assumption that farmers did not know what was good for them and that they had to be "led".

Again the underlying assumption was false. With time, empirical evidence accumulated that indicated that a farmer in a developing country was no different to his technologically more advanced colleagues in the industrial countries. He was no more of a fool than they were; just the reality he lived in was different (Lipton, 1968). Above all there was a great deal less certainty in his ambit than in Western Europe or the United States, and so he behaved differently, but no less rationally than the European or North American farmer.

Also, farmers in developed countries tend to exploit their governments, while in the third world the opposite was often the case[5]. In misdirected efforts to protect what was conceived as poor urban consumers, prices were set in such a way as to shift the burden onto peasant producers who were even poorer, and who frequently received prices far below the levels prevailing in the world market. Of course they responded by reducing their efforts, and the lack of foodstuffs and the emergence of more or less illegal markets became facts of life.

Once some of the basic realities of third world farming were understood, however, a different approach to agriculture emerged, an approach that viewed the sector as a contributor, not an obstacle, to economic development. More or less dynamic roles of agriculture were identified: as a food producer, an accumulator of capital, a provider of foreign exchange, a source of employment, a producer of inputs for other sectors in the economy, and finally as a generator of incomes and a provider of a market for products from the rest of the economy (Johnston and Mellor, 1961). With this view it became essential to study other obstacles instead, which made it difficult for the agricultural sector to play all its roles properly.

4. FACTORS IN ECONOMIC DEVELOPMENT

We concluded above that the emphasis on capital formation in the early analysis of economic development was exaggerated. Capital is not the only factor of production and it yields a contribution only in cooperation with labor and land, if we limit the discussion to the classical threesome. The relative contribution of the different factors was highlighted in exercises of so-called growth accounting[6]. The computations were typically based on some variety of the Cobb-Douglas macro production function with labor and capital, and an efficiency parameter representing technological change in the broad sense, i.e. everything that increases output when the factor endowment of the economy is given[7].

5 See Schiff and Valdés (1992) and Krueger (1992).
6 For a critical overview see Nelson (1981).

The growth accounting exercises by and large confirmed the suspicion that the role of capital had been exaggerated in the early discussion. They typically left a large unexplained residual, the technology factor, or total factor productivity as it would later be termed, but what was behind that residual was not clear. Technological change in growth accounting models was exogenous and disembodied. It came as manna from heaven and had no relation to investment, either in physical capital or in measures that would enhance the quality of the human factor.

The presumption was that much could be achieved with education (Schultz, 1963). Schooling and informal training would serve to "augment" labor and make it more productive. Frequently, investment in physical capital and "investment in man" were seen as virtually exclusive alternatives, or at least as competing instead of complementary ones. Unless there are skilled people to run sophisticated machinery, newer and superior vintages of capital will produce well below capacity, and unless educated workers have the appropriate tools and machines at their disposal they will be no more productive than their unskilled colleagues. It is difficult to separate the contributions of the two factors even on the conceptual level.

Technological change also turned out to be a problem. Economic historians could tell the growth and development economists that technological change was one of the mightiest forces propelling output increases throughout the history of mankind[8], but it took time before this fact was picked up in the model work[9]. Until investment and research and development efforts were explicitly incorporated into the models of endogenous growth from the 1970s onwards, the technology factor lived a strange and isolated life. While everyday casual observation indicated that technological change would go hand in hand both with the replacement and increase of the capital stock, and with the improvement in educational level, the most common assumption was that technological change proceeded in a completely autonomous fashion and, contrary to what history was teaching us, that it was not biased in any labor or capital saving direction.

7 See Denison (1967).

8 See Gould (1972).

9 See Grossman and Helpman (1991).

Growth accounting left out the underlying factors. It was a mechanical exercise that said nothing about what propelled investment and innovation, for example, and it failed to come to grips with the policy relevant questions.

Having said that the fact remains that capital is an important production factor when viewed in its proper context, in the interplay with labour and technological progress. The other side of the capital formation coin is savings[10]. Most savings in developing countries derive from households. The corporate sector usually is small, government budgets frequently show deficits, and parastatal corporations often run losses. Their budget constraints are soft. It is only by pure chance, however, that those with a high savings propensity are also the people who have the best projects. In other words, savers have to be connected with investors through a financial mediation mechanism.

Financial markets in developing countries are frequently fragmented (McKinnon, 1973). Savers and investors are like islands in a sea, they do not have much contact with each other. They lack information about where to find each other. As a consequence, investors are limited by the extent of their own resources. They must finance their projects themselves. Conversely, savers do not find assets that give them a high return and at the same time contribute to the growth of the economy. They are forced into gold, for example, or jewelry, or land.

Sometimes this situation is a result of what is termed a shallow financial strategy (Shaw, 1973). Actually, this is hardly a strategy at all but rather the by-product of an effort to stimulate industrialization through low real interest rates. These rates, especially when the rate of inflation is high, can play no role in the allocation of available funds to investment projects. Other criteria, like "first come, first served", for example, are employed instead. The allocation of resources becomes random, and servers prefer "unproductive" assets. The alternative is a "deep" financial strategy, with higher (above all positive) real interest rates which can help direct savings to their most productive uses. The savers abandon the hoarding of gold and jewellery and put their money in the bank instead. In this way, the

10 See Perkins *et al.* (2001), chapter 11, for an overview.

foundations are laid for the development of a variety of financial assets that correspond to differences among savers in terms of risk, maturity, etc.

5. THE MOBILIZATION OF GOVERNMENT RESOURCES

The alternative to private savings is public savings. The central resource mobilization instrument for the government is the budget[11]. Fiscal policy is of course used for a number of different reasons: stabilization, resource allocation, growth and redistribution of wealth and incomes, to mention just the most important ones. This makes it necessary to make compromises between the different aims when these happen to conflict with each other. The following remarks apply mainly to the growth aspect.

Resources are mobilized not only via the revenue side of the budget. Allocating expenditures correctly, to the sectors that have the greatest impact in terms of efficiency and growth, is as important as obtaining taxes and other revenues. If the accumulated resources are squandered on unproductive uses not even the best tax system in the world will yield any contribution to economic development.

The tax system is perhaps the most important determinant of the shares of public and private saving, investment and consumption. Increased taxes will result in a decrease in either private consumption or private savings or both, and, correspondingly, the government has a choice when it comes to the locus of investment. This may take place through the public sector, or the state may choose to channel some of the funds back to the private sector through a variety of different schemes. The choice in both cases is a political one.

Taxation in third world countries is more difficult than in the first world[12]. Most of the tax bases are considerably narrower, and assessment and collection costs tend to be considerably higher. A good case in point is income tax. In many countries only a minority reach

11 See Perkins *et al.* (2001), chapter 12.

12 See Bird and Oldman (1990), and Tanzi (1991).

the income level where they have to pay a tax on what they earn. Besides this, it is difficult to assess how much people earn. Income taxes require a system where the individual himself declares his earnings, if assessment costs are not to be prohibitively high. Hence it requires literacy. Another factor is that income taxes are easily avoided when the public administration is weak and/or corrupt.

The difficulty of raising revenue through taxes can also be illustrated by the example of land taxes. Many third world countries are predominantly agrarian, and land is an important production factor. Frequently, however, land is held in such a way that it produces an output that is way below its potential. This, in turn, makes it difficult to obtain tax revenue from the land. Theoretically a system that takes the production potential of the land into account can always be devised. If the quality of the land and the price that its produce will fetch are known, it is possible to calculate a tax rate that provides an incentive for maximizing the value of production in a given area and penalizes the holding of land for speculation or other unproductive purposes. In practice, it is virtually impossible to devise such a system. Land quality vary widely even in the same small location, and the manpower needed to handle the system would be so large that the costs would exceed the revenue obtained by a wide margin.

Indirect taxes are usually easier, since they build on real prices paid in a market, but even so the need for administrative capacity may be great. If markets are small, numerous and spread out across a wide territory, if transportation is difficult, sales or value added taxes may also be costly to administer. The result of this is that indirect taxation tends to concentrate on transactions carried out in relatively few places, and this usually means taxes on foreign trade, on imports as well as exports. Setting up a limited number of customs houses is much easier than covering local markets all over the national territory. But tariffs generate their own problems: if they are too high, goods will be smuggled instead of passing through the legal points of exit and entry.

A discussion of taxation in developing countries must also point to one of the most frequently used devices: inflation. Printing money or debasing the currency is a classic trick that governments have used throughout history to tax their citizens. The principle is simple: only the government can issue money, while the citizens have to part with real resources in order to obtain it. If the money supply increases faster than the supply of goods and services, people holding cash will be penalized since at the end of each period their cash holdings will fetch less in the market than at the beginning of the period. The difference constitutes the inflation tax. Though this is a classic trick, you cannot fool all of the people all of the time. Inflation taxes are self-defeating. In the end, the citizens will prefer to hold assets other than cash.

Thus, to sum up so far, taxation is difficult in developing countries, and increasing government revenue may be even more difficult. The costs easily exceed the revenue. This leaves the expenditure side of the budget, the possibility of increasing government resources by cutting down on spending. In the general discussion a number of candidates for reduction are usually presented. One of these is the size of the public sector itself. This may be politicized in the sense that people get jobs as political favors or because they have done the government political favors, and not on their own merits. This type of administration is usually inefficient when it comes to providing public services. A second candidate is the army. Many developing countries have oversized armies that bear no relation to the external threats the countries are facing. Third, many governments tend to spend large sums on "white elephants", projects that do nothing for the economy or for the social sectors, and whose only yields are political. Cutting expenditure is difficult, however, and care must be taken to make the "right" kind of cuts. A wholesale reduction in wage and salary rates in the public sector may simply result in increased corruption among public officials who find it difficult to survive on what they earn.

6. INTERNATIONALIZATION AND GLOBALIZATION

The internationalization of the world economy in recent decades has had a notable impact on the discussion of national development strategy. While many developing economies were able to attempt import substitution industrialization strategies up to the mid-1980s, the period thereafter has been marked by increasing outward orientation and openness. There are several reasons for this shift in development philosophy. The main cause may be the disappointing economic performance of many of the countries that focused on import substitution, which stands in sharp contrast to the formidable growth of more export oriented economies, particularly those in East and Southeast Asia. Changes in the structure of international economic institutions have also favored outward oriented strategies. With the liberalization of international trade through the GATT and the World Trade Organization (WTO), both the costs and benefits of alternative development strategies have changed. More specifically, all developing countries have come under pressure to lower their import barriers, which has made inward oriented strategies more costly and complicated, and at the same time their access to foreign markets has improved, providing new opportunities for export-based strategies. Private capital flows have increased rapidly, replacing aid as the main source of external funds for the developing world. As shown in table 1, the volume of private capital flows –in particular foreign direct investment (FDI)– grew from about U$S 6 billion in 1970 to well over U$S 200 billion around 2000. The volume of aid also grew until the mid-1990s, but has actually contracted since them. In 2000, the net flow of aid was only about one-sixth of the net flow of private capital. Private capital flows are rarely directed to the inward oriented economies but go instead to the more export oriented countries. The pace of technological change has accelerated, with most of the new technologies developed by the large multinational corporations (MNC) based in the developed countries. Inward oriented economies face severe problems in getting access to these technologies since the diffusion of modern technology takes place mainly through the foreign direct investments of such corporations.

Table 1
Net Resource Flows to All Developing Countries, 1970-2001
(U$S million)

	1970	1980	1990	1995	2000	2001
Net resource flows	11,177	82,816	99,148	260,193	261,133	194,477
Official net flows (grants and concessional loans)	5,383	34,993	55,591	54,053	35,287	36,508
Private net flows (portfolio capital and FDI)	5,794	47,823	43,557	206,139	225,846	159,970
Share of FDI in net resource flows	0.20	0.05	0.24	0.41	0.64	0.86

Source: World Bank (2002), page 12.

As a result of these changes, national development strategies have been forced to include an international dimension. It is not enough to consider only how to strengthen development fundamentals like savings and investment capacity, education, and government finances, but the challenge is rather to manage these tasks in an international context. One of the key questions has become how the national economy is to be integrated with the global economy. The remainder of this chapter will review some of the issues that have emerged in this debate, looking first at the rationale and effects of import substitution, and then going on to a discussion of how trade reform, including both the liberalization and simplification of trade regulations, can be expected to improve economic efficiency and growth prospects.

7. THE RATIONALE FOR IMPORT SUBSTITUTION

The case for import substitution is based on the fact that today's developing economies -unlike most Western countries at an early stage of their development- face an international environment that is dominated by highly developed, industrialized competitors. The idea is essentially to learn as much as possible from the countries that have already grown rich and advanced, and at the same time to shield the fledgling domestic "infant economy", at least for some time, from foreign competitors that are already rich and advanced. Hence, the objective is not only to replace some selected import goods with

domestically produced goods, but rather to create "*an economy that is sufficiently flexible, diversified, and responsive that it can weather shocks, can respond to and indeed create opportunities for growth, and can, on its own, generate continually increasing welfare for its people*" (Bruton, 1989, page 1062). The construction of this kind of flexible and diversified economy demands the accumulation of new knowledge and skills in many different fields. Protection is needed, it is argued, because it facilitates the development of a more "complete" economy and extends the scope for learning, searching, and trial and error to a large number of industries. Once the desired broad competence is established, it should be possible to achieve high growth rates as well as an ability to react swiftly and efficiently to changes in the competitive environment. Free trade, by contrast, is expected to lead to specialization and a concentration of resources in those few areas where the developing country has some comparative advantages, but also to the risk that the adjustment to unanticipated changes, e.g. in the terms of trade or foreign demand, will be much more painful and costly.

The main instruments of import substitution are tariff and non-tariff barriers that facilitate imports of the capital and intermediate goods that are needed to develop and run domestic industries, but protect against competitive imports of goods that are produced at home. In addition, the value of the domestic currency is typically fixed at an artificially high level to make the necessary imports affordable to deserving domestic firms, and various subsidies are used to stimulate investment. Attitudes towards foreign direct investment are often somewhat unclear. At the same time as restrictions on FDI protect domestic industry, FDI is also a potentially important source for learning and technology transfer. Consequently, various kinds of restrictions and performance requirements are typically imposed when FDI is allowed. In a number of countries around the world, import substitution has also been coupled with capital controls, restrictions on labor mobility and international travel, and more or less severe censorship of the mass media. The common denominator among these different forms of protection is that they aim to allow each developing country to search for its own industrial, institutional and cultural solutions, rather than adopting what is offered by the countries that are already rich.

The controls and restrictions required to protect the domestic market undoubtedly distort the allocation of resources and impose some costs on the economy. In general, the result is reduced availability of goods and services (as well as inferior quality), because protected domestic producers are less efficient than the leading foreign producers, and because domestic industry is only able to produce a limited supply of differentiated goods. Proponents of import substitution argue that this cost is only temporary, and makes up part of the necessary investment for future prosperity – it is simply the price to be paid for the knowledge and skills that are required in a modern, competitive economy. Moreover, carefully planned import substitution should aim to maximize the net returns of protectionism, which means that the costs should be carefully controlled. The longer any specific industry is protected, the greater the accumulated costs of the policy will be. Similarly, the greater the deviation between the input requirements of a protected industry and the country's factor endowment, the higher the costs will be. Hence, long or unlimited periods of protection and big violations of comparative advantages should only be allowed if the expected benefits in terms of learning are very significant. A credible scheme for how protection is to be phased out is, in fact, an essential element of successful import substitution.

8. COSTS OF IMPORT SUBSTITUTION

Although import substitution may appear as a very attractive policy on a theoretical level, it has not proved very successful in practice[13]. Successful import substitution requires the economy to manage two very difficult transitions. The first challenge is to establish a reasonably efficient and dynamic economic structure behind tariff barriers and protective devices. The second is to eventually move from protection to a more open trade environment. International experience suggests that both challenges are very difficult to meet. The distortions caused by protection are typically so serious that high sustained growth cannot be achieved even when domestic industry is shielded from international

13 There have been many empirical studies, beginning with the classical one by Little, *et al.* (1970).

competition, and the transition from protection to free trade often meets with serious resistance from the domestic interest groups that benefit from protection.

One fundamental problem is that protectionism distorts prices, so they do not fully reflect supply and demand conditions. This, in turn, distorts the allocation of scarce resources, since firms and individuals base their decisions on observed official prices. Instead of focusing on areas where the country has natural comparative advantages, human and physical resources are channeled into the production of goods that would "normally" have been imported, i.e. to sectors where the country has comparative disadvantages. The technologies adopted in these import substituting industries will, almost by definition, be inappropriate for the factor endowments of the country. In general, import substituting technology employs much capital and little labor. The typical consequence is a low rate of employment creation in the "modern" sector. However, the high capital intensity and skill requirements lead to high wages in this sector, which leads to growing income inequalities between those who have jobs in modern industry and those employed elsewhere in the economy. It is also common for regional disparities in the economy to increase as a result of import substitution; only a few locations in each country are likely to possess the advanced physical and human infrastructure needed for modern, capital intensive industry. The divergence between the country's factor endowment and the requirements of protected industries may also result in bottlenecks that could severely disrupt production.

Second, trade barriers are likely to create productive inefficiency. Domestic firms will be able to remain in operation even if they are much less efficient than the leading exporters in the world market. Even in cases where nominal and average tariffs are not remarkably high there may be substantial effective protection of local production. This reduces the motives for minimizing costs, which means that resources are inevitably wasted. In addition, a guaranteed market makes it less important to stay up to date with changes in technology and conditions of demand. Paradoxically, protection may therefore eliminate some important incentives for learning. Another aspect of this problem is that falls in international prices and production costs,

brought about for example by technical progress, may be slow to reach domestic consumers. It should also be noted that import substitution often introduces "soft budget constraints", particularly for state-owned enterprises (SOEs). The main reason is that the policy sets numerous objectives for an industry. Seen from the perspective of policy makers, this means that the success of a company is not only reflected in its business profit, but also in its contribution to the accumulation of skills and knowledge for the benefit of the entire nation. Hence, it may be easy for industry to rationalize weak financial performance with the argument that the distorted prices do not reflect the "real" underlying value of their operations. Likely policy responses are to readjust trade barriers to provide even more protection, tax relief, soft credits, investment subsidies, and other measures to improve the financial performance of the firms in question.

A third point to note is that import substitution often causes imbalances in a country's external accounts. At its initial stages, the policy is extremely import intensive, since most of the capital goods needed to establish import substitution industries must be sourced abroad. This import dependence often survives for an extended period of time since some industries must also import their raw materials and intermediate products. But at the same time the environment is biased against exports, and foreign exchange is typically in short supply (except, perhaps, in countries with very high revenues from exports of oil or other mineral resources). The resulting trade deficits can often be financed in the short run while prospects for the future are still promising, but FDI and commercial lending may begin to fall very rapidly if economic performance does not come up to expectations. This, in turn, may necessitate radical cuts in imports, resulting in bottlenecks and the disruption of production. So the success of import substitution is to some degree dependent on whether nations that are already rich and advanced are willing to finance the policy.

Additional costs arise because protectionism is likely to promote various income-generating but unproductive activities such as smuggling, lobbying, tariff evasion, and corruption (Bhagwati, 1982). These costs include the resources spent on unproductive activities as well as the losses from the new distortions that may be created. For instance, the cost of lobbying for more protection is not only the time

and money spent by industry to influence decision makers, but also the costs that occur if lobbying is successful and trade barriers are raised. Similarly, the cost of smuggling is not only measured by the lost tariff revenues and resources spent to avoid customs controls, but also includes the losses incurred by law-abiding firms that cannot compete with cheap smuggled goods. Yet, in a developing economy, the most serious consequence of this kind of rent-seeking may be that various morally questionable activities become more common (and more or less accepted), which reduces public confidence in economic institutions and "rule of law".

9. THE RATIONALE FOR TRADE POLICY REFORM

How is trade policy reform expected to alleviate the problems discussed above? There is a good reason to look at the arguments in favor of trade reform in some detail, although such a discussion will to some extent reiterate the preceding inventory of the costs of import substitution. The reason, of course, is that the case for trade reform rests on how efficiently a more outward oriented trade regime can be expected to alleviate the costs.

Summarizing a broad survey on the rationale for trade policy reform, Rodrik (1995) has argued that a more open and outward oriented trade regime is likely to be beneficial because it:

- reduces static inefficiencies arising from the misallocation of resources,
- enhances learning, technological change, and economic growth,
- improves flexibility in the face of external shocks, and
- reduces wasteful rent-seeking activities.

As noted above, there are strong reasons to expect that inward oriented policies will distort the allocation of resources and create a pattern of specialization that differs markedly from the comparative advantages of the country in question. In theory, it is not easy to demonstrate the magnitude of the welfare costs of the static resource

misallocation caused by import substitution. Theoretical models with standard neoclassical assumptions – perfect competition, constant returns to scale, no externalities, technology differences, and so forth – typically suggest that the losses do not exceed a couple of percentage points of GDP[14]. In practice, however, it is easy to observe that the costs are quite significant[15]. The capital and skill requirements in many modern industries are not compatible with the supply of these factors in most developing countries and it is not unusual to find examples of import substitution operations with negative value added, e.g. in assembly of motor vehicles. Trade reform and liberalization encourage the restructuring of industries. Once tariffs and other trade barriers are lowered, domestic prices will begin to converge towards the prices in the international market. More specifically, the prices of import substitutes will fall when foreign goods can enter the market at lower tariffs, and export goods will become relatively more expensive. This means that firms in the export sector, where the country has comparative advantages, will become more profitable, while firms producing import substitutes are likely to suffer losses. Consequently, new firms will be attracted to the export industries, while firms in the import substitution sectors will have to upgrade their productivity to international standards or be forced out of business.

The argument that an open trade regime promotes learning, technological advances, and economic growth is, in its simplest form, the flip side of the view that protectionism tends to create domestic monopolies and oligopolies that are more interested in a "quiet life" than in continuous cost reductions, innovations, and efforts to acquire new technological capabilities. In essence, trade reform is expected to accelerate the rate of technological progress because it raises the level of competition and increases the frequency of contacts with foreign technology. Domestic firms that focus on the local market are

14 It is possible to construct models with imperfect competition that come up with larger estimated losses, but such results are hard to generalize since there is no consensus about what the relevant market imperfections are. In fact, depending on what kind of market imperfections are assumed, the optimal policy may be *either* outward orientation *or* import substitution.

15 It may still be very difficult to quantify the static costs from an inefficient allocation of resources. One reason is that the welfare costs tend to be alleviated by the emergence of smuggling and black markets once the distortions from restrictive trade policies get large enough. Another reason is that technology changes continuously, which makes it difficult to distinguish between static losses and dynamic losses, e.g. in the form of slower technological progress.

forced to work harder to retain their profits and market shares when they are exposed to import competition, and firms that export must keep up with modern technology in order to maintain or improve their positions in foreign markets[16]. The formal theoretical arguments for expecting a strong positive relation between openness and growth only appeared recently, with the advent of models of "endogenous growth", but the link between trade policy, productivity, and growth has been examined in numerous empirical studies in recent decades[17]. The summary conclusion from this large body of empirical literature appears to be that openness does promote productivity growth. For instance, cross-industry studies of the relation between trade regimes and various measures of productivity typically find that restrictive trade policies coincide with periods of slower growth[18]. There are also numerous cross-country studies documenting a positive relationship between outward-orientation and economic growth[19].

The argument that outward oriented countries are better able to manage negative external disturbances is largely based on comparative studies by Balassa (1981a and 1981b) on cross-country experiences of the first oil shock in the mid-1970s. He argues that the policy responses to balance of payments problems caused by terms of trade and export demand shocks can be based either on efforts to increase inflows of foreign currency, in the form of external financing or export revenues, or efforts to reduce imports. Although outward oriented economies were more vulnerable to the initial shock, Balassa concludes that they were also more flexible during the transition out of the crisis. Instead of severely restricting imports and domestic demand, export oriented countries could respond by increasing their world market shares, which had allowed them to retain a relatively high rate economic growth

16 See Balassa (1988).

17 For some influential theoretical works on endogenous growth, see e.g. Romer (1986 and 1992) and Lucas (1988). De Melo and Robinson (1990) provide a model focusing explicitly on the impact of trade policy.

18 See Bell, *et al.* (1984), Dollar and Sokoloff (1990), Krueger and Tuncer (1982a and 1982b), and Nishimisu and Robinson (1984).

19 See Helleiner (1990), Esfahani (1991), and Rodrik (1995). In this context, it is important to note that a more open trade regime may well lead to lower labour productivity. As noted earlier, import substitution is often related to subsidization of imported capital and high capital intensities, which in turn translate into high labour productivity. Trade liberalization and exchange rate reforms typically raise the relative price of capital, which induces firms to reduce their capital intensities.

through the transition period. Similarly, comparing East Asian and Latin American experiences during the 1980s, Sachs (1985) argues that many East Asian countries were able to avoid protracted debt crises thanks to their more outward oriented policies. This flexibility also appears to be important at the micro level. For instance, studies have shown that MNC affiliates in Latin America – that are by nature more outward oriented than local firms – weathered the debt crisis better than local firms, since they were faster in reorienting their operations from domestic sales to exports (Blomström and Lipsey, 1993).

The last argument in favor of trade reform, i.e. that rent-seeking is less widespread in open and outward oriented trade regimes, assumes that a reduction in trade restrictions also eliminates some of the rents that can be sought by lobbyists or black market operators. Clearly, this occurs when quotas are removed and tariffs are lowered and simplified. However, it should be noted that some types of trade reform may create new objects for rent-seeking. As an example, there are studies on Turkey showing how lobby groups responded to the country's increasing outward orientation by shifting from actively seeking import licenses to seeking export subsidies (Onis, 1991). This kind of lobbying is potentially costly, and it highlights the danger inherent in any kind of selective policy intervention. Regulation typically creates privileges and rents, and the emergence of rents typically creates interest groups that exploit the new opportunities and may eventually oppose the erosion of their privileges.

While it is likely that trade reform will alleviate some of these problems, it must be recognized that the costs of trade reform and industrial restructuring are likely to be considerable. Some firms will go out of business because they cannot adjust to tougher competition, and others will have to adopt painful rationalization programs. Some investors will lose their capital and some workers will lose their jobs. Moreover, the government's revenues from trade taxes may fall as a result of trade liberalization, and there may be a loss of tax revenue from firms and industries that were profitable only because of protection from foreign competition.

It can be argued that these adjustment costs are unavoidable and that they make up a necessary investment for a sound business

environment. Yet it is obvious that careful trade reform should consider the costs of the reform itself (just as successful import substitution should take into account the various efficiency and welfare costs of that policy). So trade reform should not only aim at removing distortions and trade barriers as efficiently as possible, but should also aim to minimize the temporary welfare costs during the transition to free trade.

How should trade policy reform be designed and implemented to best support national development objectives? To answer this question, it is necessary first to define "trade policy reform". A broad specification from the World Bank suggests that trade policy reform includes such measures as the removal of export restrictions and export taxes, the introduction or improvement of duty drawback or temporary admission systems for imported inputs used in exports, the removal of quantitative import restrictions, and the reduction and simplification of import tariffs or the imposition of taxes on domestic production of protected items at rates equal to their tariffs. Devaluation can also be a reform (Thomas, *et al.*, 1991, page 12).

On the basis of this definition, it is obvious that the reduction and removal of various trade restrictions contribute to trade reform. It is also clear that other measures to simplify and clarify rules and regulations qualify as potentially important trade reforms, especially in countries where the overall trade policy environment is complex and opaque. The role of devaluation is to correct the overvaluation of the local currency and the resulting anti-export bias that typically characterizes inward oriented trade regimes. In addition, devaluation is an important instrument for reducing the excess demand for imports that may occur when import restrictions are removed.

A common feature of the various measures that make up trade policy reform is that they all contribute to increased openness and outward orientation. An alternative way to classify trade reform -and to make the distinction between openness and outward orientation more explicit- is to differentiate between specific measures depending on whether they emphasize "neutrality" or "liberalization", or elements of both. Reforms that entail a "shift toward a more neutral

policy environment" aim to reduce the anti-export bias inherent in import substitution. This can be done by lowering trade barriers, raising export incentives, or a combination of the two. "Liberalization" involves a reduction in trade restrictions and other policy-induced distortions and increased reliance on market mechanisms instead of discretionary interventions by the public sector[20]. In essence, this means that prices play a more important role as incentives and signals. Some examples may be helpful to illustrate these distinctions. The introduction of an export incentive to offset the anti-export bias from high tariffs makes for a shift toward neutrality, but it may be achieved without much liberalization. Replacing quantitative import restrictions with equivalent tariffs creates a more liberal but not a more neutral policy environment. The elimination of an import tariff is both a shift to more neutrality and an act of liberalization.

This categorization is important in the present context because the design, timing, and sequencing of various reforms –not least, the desired balance between neutrality and liberalization– is likely to depend very much on the initial conditions in the reforming economy. For instance, a country with high trade barriers but a well developed market economy may be able to implement reforms that aim for increased neutrality and liberalization at the same time. On the other hand, a country with a weakly developed domestic market may be wise to begin its reforms with a greater emphasis on creating more neutral incentives for exportables, importables, and non-tradables, since a comprehensive liberalization may be difficult and very costly to manage if domestic actors are not quick to respond to the new relative prices brought about by trade liberalization. History also matters, but not to the extent that the experiences of other countries can be deemed irrelevant. One of the essential elements of any development strategy should be benchmarking, to learn from both the past and the present■

20 See Thomas, *et al.* (1991).

Chapter II

THE CUBAN ECONOMY: TRANSFORMATION AND CHALLENGES

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Introduction

Cuba has had to change the nature of its participation in the international economy twice in thirty years, and on both occasions the country faced considerable costs to adapt to the new markets. The first change took place in the early 1960s, when the United States unilaterally decided to cut off relations with Cuba. The second change was due to the collapse of the socialist bloc in the early 1990s, which took place in an even more unfavorable international environment than that of the 1960s.

To make matters worse, Cuba is the only country in the western hemisphere to be blockaded by the United States. Cuba was not party to any multilateral or bilateral sub-regional agreement, nor to any scheme of preferential trade treatment in the European or the US markets (Lomé and the Initiative for the Caribbean Basin).

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The process of economic reform that began in the 1990s was aimed not only at effective participation in international trade but also at maintaining the social progress achieved during the revolutionary period. This has meant a substantial change in the structure and functioning of the Cuban economy. The aim has been to integrate strong central State action as a strategy while keeping control of the economic results, with a greater management role for State-owned firms and local governments than before.

The 1990-2003 period can be divided into two sub periods: 1990-93 and 1994-2003. The first sub-period was characterized by a serious deterioration in economic activity that reached its lowest point in 1993. The strategy that prevailed was intended to minimize the social costs of adjusting to external restrictions while creating conditions for Cuba's reinsertion into the international economy. In the second stage, during which Cuba has seen a gradual improvement in its Gross Domestic Product (GDP), attention was focused on macroeconomic stability, reemphasis of international markets and new social development targets.

Given the above, the description of the transformations that occurred in Cuba and their main results are organized here in two parts that differentiate the targets of government strategy by period: (i) the 1990-93 period, when the new international situation was assimilated and (ii) since 1994, when the basis for a new pattern of Cuban international trade was created.

1. THE CUBAN ECONOMY IN THE EARLY 1990s

Cuba is a small country in terms of population (11.25 million inhabitants in 2002) and it has a profile of advanced demographic transition. There is a low birth rate, 0.33 per thousand in 1998-2002, and a high percentage of elderly people, 24.8% were over 60 years old in 2002 (ONE, 2003). A 2002 estimate of GDP *per capita* in terms of purchasing power parity classifies Cuba among the mid-level countries in Latin America, with U$S 5,200-U$S 5,500 (Martínez, 2003 and U. Echevarría *et al.*, 2002).

In 1990-1993, the Cuban economy went through one of its most difficult periods in the whole of the 20th century. The result was that, according to estimates from the Economic Commission for Latin America and the Caribbean (1997), GDP per capita in the country was set back twenty years. Both external and internal factors were responsible for this. The crisis coincided with a time of financial and trade difficulties with the capitalist area[3] together with the effects of the Torricelli law[4] and the disappearance of the model based on relations with the Council for Mutual Economic Assistance (CAME) countries (Alvarez, 1995).

1.1 Background

With the disintegration of the socialist bloc, the Cuban economy not only lost its main markets for purchasing goods and services[5] but it also lost favorable price conditions[6] and its only external source of funds and credit[7]. Moreover, the change that was most difficult to overcome, and is hardest to quantify, was the loss of the type of relations and ties that had been established as a result of being a member of the CAME since 1972. The economy had functioned according to the principles of CAME, and these were totally different to those in the rest of the world. The external sector of the CAME countries operated on the basis of coordinating plans in the public sphere, a State monopoly on foreign trade, and the non-convertibility of currencies. The State sector predominated, the economy was run

3 In addition to the cost of the US blockade, the country is not a member of any multilateral or regional financial institution.

4 Known as the Law for Cuban Democracy, this was signed by President George Bush in 1992. It forbids any ship that has docked in Cuba to enter a US port within a period of 180 days. This abruptly suspended trade between US company affiliates in third countries and Cuba (in 1992, trade with these affiliates amounted to U$S 718 million, and 90% of it was food and medicines). This forced Cuba to search for new suppliers, and freight costs raised 15-30% above market prices (MINREX, 2003)

5 At the end of the 1980s, the socialist countries accounted for 80-85% of Cuban trade. The CAME market received 63% of sugar exports, 73% of nickel, 95% of citrus fruit and 100% of electronic components. In addition to this, it was the source of 63% of food imports, 98% of fuel and lubricants and 80% of machines and equipment (Alvarez, 1995).

6 It is estimated that prices of goods exported to the socialist bloc were 50% over those prevailing in the 1980s in the world market (Mañalich, 1992).

7 In 1988-89 about 25% of the imports from the CAME countries were financed by a commercial imbalance (Alvarez, 1995).

according to centralized plans, there were no budget financing difficulties (there was no system of direct taxation for corporate bodies or for private persons), and prices did not play a significant role in resource allocation since this was run in accordance with a material balances system.

After the collapse of the socialist bloc, the US government intensified its efforts to isolate Cuba totally in the international arena, even to the point of passing laws of an obviously extraterritorial nature. This aggravated the problems that Cuba was already facing in terms of its efforts to reassert itself in international trade. Not only did the country not have access to the largest market in the region (the United States), but it was not a member of any international or regional institution. Besides this, it did not subscribe to any agreement for sub-regional integration and was not included in the systems of preferential access that the developed countries had granted to the Latin American countries (Lomé, Caribbean Initiative, Sugar Quota System).

In addition to this adverse external environment, the leading factors for growth in the Cuban economy had been showing signs of exhaustion since the mid 1980s. There were severe macroeconomic imbalances (budget deficits, chronic trade and balance of payments deficits), and weak dynamics in financial circulation (a serious lack of investment, a poor response to measures intended to stimulate exports, shortfalls in the quantity and quality of consumer goods). These, along with other technological factors, led to great dependence on external suppliers for goods such as energy-intensive equipment, fertilizers and animal food for agricultural production.

Foreign restrictions had a big impact because the Cuban economy was highly and increasingly dependent on foreign trade, and this was reflected in the import coefficient, which rose from 15.8% in 1975 to 41.1% in 1989. Furthermore, the characteristics of the country (not a large area and with relatively scarce natural resources), added to insufficient industrial integration and a weak national base of equipment, seeds, chemical products and even hand tools for agricultural production, made the situation even worse (Alvarez, 1995 and ECLAC, 2000).

1.2 The Adjustment Process: 1990-93

The breakdown of its traditional trade channels at the beginning of the period constituted a severe external shock to Cuba. The deterioration in the terms of trade[8] (import capacity contracted by more than 70% between 1989 and 1993) was the result of an interruption of credits[9] and an abrupt fall in export income (a loss of 66.8% in the 1989-93 period[10]).

In order to ensure minimum levels of activity and nutrition, fuel and food were given priority in foreign purchases, and their share in imports increased from 43% in 1989 to 67% in 1993. On the other hand, imports of equipment, intermediate goods and other consumer goods decreased more than any other category. In 1993, the value of these three imports amounted to only 13% of the 1989 figure (Quiñones and Mañalich, 2003b). These imbalances, and the high ratio of total imports to GDP, generated further macroeconomic adjustments which resulted in a 30% fall in GDP between 1989 and 1993 (ECLAC, 2000).

This shock could not be passed on to aggregate demand through the traditional financial and monetary instruments (devaluation, interest rates, taxes) since there were no operating markets. Moreover, such a strategy would have worked against social policy objectives. Instead, the rationing system for consumption goods was extended and gross investment was severely cut back, thus generating a de-capitalization of fixed components.

In September 1990 a phase known as "the special period in times of peace" began. Foreign currency was scarce, and strict controls were imposed so as to reorganize Cuba's international position. The ultimate objectives behind the strategy were to minimize the social costs of economic contraction, and to reorganize the structure of production and adjust to the new circumstances. This reorganization clearly meant establishing new bases for adequate management in the sectors producing goods and services.

8 The fall during the 1990-93 period has been calculated at 33% (ECLAC, 2000).

9 The balance of the capital account in 1993 was one tenth that in 1989 (ECLAC, 2000).

10 Sugar made up 50% of the drop, its price falling from 51.4 cents/kilo in 1990 to 21.4 in 1992.

Some measures that were taken to deal with foreign trade were aimed at modifying the way it had been run before the fall of the socialist bloc. However, their actual enforcement was conditional upon the future evolution of Cuba's relations with the USSR. That country had not yet dissolved and it was still Cuba's main supplier. A first step had to do with Decree Law 50[11] which regulates foreign investment. This was modified in the mid 1980s to allow foreign companies to have direct links with some Cuban producers. In 1991 some authorized companies were allowed to operate independently under very restricted schemes of self financing in foreign currency. Besides this, a centrally controlled mechanism granted some State entities the possibility to retain a percentage of incoming funds to cover their operations. The 1992 constitutional changes provided continuity in the process, they reaffirmed the irreversibility of the new regulations, especially those concerning the acknowledgement of different forms of ownership (joint ventures, economic societies and associations), the elimination of the State monopoly on foreign trade, and the introduction of changes in the planning system.

In this new legal framework there was an upsurge of new commercial companies, especially in areas that had to do with foreign trade and tourism. In 1993, there were already 80 joint ventures with foreign capital (compared to 20 in 1990), and 36 of them were based in Cuba. At the same time, the country developed "self financing schemes in foreign currency" for export activities (fishing, steel, nickel, air and sea transportation, tobacco and coffee) for firms demanding low amounts of very specific foreign resources (for sports, culture and education) and for import substitution activities that were mainly linked to tourism (González, 1995).

Measures were taken to maintain employment levels and nominal income so as to protect different population groups from exclusion and to distribute the social cost of the foreign shock over the whole population. The costs of this were financed with inorganic monetary issue. Given the restricted supply of goods and services and the absence of taxes, this further raised the budget deficit. The deficit went from

11 This was an unusual event in the revolutionary period because, since the early 1960s, most Cuban investment had been made by the public sector in a context of almost total State ownership.

6.7% of GDP in 1989 to 30.4% in 1993, and increased the accumulation of monetary liquidity from 20% of GDP in 1989 to 66.5% in 1993 (ECLAC, 2000 and 2003).

As to investment, the sectors given priority were those which could boost the low stocks of foreign currency and generate the largest amounts of foreign income. These sectors were linked to traditional exports such as tourism, the medical-pharmaceutical industry and biotechnology, and sectors that substituted imports such as agriculture, food and crude oil.

However, the productive response to these measures was not what had been expected. In most sectors signs emerged that the reforms were not far-reaching enough. This was particularly evident in agriculture, but also in other economic areas, in which the "traditional" and the "emergent" sectors functioned in isolation from each other. There were a few exceptions, like in activities linked to oil production, which functioned with a self financing scheme.

This first stage came to an end in the second half of 1993. The most critical moment of the crisis had been reached, and changes towards a better functioning of the economy began.

The situation at that time could be summarized as: (i) a general decline in economic activity, (ii) an accumulation of internal financial imbalances that caused the devaluation of the Cuban peso and the deterioration of workers' income, and (iii) an increase in supervision of work and social discipline[12]. Meanwhile, a set of measures were implemented with the aim of stimulating production, creating jobs, and collecting the foreign currency that was in hands of the general public.

At the same time, the economy was operating on a dual basis with two well-defined sectors in its management, degree of autonomy and currency used for transactions. These were "the traditional" and "the

12 This could be seen in the high level of hidden sub-employment, lack of incentives to search for formal jobs, selectivity in the acceptance of jobs, high labor fluctuation, high absenteeism and a fall in the average age of retirement (ECLAC, 2003).

emergent" sectors. The latter, albeit with insufficient strength to promote recovery in the economy, acted like an "oxygen valve". It generated a minimum level of economic activity and, with the creation of a new managerial and labor culture[13], began to establish the basis for re-insertion in the international arena.

Some social indicators showed a worsening of the situation but not to the extent that might have been expected given the seriousness of the external shock. The supply of food fell dramatically, and this led to a calorie deficiency of 16% compared to the basic consumption basket recommended in 1993, from a surplus of 28% in 1989. Daily consumption of proteins fell by 40% and fats by 64% (ECLAC, 1997). Even though the health care and education sectors also found it difficult to ensure services, there was an improvement in the infant mortality rate and also in maternal mortality and life expectancy. In contrast, the deterioration in other public services such as the supply of electricity caused the standard of living to deteriorate considerably.

In July 1993, the National Assembly of Popular Power (Parliament) approved a series of measures that set in motion several modifications in the economy. These were aimed at finding alternative sources of foreign currency and at stimulating internal production. The measures included the de-criminalization of the possession of foreign currency and the creation of a network where foreign currency could be used to buy and sell consumer goods[14]. This was also intended as an incentive for individually owned small enterprises to expand their business. Besides this, a large number of State-owned agricultural farms were changed into cooperatives.

The various reforms described above had an underlying general target which was to promote a significant change in the structure and functioning of the national economy. The changes had a specific direction: to integrate the action of a strong central State with that of local governments and companies, and each would have a clear role to play. The government

13 See González (1995).

14 This currency comes mostly from foreign remittances and for services rendered in the incipient tourism industry, and it circulates on the black market. The volume of transactions on the black market was estimated to be equal to the level of the regulated retail market, but prices were 20 times higher (González, 2004).

would decide on strategies and would keep control on economic activity in general, and the other agents would have more autonomy in management than they had exercised previously.

2. THE RECOVERY OF THE CUBAN ECONOMY SINCE 1994

The recovery phase began in the context of a popular debate on the measures to be taken in order to achieve internal financial balances. Once a political consensus was arrived at and duly approved by the National Assembly of Popular Power (May, 1994), the program came into force. Since then, the reform process has never stopped. It is characterized by (1) the gradual construction of a model aimed at integrating the emergent sector with the rest of the economy, (2) the creation of a network of institutions in a consistent regulatory framework, and (3) a new culture of business management and administration. The latter, probably the most important characteristic, means that agents have had to learn how to operate in an environment where financial and monetary variables have gradually come to play a role in the allocation of resources.

On the international front, the US pressure on Cuba was intensified by the Helms-Burton Law in 1996[15]. Some preliminary estimates of the economic losses caused by the US blockade, which has been in force for more than four decades, show that these amount to U$S 72 billion (nine times the highest annual value of imports, which was registered in 1989). The main negative consequences include higher prices for contracts, more onerous financial conditions, greater sea transportation costs, higher insurance premiums for cargo and transportation, higher bank operation costs, no direct access to purchases of medicines or medical equipment (that had to be bought through third countries),

15 This law was approved by President Bill Clinton. It gave legal status to all the prohibitions stemming from the blockade, and it also attempted to stop the incipient process of direct Foreign Direct Investment in Cuba. Furthermore, it instructed the Secretary of State to press for the dismissal of all officials and business executives linked to companies that violated the blockade against Cuba. This was done by different means, including a prohibition on them entering US territory (MINREX, 2003).

impediments on purchasing efficient high technology, non-payment of authors' royalties, and restrictions on travel for US citizens (MINREX, 2003, page 54).

This very adverse environment got worse as a result of the 1997 international financial crisis and the negative impact this had on the terms of trade. As a consequence, Cuban trade in 2002 was only 61.5% of the 1991 level, and revenues from the export of services fell by almost 9% between 2000 and 2002 (ECLAC, 2003).

In addition, the country was severely damaged by adverse climatic phenomena such as the scourge of hurricanes (Lili in 1997[16], George in 1998, Michelle in 2001, Isidore and Lily in 2002), the drought that occurred in the first half of 1998 (which was the most serious in the last forty years), and the spread of pests that damaged sugar cane agriculture and the general public as a whole[17].

2.1 Economic Foreign Policy

The revival of international trade was subordinated to preserving the social progress that had been achieved. Therefore, special attention was paid to minimizing the costs of opening up the economy, even if efficiency was lost in the short term. On the other hand, the process was guided by the State, so investment was concentrated in sectors that were supposed to obtain a rapid return in foreign currency from both foreign and domestic markets. Therefore exports and import substitution activities were directly stimulated through sectorial programs, and care was taken to set up productive chains that would allow many other productive sectors to join the export chain.

The opening of the Cuban economy was governed by three main lines of action: accepting direct foreign investment, changing the trade regime, and participating in multilateral negotiations and regional organizations.

16 The damage caused by this catastrophe has been estimated in over U$S 800 million (Rodríguez, 1997).

17 There is proof that these pests were brought into Cuba from abroad.

Foreign direct investment (FDI) is the only form of capital movement that Cuba has authorized. The Law of Foreign Investment (number 77), passed in September 1995 and still in force, regulates the activity of foreign capital in the country. The qualitative changes introduced in the Law have to do with guaranteeing transparency, allowing new legal forms for investing, permitting modalities of foreign participation, and defining promotional policies. It also regulates in detail the processes of submitting and negotiating contracts. It forbids foreign investment in certain sectors such as health care and education, and it sets limits on foreign investment in other activities like the military and the mining sector. In the sphere of the armed forces, foreign investment is accepted only on the business side, and in the mining sector it can be directed only to research, operation and processing, and is subject to authorization under the Law of Mining[18].

The new legal framework allows up to 100% participation of foreign capital in business, and guarantees non-expropriation. It also permits free transfers of resources abroad without payment of extra taxes or other charges on net utilities and dividends, and the free transfer of capital when the agreement reaches its conclusion.

As a complement to the above, Cuba has subscribed to the Bilateral Agreement for the Promotion and Reciprocal Protection of Investments. As of 2001, sixty countries had subscribed to this (Cuba Central Bank, 2002). This agreement means that guarantees that are extended to parties that invest in a country take on the character of an international commitment.

The **trade regime** was modified in two main ways that have to do with the role of the State in foreign trade, and the trade policy instruments to be used.

The effects of the new institutional framework have been many and varied. First, the number of firms directly subordinated to MINCEX has declined considerably (from 50 in 1989 to only 10 in 2001). Second, agents participating in trade, individually or as corporate bodies, have

18 Passed in 1994, this law preserves State ownership of mineral resources in the subsoil and the seabed within the economic zone of the country.

increased significantly (by the end of 2002 there were 425 Cuban companies[19] in foreign trade management and 780 foreign trade representatives). Third, there has been an important change in the role of the central administrative institutions linked to trade. Two examples worth noting are the General Customs of the Republic (GCR), which is currently playing a central role in the statistical register, and the National Tariffs Commission, which was created in 1994 and whose function is to design and set up the tariff system.

In general, trade policy instruments cause minor distortions in the structure of internal prices. In some sectors they have to take account of State monopolies and also of the opening up of the market. This means that when priority sectorial programs are put into operation, institutional and taxation mechanisms have to be designed for both types of economic actors.

Sectorial programs[20] operate in different areas: technology, administration, credit, labor and salaries. These programs are aimed at promoting activities that generate foreign currency, such as tourism and industries exporting commodities like sugar, coffee, citrus fruit, tobacco, nickel, medicines and biotechnology, basic metals and metal machinery. They also support sectors that have the potential to substitute imports, such as fuel, energy, medicines, and food products (rice, beans, fruits, vegetables and cattle products).

The many agents that started to participate in foreign trade demanded institutional mechanisms that would impose some order on the operational aspects of the activity, and, specifically, that would allow trade cartels to operate.

Since 1996, custom taxes[21] have been in line with the commitments accepted by Cuba in the Uruguay Round. Hence, Cuban producers are guaranteed nominal protection that is at the same level, and at times below, the protection in force in other Latin American countries (Quiñones and Mañalich, 2003b).

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19 They could be State-owned, private societies or corporations.

20 They were included in the Economic Strategy laid down by the V Congress of the Cuban Communist Party (CCP) in 1997.

Cuba has made considerable progress in recent years as regards participation in **international institutions and agreements**. It was a founding member of GATT, participated in the Uruguay Round negotiations and signed the Final Act (the agreement setting up the WTO). Thus Cuba has been a full member of the WTO since April 1995. In the regional ambit, the most important events have been Cuba's joining the Latin American Integration Association (ALADI) as full member number twelve (August, 1999), and the signing of a trade agreement with the countries of the Caribbean Community and Common Market (CARICOM) in 2001.

2.2 Domestic Economic Policy

Domestic economic policies have been designed with three main objectives: productive reactivation, the reorganization of internal finances, and the preservation and improvement of the social model.

The measures taken to achieve **productive reactivation** included opening up the market, and far-reaching changes in the agricultural management system and in the industrial bodies. At the beginning of 1994, the Government started taking steps to impose order on the circulation and collection of foreign currency by setting up store chains and foreign exchange stalls. Apart from this, by the end of that year, markets for agricultural production began to function using Cuban currency[22], and some goods for industrial consumption began to be traded at market prices.

Changes in the agricultural sector were oriented towards designing a new framework in which "*the State partially abandons its management role, concentrating on its regulatory function and offering technical service support, the preservation of natural resources and policy design… microeconomic agents have begun to assume administrative decisions directly linked to production, under the principle of financial self reliance*" (González *et al.*, 2002, page 138). The changes made include the following[23]:

21 They had been abolished in1961.

22 Some products were excluded: coffee, tobacco, potatoes and beef products.

- The organization of specialized State farms, by handing over land and other assets (livestock, installations, equipment) to worker collectives, organized in Basic Units of Cooperative Production (*UBPC*s). Free right to the use of the land was granted, and other assets were sold to the UBPCs under a system of easy-term loans.
- Access to free-price markets was granted to all producers for commercializing their production surplus (what is left after commitments to the State have been met).
- New flexible mechanisms were introduced for the commercialization of certain merchandise. Producers were allowed to subscribe to agreements with the government for trading products that had not been contracted, and for trading surpluses at prices to be agreed upon in each case.
- Self financing schemes and foreign currency incentives were set up.

The modifications in the management system of industrial bodies were to be adopted in a gradual and discrete way[24]. The following three stages were involved (García *et al.*, 2003):

i. **Re-dimensioning of plants**: the basic goal was to adapt productive establishments to the new conditions of supply and demand for consumer goods, through a process of rationalization, one that includes the closing of plants that lack adequate potential for attaining competitive levels. This was to be done while meeting short term demand without compromising long term performance.
ii. **Improvement in efficiency***:* the process is aimed at granting broad facilities and increased autonomy to firms, on the basis of them demonstrating their potential ability for efficient self performance.
iii. **Restructuring of production***:* including the reorganization of product portfolios and business patterns.

23 See details in González et al. (2002) and ECLAC (2000).

24 In each case, the depth, intensity and degree of advancement depended on the special conditions facing the body and industry in question.

At the beginning of the period, there was pressure to put internal finances in order. The prevailing chaos was the result of the use of weak fiscal instruments and the insufficient development of the domestic monetary market. The 1994 fiscal reform was gradually set in motion and this led to a reformulation of the financial basis of the government.

The main objectives of the August 1994 Tax System Law included eliminating excess liquidity while protecting the lowest income social strata and also stimulating production.

The design and implementation of these economic policies over the years has been conditioned by having to face the challenge of preserving and improving the social model in a context of economic adjustment. The character and intensity of the economic shocks put the material foundations and the very functioning of Cuban society in jeopardy. However, all the action taken to cope with these adverse conditions was explicitly geared to maintaining the essential principles behind the Cuban social policy of the 1960s, that is to say, the citizen's right to have his or her basic needs - work, health care, education and protection - satisfied.

Up to 2000, the main objective was to reverse the deterioration in social conditions through a more efficient social policy. Since then, social policy has undergone an in-depth renovation, and solid foundations for integral human development have been laid. A number of programs in this area have been designed and carried out. They combined strategic action for development with new methods and work styles that were aimed at concentrating efforts in specific areas so as to obtain fruitful results in the shortest possible time.

These programs may be grouped into five categories according to their strategic goals: (i) an improvement in educational levels for children and adolescents, (ii) the provision of personalized social attention to the general public so as to identify and solve highly sensitive problems, (iii) the offer of a high quality health service, (iv) food security, and (v) the full employment of the work force (Rodríguez, 2002).

2.3 Functional and Institutional Transformations

A central point in the reform has been to make sure the objectives sought were compatible with each other. In order to protect the lower income strata while diversifying the supply of consumer goods, the market was split in segments according to the level of income of the population. Each segment was subject to a different set of rules regulating the access and functioning of agents involved in the exchange of merchandise. Three distinct markets started to operate: a controlled market in which certain goods (mainly food products) are distributed with subsidized prices, a free market for all other commodities (operating in Cuban pesos), and a foreign currency market (American dollars) in which prices are set within a margin that is linked to international levels.

In this way, the general public began to adjust their consumption basket to the supply in each sector. At the same time, the exchange rate was set in accordance with the supply of and demand for American dollars, which were traded through exchange houses (CADECA). This mechanism enabled the government to obtain the foreign currency it lacked (convertible or Cuban pesos). Profits obtained from economic activity in foreign currency were used to finance social services and goods offered in domestic-currency markets.

Cuban monetary policy has also undergone far-reaching changes. It has had to take into account the circulation of two currencies and the central role of planning. The reforms that have been implemented included setting up a two-level bank system in 1997 and, as of 1999, the setting in motion of new monetary instruments. These include a unified exchange rate for the business sphere that varies within a 2% band[25] depending on the characteristics of the demanding agent, and a differentiated legal set up for national and foreign currency. In addition, banking efficiency has been improved through the introduction of computers and the design of a system of inter-bank liquidation (Cuba Central Bank, 2000).

25 This replaced the several exchange rates that existed previously.

The rhythm of change in the fiscal environment was intensified in 1999. Legal instruments regulating the generation of financial resources in the public sector were passed, and taxation, budget, treasury and accounting systems were set in motion. Consequently, new techniques came into use, including the creation of anti-cyclic stabilization price funds, the stabilization of the public budget (so as to anticipate possible falls in income or increased expenditure), and the creation of trust funds providing special loans to producers. Insurance activities were also extended (Millares, 2000).

The institutional changes that were implemented also included the 1994 reduction in the number of central State administration agencies (from 50 to 32). The design of the macroeconomic policy was concentrated in three institutions: the Ministry of Economy and Planning (MEP), the Ministry of Finances and Prices (MFP) and the Central Bank of Cuba (BCC). At the same time, other institutions were created in the new economic framework such as the Tax Administration Office in 1994, and the Ministry of Auditing and Control in 2001.

Besides this, non-institutionalized working groups have been organized to support policy coordination, such as the National Tariffs Commission, the Central Commission of State Cadres, the Evaluation Price Control Group, control meetings for internal finance reorganization, control meetings for the production of food, and the group for control of the use of fuel.

2.4 Results of the Long Transformation Period

The most important of all the outstanding results achieved in this period was the reversal of economic contraction. The abrupt fall in GDP was stopped in 1994 and a gradual recovery began, with an annual average annual rate of growth of 3.95% (at 1997 prices) up to 2003 (U-Echevarría, 2003).

Increased efficiency in the use of the production factors played a key role in this recovery. In particular, capacity utilization was improved, so that its yield by the end of the period was much higher than what had been achieved before the crisis. However, labor productivity barely reached 80% of pre-crisis levels, and its dynamism

was at a standstill in 2001-2003. This might be linked to the deterioration in the terms of trade and to the structure of product growth, where the contribution of social services has been higher than that of other sectors[26] (U-Echevarría, 2003).

In the goods-producing sectors, mining and energy notably exceeded their pre-crisis performance. The former has benefited from the development of production and commercialization channels for nickel, enabling Cuba to take advantage of being one of three largest nickel producers in the world. Volumes increased from 42.7 tons in 1994 to 71.6 in 2003. Also in those years domestic energy sources developed considerably. There was considerable investment not only in exploration but also in raising capacity levels and in adapting technologies so as to use Cuban heavy crude oil. Consequently, crude oil production grew from 1.3 to 3.6 million tons between 1994 and 2003, while the production of natural gas increased from a meager 19.8 million cubic meters in 1994 to 584.7 million in 2002 (ONE, 1998 and Rodríguez, 2003).

By 2003, the shares of these inputs in production had also risen, by more than 90% in the case of electricity, 100% in cement, and by more than 20% in nickel. At the same time the supply of electricity increased from 12.0 thousand GWh in 1994 to 16.0 thousand GWh in 2003 (Rodríguez, 2003).

Sugar production fell from 4.0 millions tons in 1994 to 2.5 in 2003, and this was mostly due to the scarcity of external funds, the deterioration of sugar cane agriculture and lack of investment in the industry (ONE, 1998 and Rodríguez, 2003). However, since the beginning of 2002, measures have been implemented to increase efficiency and reduce production costs to less than 4 cents *per* pound. This involved shutting down 45% of the sugar cane mills so that the funds available could be concentrated in those sectors that could compete in international markets (considering the high costs of Cuban production and low international prices markets). Some 60% of the 2 million hectares of sugar cane land was set aside for other crops or livestock, while production was diversified into by-products and derivatives. The

26 The rate of growth in social service activities was 5.5% in 2001 and 4.8% in 2002, while the figures for other services were 2.4% and 0.8%, respectively.

entire process was managed with a view to ecological sustainability (Varela, 2004).

The immediate social cost of these measures was that at least 100,000 workers became unemployed. They were re-trained and re-located through the Improvement Program of Sugar Cane Workers. The aim of the program was to raise average education to the level of the 12th grade. In addition, 10,000 workers were trained in technological schools and 15,000 trained workers were induced to enroll in university courses, post graduate studies, and master's and doctorate programs (Varela, 2004).

The agricultural and livestock sector was also hit hard by the poor results of sugar cane agriculture. This took up 47% of the cultivable land in the country in 2000 but produced crops at barely 40% of the pre-crisis levels. Livestock production was further severely affected by a lack of foreign inputs, and it is still stagnant (ONE, 2003).

The production levels of some products, such as potatoes, bananas, beans and vegetables, expanded considerably. This was partially due to the introduction of new farming techniques, an improvement in the quality of seeds and the introduction of new forms of organization for production and commercialization. The development of urban agriculture made a big impact: the supply of vegetables, which barely existed in 1993, stood at 3.7 million tons in 2003 (Martínez, 2003).

The tourism sector developed rapidly over the period. The objective was to fully insert the country into this dynamic commercial flow. In order to do so, a considerable investment effort was needed, so as to expand hotel infrastructure, extra-hotel services and transportation. Available accommodation tripled in 1993-2003, from 12,900 to 41,600 units, while flight services were re-shaped through the partial renovation of the aviation fleet and the building of eight air terminals. This allowed a 54% increase in passenger movement in the same period (Pérez, 2000 and Rodríguez, 2003).

The government's target was to coordinate the development of the tourist sector with that of the rest of the economy and to take advantage of its progress. Production connected to tourism includes

food services and light-and metal-mechanical products, which became an additional and important source of jobs and funds. Besides this, 80% of investment went on domestic resources, a third of the visitors were moved by Cuban tour operators and airlines, and the share of Cuban products in total purchases in the tourism sector increased from 18% in 1993 to 69% in 2003 (Rodríguez, 2003).

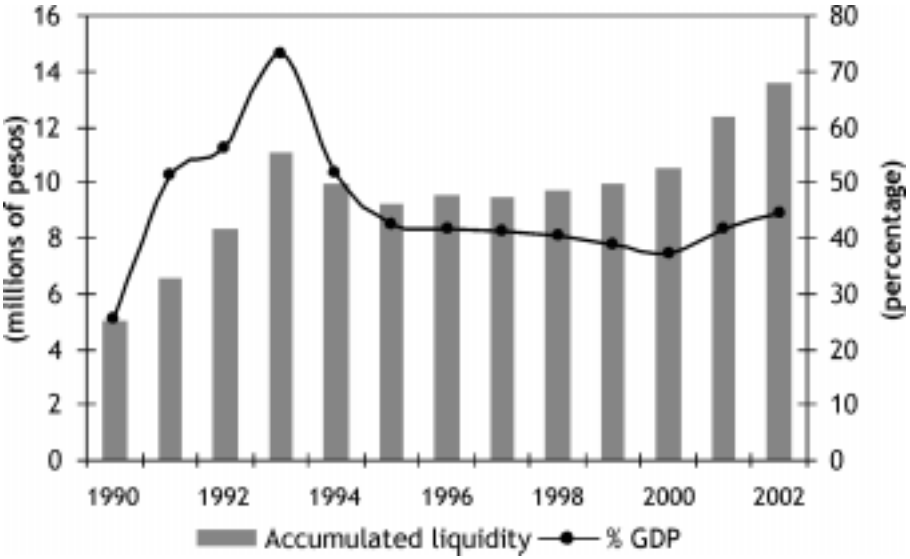
The communications sector was also strongly promoted during the period. As a result, the number of telephone lines in 2003 reached approximately 715,000, double the 1994 figure, while the quality of the service improved considerably (by 2003, 80.5% of the service was digitalized). In addition, fiber optic came into use in most of the country, increasing data transmission possibilities and the use of the internet (IPS-2004b).

The development of biotechnology was consolidated during the period to the extent that in 2003 it generated 600 patents for products such as vaccines, recombinant proteins and monoclonal antibodies. Some of these are being sold to more than 40 countries, and there are ongoing technological transfer operations for the construction of production plants in other countries (Rodríguez, 2003).

The process of rationalizing public finances has yielded positive results. The budget adjustment measures have been successful, according to the indicator of persistence proposed by Alesina and Perotti[27] , since the budget deficit fluctuated between 2.5% and 3.0% of GDP in the 1996-2001 period. In 2002 there was a slight increase to 3.34%, but this was still four points below the 1994 level (see graph 1).

27 The adjustment would be successful if, by comparing the year of adjustment to the next three years, the primary deficit/GDP is 2 percentage points lower or the ratio debt/GDP is at least 5 percentage points lower. The adjustment year is identified when the ratio of primary deficit/GDP falls to less than 1.5 percentage points (Alesina *et al.*, 1998).

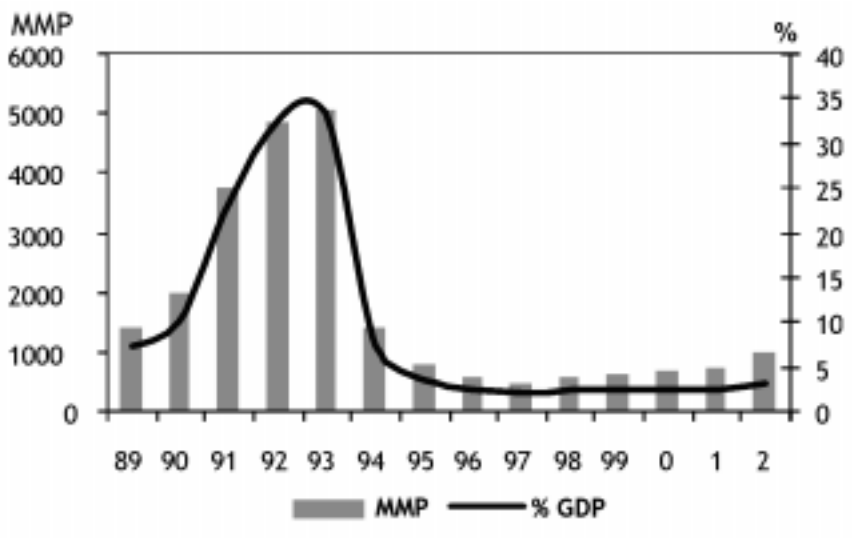
Graph 1
CUBA: BUDGET DEFICIT



Source: ONE (1998, 2003).

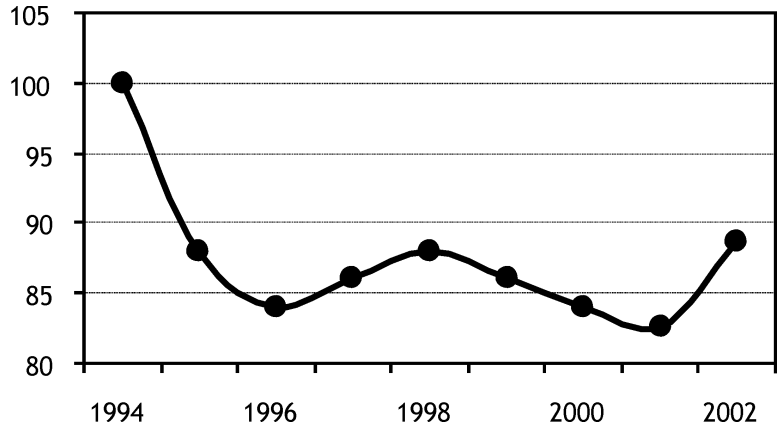
The ratio of currency in the hands of the general public to GDP tended to fall between 1993 and 2000 (from 73.2% to 37.2%), as a result of the control of supply, the recovery of the economy and the increased demand for funds for opening up new markets (graph 2). However, in the 2001-2003 period, this proportion was again above 40%, which created slight inflationary pressure, and this was reflected in the evolution of the consumption price index and the exchange rate (U-Echevarría, 2003, see graph 3 and 4).

Graph 2
CUBA: ACCUMULATED LIQUIDITY



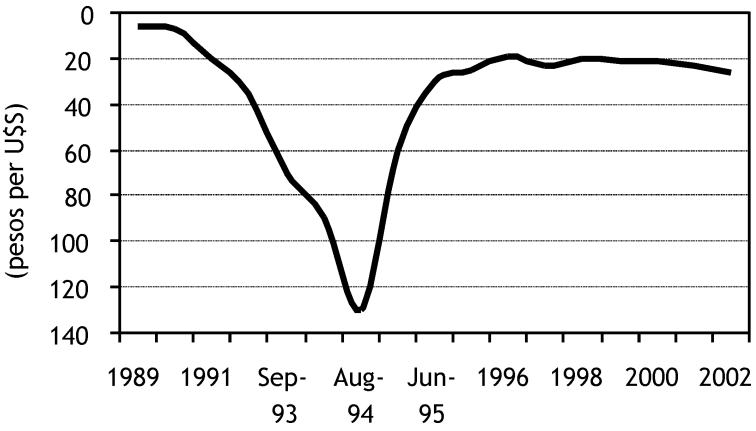
Source: ONE (1998, 2003).

Graph 3
CUBA: CONSUMPTION PRICE INDEX (1994 = 100)



Source: U-Echevarría (2003)

Graph 4
CUBA: UNOFFICIAL EXCHANGE RATE
(Peso per U$S)



Source: U-Echevarría (2003).

The balance of payments continued to show a deficit in the current account, which can be explained by the deficit in traded goods(see table 1). The deficit almost tripled in the period 1994-2002 and was partially financed by a positive balance in services and in net transfers.

Table 1
CUBA: CURRENT ACCOUNT BALANCES 1994-2002
(millions of pesos)

	1994	2000	2002	2002/1994 (%)
Current account	**-260.2**	**-776.0**	**-293.0**	**127.0**
Goods	-971.4	-3,117.2	-2,724.0	280.4
Services	663.8	2,223.0	2,211.0	333.1
Income	-422.8	-622.2	-600.0	141.9
Transfers	470.2	740.4	820.0	174.4

Source: ONE (1998, 2003), ECLAC (2003)

The performance of exports played an important role in this trend, as volumes and prices of the main export goods both fell (the value of sugar sales, for example, fell by 58.9% in the period, according to ECLAC, 2003).

Between 1994 and 2002, exports of services grew faster (9.3%) than total exports (5.4%). Tourism services in particular grew considerably, from 619,000 to 1,686,000 visitors. As a result, the export structure changed towards a predominance of services, a sector that increased its share from 45.7% to 63.5% over the period (ONE, 1998 and ECLAC, 2003).

The trade pattern by market registered a structural change at the beginning of the decade. The American continent came to account for 39.1% of total exchange in 2002, while in 1990 its share had only amounted by 6.5%. Overall, the Latin American share grew from 5.2% to 28.0% in the period. The European Union accounted for much of the flow, with almost 33% of trade in 2002 (ONE, 1998 and ECLAC, 2003).

There was an unprecedented situation, when compared to the past four decades that came about because of the peculiar conditions of trade with the United States. Since December, 2001, after hurricane Michelle (which was considered the worst of the century), the sale of food and pharmaceutical raw materials was authorized. Cuba had to pay cash for these supplies and had to use US transportation, because US companies were not authorized to grant credits and the use of Cuban ships was prohibited. The total value of these purchases reached U$S 720 million in 2001–2003, which put the United States in eighth place on Cuba's list of trade partners. At the same time, in 2003 Cuba became an important market for some US products: in that year Cuba ranked as the 14th buyer of US wheat and as the 8th for cut chicken pieces (Veloz, 2004).

The dynamism of FDI flows was favorable in those years, especially when the prevailing environment is taken into account. At the end of 2003, 342 companies accounted for more than 30% of external trade in goods and services. The total estimated amount of FDI at the beginning of the 1990s rose to more than U$S 6 billion. The funds

came principally from Spain, Canada, Italy, France, Mexico, the United Kingdom, Germany and Panama. The basic industries, tourism, construction, agriculture, light industries and foodstuffs, were the main host sectors (IPS-2004a).

There was also some improvement in the standard of living of the general population in the period. There was an increase in the daily *per capita* consumption of nutritional energy and proteins, from 1,940 kilocalories and 46 grams in 1993 to 3,193 kilocalories and 82.3 grams in 2003. Unemployment fell from 9.9% in 1993 to 2.3% in 2003 (1,188,973 new jobs were created between 1995 and 2003). There were considerably fewer power cuts, telephone services and gas supply increased, and television, radio transmission and newspaper circulation all grew (Rodríguez, 2003 and Morales, 2004).

The health programs that were implemented resulted in improvements in some indicators. These include the infant mortality rate for children less than one year of age (which dropped from 9.4 per 1,000 live births in 1993 to 6.3 in 2004), the extension of minimum access to surgery in all the provinces, and the elimination of some infectious and contagious diseases, namely measles (1993), German measles (1995) and mumps (1995) (ONE, 1998 and De la Osa, 2004).

There was also progress in the area of education: the number of students dropping out of secondary school decreased from 13.4% (13.4 thousand) in the 1994–1995 school year to 0.3% in the 2001–2002 school year. Furthermore, integral improvement and universal courses brought about a return to schooling for young people who did not study or work, so that by the end of 2003 total enrolment exceeded 254,000 students in polytechnic institutions and 4,000 at the University of Information Technology. Computers were brought into all primary and secondary schools (Pérez, 2000 and Rodríguez, 2003).

3. FUTURE CHALLENGES TO BE FACED

Maintaining continuity in the growth plan represents a major challenge because of the difficult circumstances prevailing in the

international economy, which are more severe still for Cuba in view of the additional costs caused by the US blockade, such as the shortage of foreign financial resources. This will continue to be a fundamental obstacle to overcoming the economic crisis.

Consequently, the challenge of achieving greater export growth[28] is just as important as renegotiating the foreign debt[29]. Increased exports would mitigate the difficult situation of the balance of payments, allow advantage to be taken of scale economies in some industries (including paper, metals and textiles), and help in speeding up the development of management capacities.

As to trade policy, Cuba's major task is to subscribe to bilateral and sub-regional agreements that would grant favorable conditions of access for Cuban exports, and would lessen the impact of the US policy which is aimed at isolating the country in the international arena[30]. This is a serious challenge for the system that regulates the Cuban economy because its mechanisms are different than those in other countries. It is also a challenge for Cuban producers since they will face greater competition in the domestic market.

At the same time, there is plenty of scope for internal policies that would lead to greater diversification in exports, thus avoiding the risk of income concentration in a few sectors. This calls for the updating of the export strategy for each good and service so that all can be adapted to the competitive situation of the country. Maximum returns from natural comparative advantages and also from capitalization in soft sectors (biotechnology and software) must be sought.

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28 Mendoza and Robert (2002) confirmed the importance of the model of Growth with Restrictions in Cuba's Balance of Payments, and demonstrated that the recovery of the economy is primarily based on endogenous sources of growth, since the contribution of exports of goods and services was unstable in the 1994-2000 period.

29 In 1986 the country declared a moratorium on the debt, and although negotiations with the Club of Paris have not been renewed, bilateral contacts have been made with creditors.

30 Estimates of the cost of non-access to the US market indicate a penalization in the growth of exports that exceeded U$S16 billion in the year 2000, almost three times more than the real value (Quiñones and Mañalich, 2003a).

Undoubtedly, the most immediate way of "oxygenating" foreign finance is still to use the financial resources available in foreign currency in an optimum way, and to maintain this until a recovery of income levels is achieved. Furthermore, a change in the structure of imports is required, since in 2002 about 39% were foodstuffs and fuel, while only 13.5% were capital goods.

To sum up, "*the dilemma of the Cuban economy for the coming years is centered on two main questions: to increase income in foreign currency and to make better use of the domestic productive factors so as to carry out economic tasks*" (González, 2004, page 8).

In the light of these considerations, there was an in-depth analysis on the distortions caused by the general prevalence of the dual monetary model, and the change in the foreign environment influencing exporting sectors, and this was completed by mid-2003 (Rodríguez, 2003 and González, 2004). The points made included the following:

- the excessive dollarization of inter–company relations,
- price-setting higher than real costs for goods and services,
- the incorporation of suppliers of national value added into this circuit, with their access to imports not always being justified[31],
- important sectors for import substitution were excluded from the financing mechanisms,

The measures that have been brought in since that time are aimed at correcting these trends through the centralization and rationalization of expenditure. They include eliminating the circulation of the dollar and the obligatory use of the convertible Cuban peso (CUC) in business transactions[32], the imposition of exchange controls by the Central Bank, new bases for charging for goods and services in convertible pesos, a revision of the import rights of companies, and an evaluation of self financing schemes so as to reduce them to what is strictly necessary.

31 It is estimated that the system created a total circulation of the dollar that was double the amount required for imports (González, 2004, page 3).

32 These measures were only applied to companies that were 100% Cuban.

Consequently, at the beginning of 2004, the Cuban economy entered a new phase in the process of modifying its management mechanisms. The evaluation of the implementation of these mechanisms and of the results obtained will be the object of future studies and debate

Chapter III

CUBAN COMPETITIVENESS AND EXPORT PERFORMANCE IN THE 1990s

Isis Mañalich[1]

Introduction

By the end of the 1980s international conditions had become particularly unfavorable for Cuba. In addition to the US blockade there were also changes in the international economy, the most important of which was the collapse of the socialist bloc and the USSR, which, over the previous 30 years, had accounted for 80% of Cuban trade.

Early in the 1990s Cuba started a far-reaching reorientation of its development strategy, with a special emphasis on trade. The most important issue affecting the Cuban economy was the scarcity of foreign currency, due to the loss of markets in the former members of the Trade Agreement between the Socialist Countries (CAME). The country had to search for alternative ways to lessen the effects of the economic crisis. Increasing exports, both of traditional products and of new goods and services, and searching for new markets, were seen as possible means of attaining this target. Hence, it was important to evaluate the potential of the country in a relatively short period of time in order to plan future development.

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This study presents an overview of the performance and trends in Cuban exports over the last decade, with emphasis on the dynamics of the export of key goods, their performance and their insertion in the international market. To do this, competitiveness matrices will be used. Some ideas are also offered on strategies for the international insertion of the products analyzed, and there is a comparative analysis of these products with competing countries in Latin America.

1. THE CUBAN EXPORT SECTOR

1.1 General Aspects

In the 1990s most of the country's products were affected by a lack of imported inputs and of funding to purchase them. This led to a rapid fall in the value of Cuban exports, which were also affected by the loss of the preferential prices that the country had traditionally obtained in Eastern Europe.

However, revenues from exports showed a trend towards recovery in the second half of 1990s, mostly due to the performance of exports of services (see table 1).

Table 1
CUBA: EXPORT INCOME, 1990-2001
(U$S million)

Exports	1990	1995	1997	2000	2001
Goods and services	5,940.0	2,926.0	3,882.0	4,354.3	3,873.0
- Goods	5,414.9	1,491.6	1,819.1	1,675.9	1,661.5
- Services	525.1	1,434.4	2,062.9	2,678.4	2,211.5
Tourism	243.0	1,100.0	1,515.0	2,000.0	906.7

Source: ONE (1998 and 2003) and Central Bank of Cuba (several).

Moreover, exports of goods were seriously affected by the suspension of payments for the main export products, at the prices previously agreed with trade partners in the now defunct CAME. The production of most exportable goods fell, mostly because of the lack of imported inputs (see table 2). As a result export *per capita* in dollars fell almost 70% between 1990 and 2000[2].

Table 2
CUBA: DYNAMICS OF VALUE OF EXPORT GOODS
(increase %)

	1995/90	2000/90	2000/95	2001/90
Total Exports	-14.5	-11.1	2.5	-10.2

Source: Author's evaluation based on ONE (1998 and 2003).

This fall meant a reduction in the country's share in international markets, and it also reflects a fall in the competitiveness of Cuban exports (see table 3).

Table 3
CUBA: INTERNATIONAL MARKET SHARE, 1990-2000
(%)

	1990	1995	1997	2000
Percent	0.15	0.03	0.04	0.03

Source: Author's evaluation based on ONE (1998 and 2003).

This considerable share reduction in international markets reflects a substantial change in trade relations. The income of exports of goods (sugar, nickel and citrus fruit) before 1990 was mainly because the prices received from the former Soviet Union and from other socialist countries. Moreover, Mañalich (1992) concludes that average prices of those goods exported to the former socialist countries were in average 50% over world market prices.

2 National Office of Statistics.

The changes in the structure of exports towards the end of the 1990s were significant: sugar lost its traditional predominance over nickel products in 2000, while new exportable goods grew in importance. Until 1997, only four products (sugar, nickel, tobacco and fishing) accounted for 85% of total exports, but in 2000 some 25% of income came from other exported goods, like fruit and vegetable conserve (4.7%), steel (3.8%), medicines and pharmaceutical products (2.1%) and cement (1.4%), as can be seen in table 4.

Table 4
CUBA: STRUCTURE OF EXPORTS BY PRODUCT
(U$S million and %)

	1995		2000		2001	
	U$S million	%	U$S million	%	U$S million	%
Exports	**1,491.6**	**100.0**	**1,676.0**	**100.0**	**1,660.6**	**100.0**
- Sugar	714.3	47.9	454.0	27.1	545.3	32.8
- Nickel	323.7	21.7	553.0	33.0	437.8	26.4
- Tobacco	102.1	6.8	166.0	9.9	263.1	15.8
- Fishing	122.8	8.3	92.0	5.5	79.2	4.8
- Other	176.5	15.3	411.0	24.5	335.2	20.2

Source: ONE (1998 and 2003).

On the whole, during the 1990s Cuban exports became considerably more diversified. A comparison of the concentration index of Cuban exports in 1990 with selected years in the decade shows there was a considerable reduction in the degree of concentration, down to 40% in 2000 (table 5).

Table 5
CUBA:CONCENTRATION INDEX
OF EXPORTS BY PRODUCTS,
1990-2000
(%)

	1990	1995	1997	2000
Index	79.9	51.0	50.6	38.5

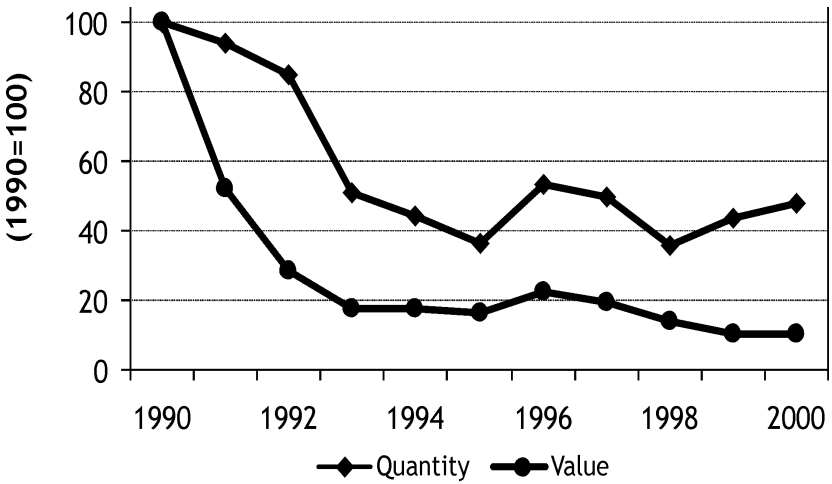
Source: Author's calculations.

1.2 Brief Description of Export Performance by Selected Products

1.2.1 Sugar

In spite of the efforts made by sugar producers, it was not possible to decelerate the fall in exports. This fall was due not only because of the price reduction, but also because the dramatic reduction in production. As a consequence, export quantities were erratic, with maximum levels considerably below those of the previous decade (see graph 1).

Graph 1
CUBA: DYNAMICS OF SUGAR EXPORTS, 1990-2000
(%)



Source: Prepared by ONE.

This reversal was very much linked to a lack of financial resources, since the country not only lost its main export markets but also its main supplier of inputs, equipment and spare parts required by the industry.

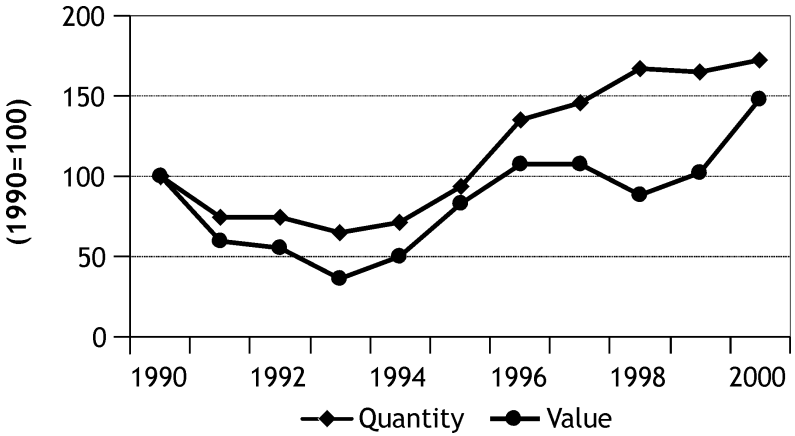
Because the urgent need to increase income from exports, the available resources were reallocated to more competitive production activities vis a vis international markets, while other activities with

low levels of productivity were de-emphasized, as was the case of sugar mills[3].

1.2.2 Nickel

Nickel was one of the products whose exports in the second half of the decade exceeded the levels achieved in 1990, even though prices were low for some years. However, since 1996 there has been sustained growth in the exported quantities and, consequently, incomes have only been affected by price variations (see graph 2).

Graph 2
CUBA: DYNAMICS OF NICKEL EXPORTS, 1990-2000
(%)



Source: Prepared from ONE.

1.2.3 Tobacco

On the whole, exports from the tobacco sector recovered rapidly and this was influenced by the sales of rolled tobacco. However, there was a fall in 2000, almost down to the 1997 level (see table 6).

3 The reorganization and improvement of the sugar industry began in early 2002 with the closing of 70 of 144 sugar mills.

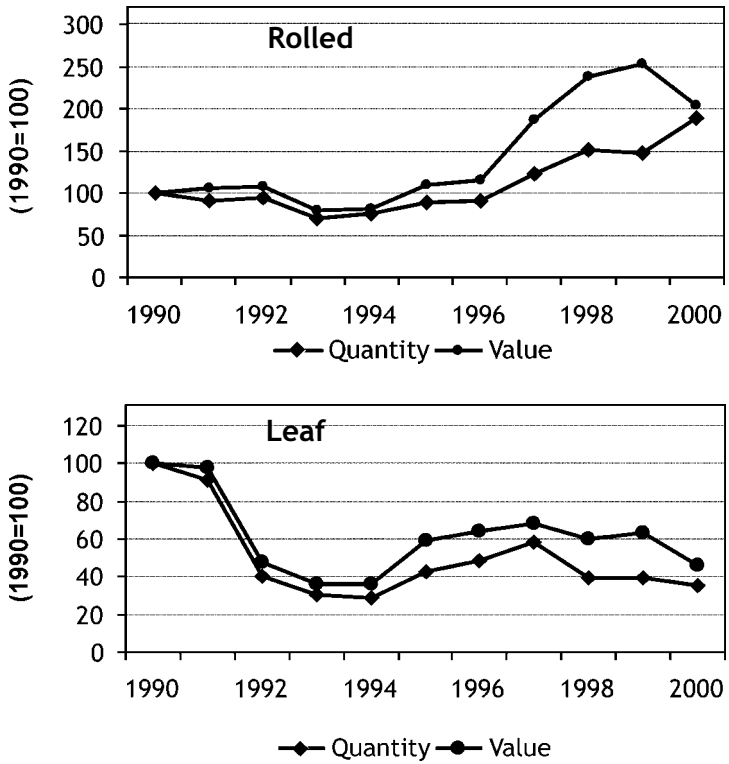
Table 6
CUBA: EXPORT VALUES OF TOBACCO PRODUCTS
(million of pesos)

	1995	1996	1997	1998	1999	2000
Exports	102.1	108.9	161.2	191.2	205.3	166.3

Source: ONE (2001).

The fall in the value of tobacco exports in 2000 was linked to changes in the varieties exported; the quantities of rolled tobacco increased during that period, thus affecting the prices of the products (see graph 3).

Graph 3
CUBA: DYNAMICS OF TOBACCO EXPORTS (%)

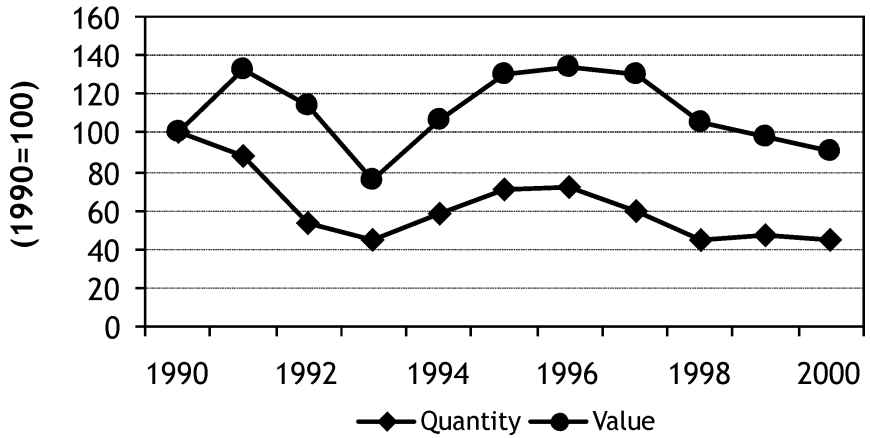


Source: Author's calculations based on ONE (1998 and 2003).

1.2.4 Fishing

The value of exports of fishing products decreased with the collapse of the socialist bloc but recovered afterwards, although only temporarily, so that by the end of the 1990s their value was just 90% of that in 1990. It should be noted that the price of these products was a key factor for this performance of the sector, as the physical quantities exported never reached the levels registered in the 1980s (see graph 4).

Graph 4
CUBA: DYNAMICS OF EXPORTS
OF FISHING PRODUCTS , 1990-2000
(%)



Source: Calculations of the author based on ONE (1998 and 2003).

To sum up, the only exports that can be considered to have recovered to the levels prior to collapse of the Socialist bloc are nickel and tobacco. The export levels of the other goods have been quite erratic.

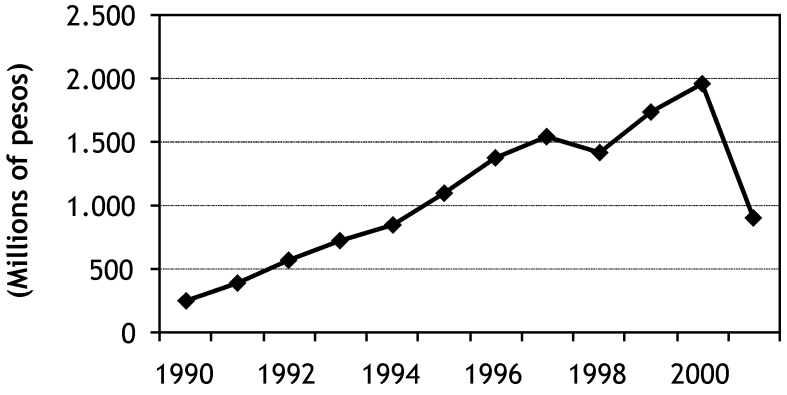
1.2.5 Tourism

In the last decade of the 20th century the rapid growth in the level of income from services is a clear illustration of an important structural change in the Cuban economy, especially when one considers that 60% of the total increase was due to the rise in revenues from tourism.

The 1990s were decisive for tourism service exports, which reached their highest level in the history of the country. A key variable behind this favorable performance was the increasing dynamics of tourist arrivals, as the rate of growth was 16.4% *per annum*, much higher than the 3.8% registered in the rest of the world (García, 2003).

Income from tourism increased from U$S 243.4 million in 1990 to U$S 1,952 million in 2000, which amounts to an average yearly increase of 23.1%. In 2002, however, there was a considerable fall in the level of revenue from tourism as a result of the events of September 11, 2001 in the United States (see graph 5). Even so, in 2001 there was no decrease in the arrival of visitors, because of the significant increase of tourists in the early months of the year. However, there was a substantial reduction in the number of arrivals in 2002 (5% relative to the previous year), mainly because of the decline in the number of tourists from Italy, Germany and France (García, 2003).

Graph 5
CUBA: DYNAMICS OF TOURISM EXPORTS, 1990-2001



Source: Author's calculations based on ONE (1998 and 2003).

During the second half of the 1990s, Cuba re-emerged as a major tourist destination in Latin America, receiving a million visitors *per* year (García, 2003).

In the regional context, the share of services in Cuba's foreign sales increased markedly. This contrasts with what occurred in Latin America as a whole. Between 1980 and 2000 the share of services increased by more than 20% in five countries (Costa Rica, Nicaragua, the Dominican Republic, Panama and Uruguay), but in another five there was a significant fall in the same period (see graph 6).

Graph 6
LATINAMERICA:RATIO OF SERVICE TO TOTAL EXPORTS, 1980 and 2000
(%)

Source: Quiñones and Mañalich (2003)

2. ANALYSIS OF COMPETITIVENESS

2.1 Cuban Exports

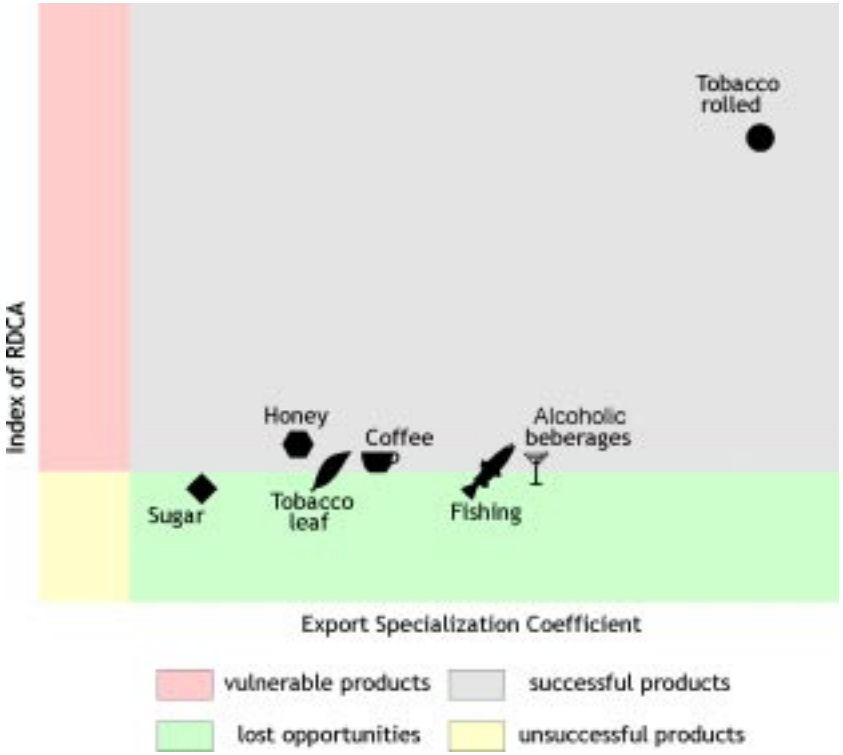
In the context of the new international scenario characterized by globalization, growth patterns in recent years emphasize the importance of the competitiveness of exports, which is, in turn, directly linked to their performance. Cuba has had to face a great challenge in the export sector to revive its economy, and this challenge will continue in the years ahead. The country's success will depend on the competitiveness of its main exports goods, hence special attention should be paid to them.

There are many indicators that are used worldwide to evaluate the competitiveness of products, companies, sectors or countries. Some are based on costs or prices, or are related to comparative advantages and competitiveness, including market share and positioning, and are used to outline the matrices of competitiveness. These seem to be useful for analyzing the performance of Cuban exports from the point of view of specialization and competitiveness.

The specialization matrix shows whether the country is specialized in a specific good or not and hence is an important input for the design of development and growth strategies. The matrix combines two indicators: the export specialization coefficient and the index of revealed dynamic comparative advantages (see Dussel, 2001). The specialization matrix for the Cuban economy for the period 1990 – 2000 is shown in graph 7.

The matrix shows that of Cuba's main export goods, only rolled tobacco showed a clear specialization pattern in 2000 compared to 1990, and accordingly, it was one of the successful products. The majority of products are found above the horizontal axis, indicating that in these goods, although the country has an export specialization; it had no comparative advantages in the base year and has maintained the same level as in 1990. As explained in the previous section, sugar has not recovered from the crisis it went through at the beginning of the decade, and it appears to have a comparative ge, which places

Graph 7
CUBA: SPECIALIZATION MATRIX, 1990-2000[4]
(1990 = 100)



Note: RDCA = Revealed Dynamic Comparative Advantages
Source: Own preparation.

this product among the unsuccessful disadvantaones. However, it should be remembered that Cuban exports fell markedly as a result of the demise of the socialist bloc, so the main objectives of the country

4 Export Specialization Coefficient: $E_{ij} = \frac{x_i / X_i}{x_T / X_T}$
where :
i products, j years
x_i= country export value of product i
X_i = world export value of product i
x_T = country total exports
X_T = world1 total exports

Index of Revealed Dynamic Comparative Advantage: $VCRD_i = E_{i2} / E_{i1}, E_{i3} / E_{i2,...}$

were to regain previous export levels and achieve adequate participation in the international market. As a result, the situation was reflected in a specialization matrix that, although not particularly favorable, does show a positive result in terms of attaining the specialization levels that prevailed prior to the crisis. That can be seen as the point of take-off of a successful re-insertion in the international economy.

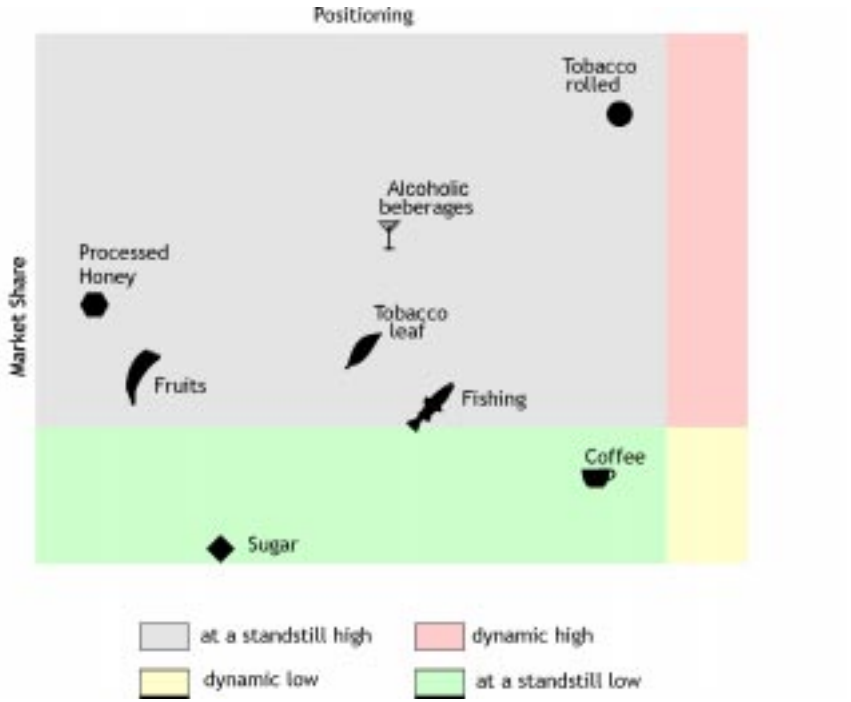
The competitiveness matrix is used to show the competitive performance of selected Cuban export products (see Fajnzylber, 1991). This matrix is formed by the combination of two indicators: efficiency or market participation and placement or contribution of the sector. The use of this matrix to measure competitiveness has the advantage of offering an integral view of domestic performance relative to the rest of the world (or to the market taken as a reference). This allows us to know the situation of the product being analyzed not only internally in the country but in the corresponding international scenario as well. The competitiveness matrix of the Cuban economy for the period of 1990–2000 is given in graph 8.

It can be seen that the majority of Cuba's main exports are in the quadrant of vulnerable products. This raises two important considerations:

i. The country's share in the world market increased in 2000 compared to the base year, which indicates a recovery in the Cuban economy (this is also shown in the specialization matrix);

ii. in the decade, Cuba exported products with slow growth in the international market, indicating that, in spite of the effort made, the country did not compete satisfactorily.

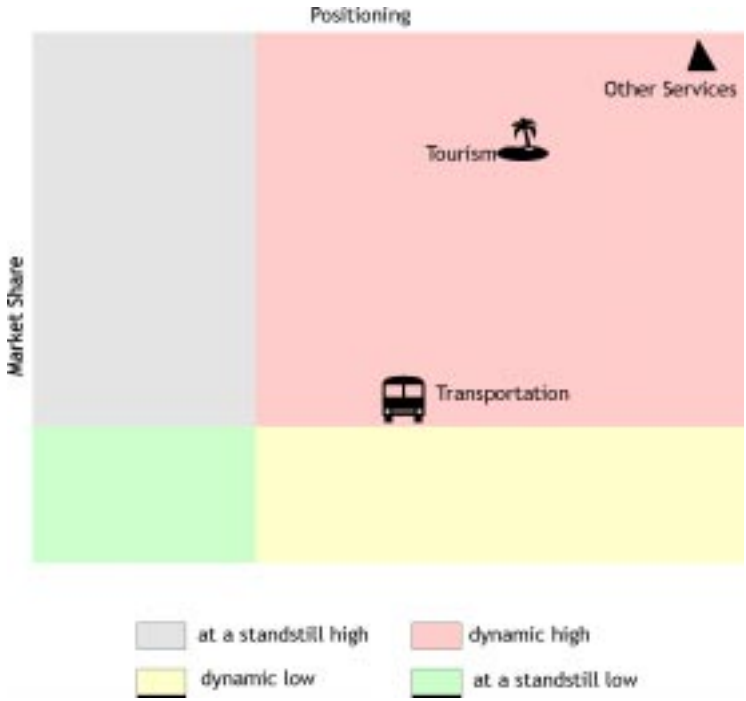
Graph 8
CUBA: MATRIX OF COMPETITIVENESS OF EXPORTS BY GOOD,1990-2000
(1990=100)



Source: Author's preparation based on data from ONE (1998 and 2003) and FAO (1990 and 1998)

However, when the analysis is made for services, the situation is very favorable for Cuba. The products of the three sub-sectors analyzed are found in the **successful** quadrant, and the group of other services shows the most dynamic performance during the decade. This happened particularly in tourism, a sector that underwent considerable expansion (see graph 9).

Graph 9
CUBA: MATRIX OF COMPETITIVENESS OF THE EXPORT OF SERVICES, 1990-2000
(1990=100)



Source: Quiñones and Mañalich (2003)

2.2 Some Reflections on the Situation of Latin American Competitors

It is important for Cuba to know the competitive situation of other developing countries, especially those in Latin America, which generally produce exports similar to those of Cuba.

Developing countries are characterized by a market profile that is generally of the primary sector, of low added value, and which emphasizes certain exporting sectors including textiles, shellfish and crustaceans, wood, fruit, coffee and flowers. The exports of some of

these countries performed successfully in the last few years, and there are some points in their experiences that are common to all (Dagata, 2001):

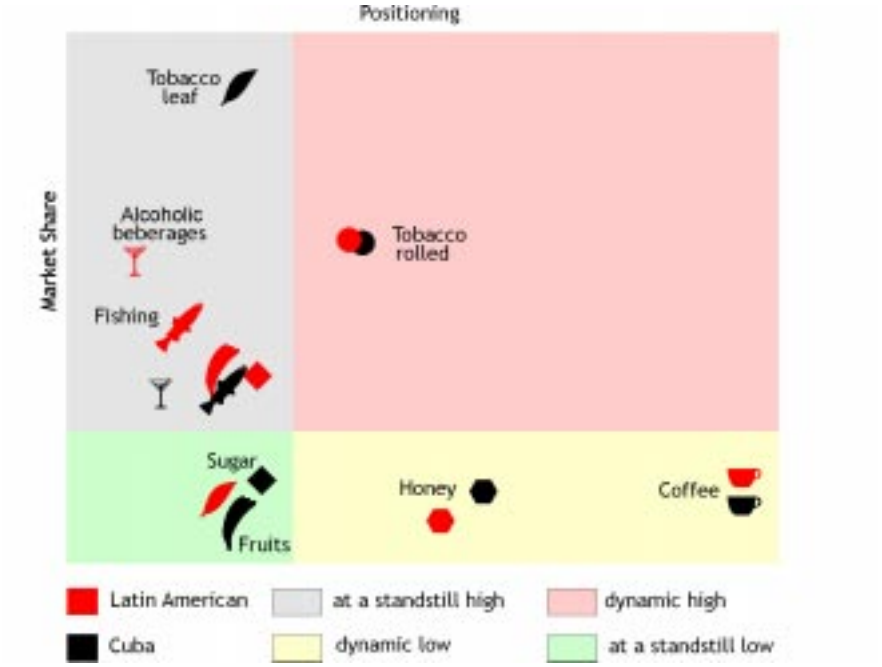
- All of them increased the added value of their products;
- they not only managed to penetrate some new market segments, but they also achieved forms of innovation of their production;
- they adopted practices that revolutionized services;
- they were able to transform their comparative advantages into competitive advantages; and
- they overcame technical and structural barriers.

Like Cuba, the Latin American countries have traditionally been seen as primary goods exporters (see ECLAC, 2001) in sectors in which they have proven natural advantages. However, for a number of years now, they have been trying hard to change this situation. Since 1990, the share of agricultural and agro-industrial products in the total value of Latin American exports has fallen. In contrast, there has been a rise in activities with major economies of scale and in those promoting scientific and technical progress, which has had much to do with export processing zones.

In this, the Latin American countries are similar to Cuba, which makes them competitors as they are suppliers of the same goods in the same markets. Cuba has to compete with these countries in the struggle to achieve and/or maintain market share for the goods considered in this study. In order to make a comparison, the competitive situation of the main Latin American exportable goods in the international market for the period 1993–1998 has been studied[5]. This provides an indication of the extent to which these countries may be important rivals in markets where Cuban products are sold (see graph 10 and graph 11).

5 This period was chosen because in 1993 Cuban exports were at their lowest level in the decade, while 1998 is the last year for which compatible statistics are available both for Cuba and for Latin America.

Graph 10
CUBA AND LATIN AMERICA: MATRIX OF COMPETITIVENESS FOR THE EXPORT OF GOODS
1993-1998



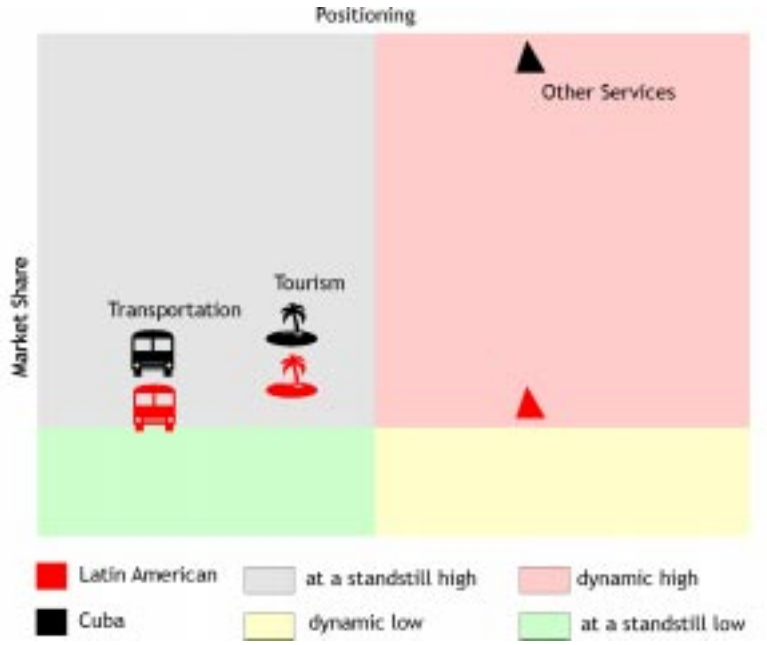
Source: Author's calculations, with data from WTO (2000), ECLAC (2001) and FAO (1990a-b, 1998a-b).

Cuban and Latin American exports have been placed in the same matrix to make comparison easier. It can be seen that Cuba is very similar to the other Latin American countries, which indicates the extent of the rivalry between them.

The results for sugar give cause of concern because sugar is in the vulnerable category for Latin American countries and Cuba's share in the market increased. In some categories such as beverages and, to a lesser extent, fishery products, the general situation for Latin America as a whole is more favorable than it is for Cuba. Cuba shows a clear

advantage only in the results for tobacco leaf since, for Latin America, this is the only product that is placed in the category of withdrawal or unsuccessful.

Graph 11
CUBA AND LATIN AMERICA: MATRIX OF COMPETITIVENESS FOR THE EXPORT OF SERVICES, 1993-1998



Source: Author's calculations, with data from WTO (2000), ECLAC (2001) and FAO (1990a-b, 1998a-b).

Fishery products are among the most important Latin American exports, especially the group of crustaceans and mollusks - where Argentina and Panama stand out - and frozen shrimp, in which Ecuador is the leader. Great progress has been made in assorted fruit such as pineapple and concentrated orange juice (ECLAC, 1998).

In the 1990s, in the Central American region in particular, export performance relied on coffee, sugar and seafood, mainly lobster and shrimp. The four main products coincide with those that are the most important for Cuban exports.

Despite the importance of coffee for the region, exports were quite volatile and the favorable results obtained are mainly due to high prices. Most of the sales of Latin American coffee (75%) go to Europe, Asia and Canada; markets with which Cuba does engage in trade (ECLAC, 1998).

Sugar is another very important exportable product for the Central American nations, and Guatemala is the biggest supplier, controlling more than 70% of sales in the region. This country has very varied destination markets (more than 14 countries), and the United States accounts for about 15% (ECLAC, 1998).

It can be seen that Central American exports of fish have risen steadily over the past few years, even when prices have fallen. Notable in this group are exports of lobster, and also shrimp which has benefited from a system of shrimp farming that is supported by the application of new and advanced technologies from Asia (ECLAC, 1998).

In this regional context it is difficult for Cuba to enter new markets in the short term or to consolidate or develop in its current markets. There is an urgent need to improve production efficiency so as to increase the competitiveness of Cuban exports.

3. STRATEGY

The change in Cuba's pattern of repositioning in international trade negatively influenced its export growth in the 1990s. The behavior of exported goods was a determining factor, because not only physical volumes but also prices fell in the international market.

The recovery of market share that Cuban exports achieved in the period 1993–2000 was based on sectors characterized by slow growth

in demand and in which there was strong price competition among the exporting countries. Hence, prospects for the near future are uncertain. A good strategy would be to diversify exports towards goods and services that appear as dynamic in international trade and that rely on the wealth of knowledge in the country. The strategies of insertion should be appropriate depending on the competitiveness of each sector. The analysis of competition and the challenge of enlarging the exporting sector, suggest four main strategies:

i. **Strategy of maintenance:** products that fall in the success quadrant because of their performance should follow a strategy of maintenance and should attempt not to lose their share or dynamism in the market.
ii. **Strategy of production support:** goods that are dynamic in the international market but have not managed to achieve good export performance (and are therefore located in the lost opportunities position), should be provided with internal support. They should be given priority when it comes to allocating resources for development so that they can take advantage of possible profits available in accordance with their market situations.
iii. **Strategy of search for spaces:** products with good export performance but which are unfavorably placed in the world market (vulnerable) have to face the challenge of increasing their market share and/or improving quality varieties so as to satisfy clients and be in line with demand. For example, the demand for products of agricultural origin is great, with the current trends towards healthy organic fare, fishery products, specific varieties, and especially live products.
iv. **Strategy of product/market diversification:** Some products are poorly placed as regards competition due to a fall in export dynamism and a loss of market share (withdrawal). The strategy for this group should be to improve their share, either by conquering new markets or by developing new varieties with greater commercial value.

Most Cuban funding for exports is directed to products in the vulnerable category, which shows that for them to achieve a successful performance, dynamic markets must be found. Therefore a study of international demand is absolutely essential.

Another important factor necessary for positive results in the short term is selectivity. The issue here is to direct resources towards those activities for which demand is high and therefore more dynamic. Moreover, selectivity also has to do with giving priority to firms and/or products that have the greatest potential for growth and the best chances of success in consumer markets

When it comes to selecting possible successful companies, capacity is not the only criterion that should be taken into account. Other characteristics that should be considered are whether the company is dynamic, if its production is sound, if it has international experience, if it has or can obtain funding, and if a particular item is unique.

The products that have been very dynamic in the market over the past few years include services, mainly in telecommunication, and information science technology. This sector is among those that have recently been chosen in Cuba for short and medium term development support. Great importance has been given to preparing and training the labor force. An innovative educational program is being developed which involves students using computers and foreign languages from an early age, and this will later be strengthened at the university level.

It should also be mentioned that Cuba's strategy for the agricultural sector is shifting towards ecological products, and the target is to increase exports of products such as sugar, coffee, honey and fruit. Although demand for these products is high, they are priced higher than traditional products so they are extremely competitive.

4. CONCLUSIONS

In the highly competitive modern world, great importance is placed on product differentiation as a means of adequately satisfying consumers. Therefore, Cuba is facing the challenge of having to achieve great diversity in its products so as to be able to penetrate international markets. The new dynamics of trade mean that in order to compete in international markets high quality products must be offered. To do this, Cuba needs to improve its production processes and to incorporate new technologies and/or innovations. The time for homogeneous products has come to an end. The market is ruled by consumers, and they are demanding variety to satisfy their numerous needs. A nation's chances of coping with the new market conditions depend on its finding a "window of opportunity" that leads to success.

Besides this, if competitive export performance is to be achieved, it is necessary to direct productive efforts towards goods for which international demand is growing significantly and for which new varieties can be developed, and it is also necessary to conquer adequate international markets.

It is important to note that international markets are already replete with competitors and new penetration by one country means that another country will lose some of its share. Therefore if a market position is to be maintained a country has to be competitive, and it must be even more competitive if the aim is to displace competitors. At the same time, when a niche is sought, this does not necessarily mean that the niche is unoccupied, waiting to be discovered, located, penetrated and taken over. It often has to be conquered, and to do this the new product must be much more efficient than the one that is being displaced. Above all, producers must be prepared to adapt to the new conditions prevailing in the international market, that is to say, to strong competition.

If the aim is to achieve sound export growth, it is also absolutely essential to design a strategy that makes it possible to pick winning companies. This involves using criteria of capability, dynamism and

excellence to select the companies that should receive financial resources and investment.

In global terms, the improved performance of some products since 1994 can be considered favorable. However, the balance of competitiveness cannot be said to be positive since the majority of Cuban sales involve products that are at a standstill on the international market. In addition, opportunities in dynamic markets are not being sufficiently exploited, which is the current situation of coffee and honey, for example. As a result, the opportunity to place these products in a good competitive position is being missed.

Lastly, it is important to point out that the analysis of competitiveness made in this study is not comprehensive; it does not cover the competitive situation of Cuban exports as a whole. In the first place, the analysis was undertaken for groups of products, and greater variety could yield very different results. Secondly, the indicators were calculated for the world market as a whole, but different results would emerge if the analyses were made for specific markets, such as the European Union or Canada, for example, where Cuban products are probably better placed■

Chapter IV

FISCAL POLICY IN CUBA, 1994 - 2002

Noel Chaviano[1]

Introduction

In Cuba, Gross Domestic Product (GDP) grew at an increasing rate during the 1975–1985 period and growth indicators were stable. The economic policies applied in the period were based on a model of overall development and showed signs of decay. By the end of the decade levels of investment were low. What is more, while a significant percentage of resources came from abroad, exports – both traditional and non-traditional –grew only slowly.

There were errors in the design and practical implementation of economic policies, which were basically similar to those prevailing in the European socialist countries. In particular, the main policy instrument was the allocation of raw materials, which was centrally decided, while financial and monetary policies played a secondary role. At the same time, the 40-year economic blockade of Cuba by the United States was intensified, and the Toricelli and Helms-Burton Acts were enforced. This made it more difficult to obtain external financing and to satisfy the ever-present need to obtain resources to cope with that aggressive policy.

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The worst year in terms of stagnation was 1993. From 1989 to 1993, Cuban GDP dropped by approximately 33%. The fiscal deficit rose to 5,050.6 million pesos in 1993, equivalent to 33.5% of GDP. Budget revenues amounted to 9,519.9 million pesos –practically the lowest of the period – equivalent to 63% of GDP, while budget expenditure amounted to 14,586.5 million pesos (96.5% of GDP).

In spite of these difficulties, the public expenditure policy in force before the economic crisis remained unchanged, so the amounts allocated to education, security, social assistance and health care were maintained, as was expenditure to avoid unemployment and wage reductions. Subsidies to business activities were kept up to maintain an even distribution of the economic consequences of the crisis and to protect the general public, particularly the most vulnerable sectors, from the negative impact of that crisis.

The measures taken to combat the crisis were carefully designed to preserve the achievements of the revolution and evenly distribute the negative economic impact so as to avoid abrupt adverse consequences for the most vulnerable sectors of the population. This policy stands in contrast to most Latin American and capitalist countries where shock policies were implemented. In Cuba, both general policy and fiscal policy had astonishing results, as will be seen below. At the beginning of 1994 the National Parliament passed a package of fiscal policy measures, and these instruments will be described in detail in the next section.

1. FISCAL POLICY

As a response to the prevailing situation, specific economic policy measures were designed, and the main targets were as follows:

- To reconstruct the internal finance system so as to create a suitable economic environment for carrying out in-depth changes.
- To maintain past achievements in the areas of education, health, assistance and social security.

- To maintain the leading role of the system of state property in order to keep control of the economic means required to re-establish growth and to make strategic economic decisions. The economic space corresponding to other, non-governmental sectors of property, had to be extended in line with the interests of overall economic policy.
- To undertake the operational and economic decentralization of state companies so as to increase autonomy, efficiency and competitiveness.
- To open up the country to foreign private capital in order to increase its participation in the economy, basically in the state property sector.
- To decentralize foreign trade.
- To concentrate foreign investment and resources in areas of rapid recovery (tourism, sugar production, biotechnology, pharmaceuticals, mining, oil production), which would be provided with foreign currency, and in areas which underpin the operation of the economy such as transport, communications, computers, agriculture, and energy generating.
- To change the form of land ownership, giving more space to cooperatives.
- To authorize the use of foreign currency.
- To extend self-employment.
- To allow the controlled use of market mechanisms in certain areas of the economy to stimulate production.
- To reorganize the state system.
- To reduce the excess of money in circulation.

Within the framework of this general economic policy, an active fiscal policy was laid down.

2. TAX POLICY

Tax policy is a major part of fiscal policy. It can be used not only as a means of obtaining resources for balancing the public budget, but

also as an instrument to control the economic and social processes needed to bring about a suitable balance to guarantee macroeconomic stability. This stability is essential for the economic and social development of a country. The major factors that led to demand for far-reaching changes in tax policy had to do with structural changes in the economy and with the insufficient contributions to the budget inherent in the previous system.

Tax policy reforms were undertaken in the framework of a general economic and social strategy designed to cope with the economic crisis at the end of the 1980s and the beginning of the 1990s, to guarantee full mobilization of internal reserves for development with an adequate level of efficiency, and also to foster the insertion of the Cuban economy into the global economy.

A coherent tax policy in line with Cuban social policy was designed to gain social acceptance. This policy would guarantee the fair distribution of taxes, and the strict and efficient use of national resources. Economic and social well-being was to be attained with the participation of most economic agents, including new agents who would actively take part in economic and social life. Likewise, efficient logistics would be shaped through the creation of a tax office.

Before 1994, the tax system was structured with legal provisions that were unconnected, that were enforced at different times during the national economic development process, and that were linked to different objectives and policies. The new policy established a new integral tax system which would stimulate work and production while covering budget expenditure in a stable manner. The target was to achieve a balanced budget and a reduction in the excess of monetary liquidity. This would be done on the basis of social justice so as to protect the low income sectors of the population.

The tax reform would also bring about:

- the restructuring and updating of the income tax system, or income registration system, in accordance with the changes that

had taken place in the economy, making it more complex and diverse;

- the transformation of the tax system into an active element for management within the framework of the management system; and
- better use of the basis for tax payments.

The new tax system was designed to guarantee social justice by protecting the most vulnerable sectors of the population, and the stability, economic development and management efficiency of the system itself. The principles of equity, sufficiency, stimulation, efficiency and legality were observed. These principles, in turn, required the gradual process of implementing these new rules to incorporate certain features such as generality, capacity of payment, uniformity, diversity, flexibility, stability and simplicity of collection. As mentioned above, the first step on the path to fiscal reform was taken on August 4th, 1994, when the National Parliament passed Act No. 73 of the Tax System. The Act established the taxes, contributions and tax rates. Taxes were levied on profits, income and revenues from sales, with special levies on products, public services, the ownership or possession of certain goods, land transport, transfers of properties and estates, documents, the use of the labor force and the use and exploitation of natural resources. There were also taxes designed to protect the environment. Contributions to social security were established, and taxes were levied on toll services, announcements and advertising.

When Act 73 came into force, new taxes on profits were gradually implemented for every type of legal entity. These new levies replaced the former system with a tax on profits generated by the private sector and the public companies. The taxes on net profits will be imposed gradually as state companies become more efficient, at a rate of 35%, in line with international practice.

The tax on profits is part of the new system of financial relations between Cuban state companies and the state. Its main objective is to give more autonomy to companies so as to enable them to expand production, reduce costs and raise efficiency. This system also seeks to expand the sources available to firms for generating self-owned

resources for investment in development, and also the availability of bank credit. This strategy is expected to isolate the development of firms from the evolution of the national budget, thus helping to reduce the budget deficit.

Since the beginning of 1994, the revenue from taxes on profits has steadily increased, from 42.6 million pesos (0.3% of total revenue) to more than 1,700 million pesos (over 11% of revenue) in 2001. Growth in 2001 was the result of incorporating almost all new companies into the new tax system established under Act 73, and of the increase in efficiency that flowed from economic change.

Another major change introduced by Act 73 was the gradual conversion of the 'circulation tax' into a tax on sales and a special levy on products, thus changing the indirect tax structure. This tax is paid by state companies that retain the differences in the prices of goods for general consumption when sale prices –which are set officially– are above the officially established company prices. Until the enforcement of Act 73, the 'tax on circulation' accounted for most public revenue. In 1993 it amounted to 3,310 million pesos (34.7% of total revenue) but by 2002, this 'tax on circulation and sales' accounted for only 26.2% of these revenues.

The tax on sales is a percentage of the gross income from the sale of products in agricultural markets and in the manufacturing and handicraft product markets that were opened in 1994. As a complement to the levy on sales and circulation, and in the framework of indirect taxes, a special tax on goods for use and consumption was imposed under Act 73, with an excepted for exports. The Act levies a tax on those goods not classified as basic necessities (which were specified in order to limit their use). Likewise, there is a tax on goods such as alcoholic drinks, cigarettes, cigars, fuel, automotive vehicles and other goods considered luxury items. This levy was basically aimed at collecting excess money in circulation that was in the hands of large money owners in the general public.

In 1994 – the first year that the system was implemented – yields from this tax amounted to 1,732 million pesos, equivalent to 13.6% of

budget revenue and 9.0% of GDP. In 1998, the figure rose to 2,292 million pesos (18.3% of total revenue and 9.6% of GDP), and in 2002 to 2372.5 million pesos (14.6% of total revenue or 7.8 % of GDP).

The tax on public services that was in force prior to the reform was taken into account in the framework of Act 73. As a result of successive additions –in line with Act 73– this tax also covers services such as the use of telephones, gas and water, the telegraph service, transportation (both passenger and cargo), gastronomic services (excluding the private sector), lodging (including lodging in private establishments, which increased at that time), recreational activities, electricity transmission and delivery, and geological surveying, mining and geodesy. As a result of the measures decided in May 1994, there was a considerable increase in tariffs on selected services such as transport, electricity, postage, water and sewage. In addition to this, certain services that were formerly free of charge, started to be paid for. The rise in these tariffs and some improvements in hotel services brought about an increase in the yield of taxes on services. In 1993 the yield was 300.7 million pesos (3.2% of total budget revenue or 2% of GDP). By 1998 the figure had increased to 466.9 million pesos (3.7% of total budget revenue and 2.0 % of GDP), and by 2002 it was 639 million pesos (3.9 % of total budget revenue).

As a result of the tax reform, indirect taxation increased from 37.9% to 44.3% of total budget revenue in 1998 and to 65.1% in 2002.

Act 73 established taxes on private income as a direct tax for private workers and for government company workers, and also a progressive tax on self-employed workers and a general progressive tax on foreign currency. Small sugar-cane producers, who were subject to special tax regimes, were also included. In practice, this important duty has not been levied on wages and pensions in domestic currency, even in those sectors where there have been wage rises. In September 1993, the tax on self-employed workers was increased in line with new provisions for certain types of work. The number of workers in these types of work increased to almost 200,000 by 1995, although new registrations declined subsequently. However, the tax yield grew as a result of improved registration, control and collection. Likewise, the revenue from private income tax for private transport workers,

artists and professionals has increased since 1996. In 1993, the tax yield from private incomes was 33.7 million pesos (0.4% of total budget revenue), in 1998 it was 274.6 million pesos (2.2% of total revenue), and in 2002 it was 300.7 million pesos (1.8 % of the total).

Act 73 imposed a tax on the use of labor, which is part of the new relationship between firms and the tax office. All sectors of the economy where the new tax system applies are required to pay. Profitable companies must pay a labor tax equal to 25% of their payroll, while joint venture companies pay 11% of salaries, wages and bonuses. From the beginning, the application of this tax has been subject to exemptions and concessions in certain sectors, although these have been increasingly abolished in recent years. As a result of economic recovery and of changes in the relationship between companies and the tax office, the amount of revenue from this tax has been growing steadily. While 27.6 million pesos were collected in 1994 (0.2% of total budget revenue), in 1998 the amount reached 76.1 million pesos (5.6% of total revenue), and the figure in 2002 was 1,149.6 million pesos (7.1% of total budget revenue).

The Act established a contribution to social security, to which all companies employing beneficiaries of the social security regime were bound. The rates of this contribution are set every year in the State Budget Act, and they are calculated on the basis of wages, salaries or any other income earned by workers in companies that hire personnel. Companies must pay the equivalent of 12% of the payroll and retain 2% of the payroll for direct social security payments. It was established that workers would pay 5% of their earnings as a special contribution to social security. Prior to the Act they had not been required to make any contribution at all; only the government (directly) and companies that hired workers contributed to financing the social security system. In fact, at the moment, only workers in companies involved in the business re-engineering process pay a social security contribution. This process was established in line with Decree-Law No. 187 of August, 1998, that authorized firms to pay in accordance with the new salary scale.

The main objective of the re-engineering of government enterprises is to maximize their efficiency and competitiveness through granting

powers and establishing policies, principles and procedures that foster the initiative, creativity and responsibility of all the executives and workers. This is aimed at boosting the levels of efficiency, authority and executive decision making in companies by applying new business management techniques and methods.

As explained in the section on other taxes and duties, the revenue sources that have evolved more dynamically and undergone the biggest changes are tariffs, tolls and airport service rates. Tariffs on all types of imports, including those for the state, have been extended by Decree 92. Tax rates have changed on a number of occasions during the period, and the current average is 11%. At the beginning of the period, revenues rose as a consequence of the increase in the tariffs charged. Later on, as these rates settled down to an average of 11%, revenues fell because of exemptions and concessions made in response to the demands of the World Trade Organization (WTO) and to Cuba's joining the Latin American Integration Association (ALADI). These changes in revenue also reflect the recovery of the economy and the increase in import prices.

Toll and airport service revenues have risen as tourism increased in the country in recent years. Airport service rates were raised to 20 dollars per tourist, which has also contributed to the increase in the amount collected.

As a result of what was outlined in the section on other taxes and duties, 349.3 million pesos were collected in 1993 (equivalent to 3.7% of total budget revenues). In 1998 the figure rose to 571 million pesos (4.6% of total revenue) and in 2002 it further increased to 565.6 million pesos (3.5% of total revenue).

Contributions to the state from government companies are included among non-tax revenues. Before the implementation of the new tax system, these were mainly made up of contributions from companies and the payment for state investment reimbursement. The amount of these contributions varied during the period. This reflects the gradual inclusion of companies in the new system of relationships with the tax office, but also the recovery of the economy. Both can be seen as the consequence of the increased efficiency and the rise in production

levels of key domestic export products. This result also shows that companies have begun to invest using their own resources, which means they have not fed resources back into the state budget. Budgetary expenditure for state company investment also fell. This explains why the amount of these contributions varied from 1,719 million pesos to 1,606 million pesos between 1993 and 2002 (from 18.1% to 9.9 % of total budget revenues, respectively).

Depreciation income has tended to decrease. Since the budget ceased to be a source of funding for public firms, the government has been holding these resources and using them for investment financing. This is why the amount decreased from 1,287 million pesos in 1993 to 373.6 million pesos in 2002.

Table 1 shows the behavior of aggregate revenues:

Table 1
CUBA: STRUCTURE OF AGGREGATE BUDGET REVENUES, 1998-2002
(% of total revenues)

	1998	2002
Sales Tax	40.6	40.9
Tax on Services	3.7	3.9
Tax on Profits	9.0	10.4
Tax on Labor	5.6	7.1
Tax on Private Incomes	2.2	1.8
Other Taxes and Duties	4.6	3.4
Contributions to Social Security	8.2	8.2
Contributions from government companies	11.5	9.9
Other non-tax income	10.5	11.7

Source: Ministry of Finance and Prices (1994-2003).

The outstanding trends in the period have been:

- The declining importance of indirect taxation. Commodity taxation in particular has fallen as services taxation has increased.
- The increase in direct taxation, although private income taxes are not significant and do not share this behavior.
- The yield of the levy on work, made up of taxes on labor and social security contributions, is increasing.

Special regimes stimulating key sectors are of vital importance in the new taxation system. Three activities in particular ought to be mentioned: foreign investment, foreign trade zones and industrial parks, and the agricultural sector.

3. BUDGETARY EXPENDITURE

As a result of the sweeping changes that the Cuban economy underwent between 1993 and 2002, the share of budgetary expenditure in GDP fell gradually from 96.5% to 56.9% over the period. As was mentioned above, in order to distribute the effects of the economic crisis and lessen its impact on the general public as much as possible, budgetary expenditure was not reduced abruptly in spite of the fact that revenue dropped. During the 1993-2002 period, expenditure grew from 14,566.5 million pesos to 17,193.2 million pesos, while revenue increased from 9,515.9 million pesos to 16,196.7 million pesos. This led to a permanent budget deficit which, after reaching a record peak in 1993, started to fall with the gradual recovery of the economy.

Budgetary expenditure consists of the overhead expenses of budgeted activities, business and cooperative transfer fees, and capital outlay expenditure. The overhead expenses of budgeted activities make up the gross expenditure needed to run budgeted activities, and consist of wage costs and other expenses, mainly for the acquisition of raw material. These expenses increased continually over the period in response to the policy of maintaining the achievements of the revolution in the social sectors, which contributed to sustaining and raising the

quality of life of the population. This policy helped to bring about an equitable distribution of the effects of the economic crisis. It also made it possible to maintain the level of provision of basic services, and not one social service was cut during this period in spite of the serious negative effects of the economic crisis.

Overhead expenditure is concentrated in education, public health, social security, welfare work, housing and community services, so the basic achievements of the revolution were maintained. Welfare expenditures increased. These expenditures include compensatory salaries for excess personnel in companies that changed their patterns of production, or for people who had to be transferred to other firms for efficiency reasons. Expenditures on culture, arts, sport, and defense-related activities, were maintained at their previous levels or showed modest increases.

Overhead budgeted activities include wages paid and other expenditure in specific sectors. Expenditure on wages in education and public health mainly reflect the annual entry of high school and higher education graduates into budgeted activities. It is worth noting that no hospital or school was closed during the period under analysis. Likewise, the overall performance of these activities can be taken as examples of what can be achieved in public services when better use is made of the resources available.

The behavior of expenditure reflects the trend for skilled workers to move from certain activities to sectors linked to the emergent economy. These emerging sectors have benefited from the schemes designed to meet economic contingencies, and have thus been able to pay higher wages than the rest of the economy because of the priority they have been given. Likewise, there were wage increases for workers employed in the main branches of the budgeted activities, except for those in the public administration. This was made possible thanks to the opportunities that were generated by the gradual economic recovery.

Similarly, and as a result of the measures taken during this period, some previously budgeted activities became totally or partially self-financing. In order to achieve this, some services that previously had

been provided free of charge started to be paid for, although the charges were low. The objective here was not just to generate revenue but also to educate the public to the idea of contributing – at least partially – to state expenditure in certain areas.

Despite the negative effects of the economic crisis some other expenditure on budgeted activities was also increased, which reflects the priority given to the development of these activities. Hence, money was spent on acquiring certain raw materials that were scarce or in order to counter-balance the negative effects of the measures taken during the period. In 1993, overhead expenditure for budgeted activities amounted to 6,297.7 thousand millions pesos (43.2 % of total budgetary expenditure), in 1998 it increased to 7,081.6 million pesos (54.2%), and in 2002 it reached 11,468.7 thousand million pesos (66.7%). This behavior shows the most dynamic overhead expenditures in the period were those on business and cooperative transfers. These expenditures included subsidies for company losses and subsidies for price and product differences. In 1993, subsidies for company losses amounted to 5,433.9 million pesos, which was 37.3% of total budgetary expenditure. These high figures are partly a consequence of the policy of distributing the effects of the economic crisis so as to minimize the impact on the population. Therefore, despite the lack of material resources, raw materials and other inputs that resulted from the drop in imports, companies were able to continue working and to keep all their workers.

Since 1993, a series of measures have been taken aimed at improving this situation, such as linking the budgetary financing of losses not to actual losses but to the production levels attained, making financing for companies conditional upon those companies implementing a package of measures geared to gradually reducing, and subsequently eliminating, company losses, reducing costs and increasing efficiency. Moreover, subsidies have become conditional upon the correct application of the collection and payment policy, on budgeting, on the systematic control of income and expense budgets, and on meticulous cash flow control. Similarly, subsidies for company dining-rooms and cafeterias have ceased, self-financing systems for private activities and joint ventures with foreign firms have been

created, and companies have been restructured, adapting, in general, to the new conditions of the economy. This has undoubtedly resulted in improved efficiency.

In addition, during the period, basic units for cooperative production in rural areas were created from government companies. Although some economic aid from the state was needed initially, this has led to a decrease in state company losses. Also at that time agricultural markets and industrial product markets were established. State companies are allowed to sell part of their output in these markets, but only after they have fulfilled their commitments to the state. These markets work with prices that are set by supply and demand.

During the period, the Ministry of Finance and Prices established a new financial relationship between companies and the state, and this has resulted in greater autonomy for companies. This relationship regulates the companies' internal financial relationships and thus establishes the responsibilities of the companies to the state. This system has also led to a more efficient work order in companies. In accordance with the general basis for business re-engineering, passed in 1998, companies began to work with a new management system with greater autonomy, and consequently greater obligations and requirements. This system also sets workers' payments as a function of results. All these measures have led the companies with the highest economic impact to start operating more efficiently. In bringing about a gradual economic recovery, the level of firms' losses has been reduced, as has the budgetary financing of them. Managerial activity losses decreased during the 1993-2002 period, from 5,433.9 million pesos in 1993 to 1,139.4 in 1998, and to 624.6 million pesos in 2002. These figures correspond to 37.3%, 8.7% and 3.6% of total budgetary expenditure, respectively. Another important component of managerial overhead expenditure is the price and product difference subsidies system. Price difference subsidies apply mainly to the prices of basic commodities and other products distributed to the general public at retail prices that are below the wholesale price, such as meat and meat products, rice, coffee, sugar, fish, milk, etc. These subsidies protect people on low incomes

from the high prices at which some products are offered on the market. The subsidies were raised during the period, and this was made possible because the level of sales generated by the economic recovery also rose.

Product subsidies are granted to companies for products whose prices are set by the government, a system which creates a need for compensation for part of those companies' production costs. In 1993 these subsidies amounted to 735 million pesos, which was 5.0% of total budgetary expenditure. In 1998 they increased to 1,352 million pesos, or 10.4% of total budgetary expenditure, but in 2002 they fell again and the figure was 928.5 million pesos (5.4% of the total).

4. CAPITAL EXPENDITURE

Another important element in budgetary expenditure is capital outlay expenditure. During the economic crisis from 1989 to 1993, state budgetary financing of investment showed a downward trend. Compared to the 1989 total, this expenditure fell to 33% in 1993, a figure equivalent to 1,022 million pesos. In 1989 budgetary expenditure on investments amounted to 2,038 million pesos. This was a direct consequence of domestic economic circumstances, mainly the serious shortage of material and financial resources.

In the light of all this, domestic investment policy has mainly concentrated resources in economically functional sectors which bring in convertible foreign currency, such as the tourist sector, bio-technology, pharmaceuticals, energy generation and mining.

Until 1995, the state budget had financed planned investments completely. In the course of 1996, with the gradual incorporation of numerous companies into the tax system, part of this investment was funded with resources raised from profits or from the accrued depreciation in those companies, but even so the budget continued financing a considerable part of these investments.

As of 1997, bank credits were introduced as a source of investment financing for the companies incorporated into the new taxation and financial relationship system. This was a consequence of improvements in financial activities, which acted as promoters of the change in the investment process.

As the economy recovered and a larger number of companies began to work with the new taxation system, the number of budget-financed investments decreased and tended to stabilize. These investments are considered to be a public responsibility of vital importance for the country, so special attention has been paid to financing these expenditures through the budget. Allocation and control mechanisms are being improved. Thus, in 1993 state budget-financed investment amounted to 2,038 million pesos (14% of total budgetary expenditure), in 1998 the figure decreased to 1,580.8 million pesos (12.1% of the budgetary expenditure), and in 2002 it was 1,950 million pesos (11.3% of the total budgetary expenditure of the state).

5. CONCLUSIONS

This study presents evidence that shows that the measures adopted during the period paved the way for the country to emerge from the economic crisis in general and the budgetary crisis in particular. However, it should be noted that budget costs have tended to increase in order to deal with the accumulated problems of the last ten years and to maintain social services. It is thus expected that income will have to be tightened so as to be able to cope with growth.

Overall, the most important challenge that fiscal policy will have to face in the years ahead will be to generate sufficient revenue to meet growing budget costs

Chapter V

OVERVIEW OF THE VIETNAMESE ECONOMY IN THE 21ST CENTURY

Nguyen Quang Thai[1]

Introduction

This paper gives an overview of the major achievements, the changes in development policy, the measures taken, and the challenges that remain in the economic development of Vietnam.

1. MAJOR ACHIEVEMENTS IN THE PAST

Vietnam has been implementing official reconstruction programs since 1986. These programs were initially based on a practical review of development and the implementation of a pilot reconstruction scheme in the agricultural and manufacturing sectors. The renewal process accelerated considerably in the 1990s. A first step was a change in the concept of development itself, with a gradual shift from a centrally planned and heavily subsidized economic model to a commodity model in which the state would design and apply macro policies. New economic policies have been implemented in a more compatible manner, in line with the reconstruction program and the international integration process. It could thus be said that a socialist oriented market economy is currently being built.

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The evolution of Vietnam Gross Domestic Product (GDP) by major sectors is presented in table 1.

Table 1
VIETNAM: GDP AND THE SHARE OF MAJOR INDUSTRIES
(%)

	1986	1990	1995	2000	2003	Change 2003/1986
Primary Sector	**38.1**	**38.7**	**27.2**	**24.5**	**21.8**	**- 16.3**
- Agriculture	30.9	32.7	23.0	19.8	16.7	- 14.2
- Forestry	5.0	3.0	1.3	1.3	1.1	-3.9
- Fisheries	2.2	3.0	2.9	3.4	4.0	+1.8
Industry-Construction	**28.9**	**22.7**	**28.8**	**36.7**	**40.0**	**+11.1**
- Mining industry	1.8	5.2	4.8	9.6	9.4	+ 7.6
- Processing industry	22.4	12.3	15.0	18.6	20.8	-1.6
- Electricity, water, gas	1.8	1.4	2.1	3.2	3.9	+2.0
- Construction	2.9	3.8	6.9	5.3	5.9	+3.0
Services	**33.1**	**38.6**	**44.1**	**38.7**	**38.2**	**+5.2**
- Trade	12.7	13.0	16.4	14.2	13.8	+1.1
- Hotels, restaurants	3.2	4.2	3.8	3.2	3.1	-0.05
- Transport, storage, telecommunications	1.7	3.4	4.0	3.9	3.7	+2.1
- Finance, credit	0.8	1.2	2.0	1.8	1.8	+1.0

Source: GSO: Statistical book for several years.

1.1 Transition from a Centrally Planned Economy to a Market System

The transition from a centrally planned economy to a market system can be characterized by:

i. **Changing from a "single-sector" economy, with planned development only for the socialist economic sector (state owned and collective), to a multi-sector economy with development plans designed for each economic sector considering their specific type of ownership.**

In the past, the socialist economic sector dominated the economy. Planning and management were conducted mainly for the public economic sector (state owned and collective). In the current transition process, planning covers the activities of all economic sectors, including the domestic and foreign ones. The main result of the reconstruction policies is that the public sector still plays a major role in important fields of the economy such as financial organizations, banks, credit institutions, the stock exchange and reserves. State-owned enterprises mainly dominate physical infrastructure activity such as energy supply, transport, urban construction and water supply. The non-state economic sector is allowed to develop and do business in certain areas that are permitted by the state. Currently, the non-state sector contribution to GDP is over 60%. In agriculture, the non-state sector contributes up to 97% of GDP, and it employs the majority of the population. Home-based small and medium enterprises account for a large percentage of the GDP in the manufacturing and trade sectors. These sectors have also registered the highest growth rates, thanks to the introduction of the Law of Enterprises and the Law to Encourage Domestic Investment. In the early 1990s, there were almost no enterprises with foreign capital, but in 2004 the Foreign Direct Investment sector (FDI) accounted for over 35% of the value of industrial output and 14% of GDP. In 2002 FDI enterprises accounted for only 3.7% of the total of firms, but they employed 15.3% of the labor force, owned 24.5% of total capital and produced 19.2% of total production. Their share in the overall contribution to the public budget was 41.4%.

ii. Changing from a "closed" economy, which had relations only with socialist countries, to an "open" economy that has trade relations with 170 countries, and that has made agreements on investment preferences and protection with over 40 countries in the world.

In the past, domestic trade dominated in Vietnam. The small proportion of foreign trade was carried on mainly under agreements with the former Soviet Union and other socialist

nations. Since the country started on the road to reconstruction, Vietnam has succeeded in penetrating markets all over the world. Export sales in 2003 were nearly ten times the 1990 level, with an export value exceeding U$S 20 billion, which accounted for over 50% of GDP. Only 2 years after implementing a Bilateral Trade Agreement with the United States (BTA), that country has become the main importer of Vietnamese goods and accounts for over 20% of her total exports. Trade relations with Asian countries are still very important, but their share in total Vietnamese exports decreased from 60% in 2000 to less than 50% in 2003. Markets for Vietnamese exports have multiplied, and today include countries in Western Europe, America (including Latin America), Oceania and Africa. Thanks to the normalization of Vietnam's relations with the most important international organizations since 1992, committed Overseas Development Assistance (ODA) now stands at U$S 25 billion, with a disbursement rate of over 50%. This means that an important source of capital has been made available for improving social and economic infrastructure by investing in key sectors (electricity, transport, irrigation, education, health, environmental protection, human resources training, and adequate regulatory institutions). Vietnam has also attracted a considerable amount of FDI, which is considered an integral component of the national economy. Negotiations with the Club of Paris and the Club of London, and, even more important, with Russia (representing the former Soviet Union's interests) have enabled Vietnam to maintain its national foreign debt of over U$S 12 billion, and keep the annual debt service ratio (principal and interest) at less than 10% of the value of exports. In addition to ODA and FDI, Vietnam receives about U$S 3 billion per year in remittances from Vietnamese people living abroad, which helps to keep the foreign exchange balance under control. Vietnam's foreign currency reserves are still at a modest level, but they have been gradually improving.

iii. There has been a change from a highly centralized "mandatory" planning mechanism (setting targets for public-

owned enterprises and even for each farming household) to indicative planning, with less and less setting of controlled targets. Economic regulation has become more and more flexible, thus facilitating production and business for all economic sectors, and at the same time ensuring social equity and the sustainability of the achievements of the socialist regime.

The state has controlled inflation mainly through the use of indirect instruments including flexible commodity pricing[2], flexible exchange rates and interest rates, and a close monitoring of market signals. The state currently controls the prices of only five or six items, which are considered to be important in society. In addition, appropriate support policies are being implemented to assist disadvantaged areas. Apart from the above, enterprises are free to engage in commodity trading and private firms are allowed to export directly. As a result, total retail and service revenue is increasing at 12% per annum[3], and this has become the most important factor in accelerating the rate of economic growth.

The changes in the economic framework have generated positive effects on the structure of production, and fostered an increase in the share of the manufacturing and service sectors: these have grown steadily over the past 17 years of reconstruction.

1.2 Three Observations on the Structural Changes in Three Major Industries over the Past 17 Years

First, the viability of these changes rests on the rapid rates of growth in the industrial sector, including the construction industry. The mining and extraction industries in particular have made rapid progress, especially in the production of oil, gas and coal. In the oil and gas sector, for instance, production currently stands at nearly 2 million tons per year (or the equivalent in oil), having started from

2 For some common goods and raw materials such as oil, gas, and electrical power.

3 If factor prices are netted out, the annual rate is around 8%.

zero, while coal production has risen threefold to over 15 tons, and is expected to reach 20 tons per year in the near future. Vietnam has been implementing official reconstruction programs since 1986. The electricity sector has also grown considerably, both in production and in domestic consumption. Current production is four to five times higher than the 9 billion KWh produced in 1990. Manufacturing industry is another sector that is developing vigorously, accounting for about 80% of the value of industrial output. The garment, textile, leather and leather shoe industries have made remarkable progress, contributing greatly to the increase in revenue from exports. Steel production has achieved a remarkable increase since 1990, when only 100 tons were produced nation-wide compared to the over 2.5 million tons produced today. The electric and electronics industry has also done well. The construction materials industry delivers over 20 million tons of cement, and construction itself, both industrial and residential has boomed (with rapid urbanization and the construction of new rural areas). In short, over the past 17 years, the share of industrial sectors (including construction) in GDP has increased by 11 percentage points thanks to a continuous high rate of growth, in the context of accelerating industrialization and modernization. This trend is unavoidable, but certain adjustments in the internal structure of the country are needed so as to increase efficiency.

Second, agriculture, forestry and fisheries are still developing rapidly. These sectors have special features, they greatly contribute to social and economic stability; they ensure food security, create jobs and accelerate rural industrialization and modernization. Forestry is currently focused on forest protection so its level of production is low, while fishing has developed enormously and this has helped to accelerate exports. The development of agriculture is diversified. Vietnam is no longer a mono-agricultural country; the focus now is on developing both short term and long-term industrial crops. To sum up, although agriculture, forestry and fishing have registered relatively high growth rates compared to the traditional in agriculture, their share in GDP has fallen by 16 percentage points. This reflects an inevitable trend in the development process and the structural changes brought about by industrialization and the re-allocation of the labor force.

Third, services have grown strongly, especially in areas connected to physical infrastructure and urban development, but this expansion is not evenly distributed. Service development has been slow, particularly in recent years, compared to economic development in general, and this has hindered economic growth. In the transport sector, during the reconstruction years, the volume of cargo transported has increased on average by a factor of five, but if we consider only the volume transported by the private sector, the factor rises to over ten times its previous level. This is a considerable amount given that 75% of total cargo is privately transported. In short, the service sector has increased its share of GDP by 5 percentage points over 17 years, and has contributed to improving the efficiency of the economy. As a result, the gap in per capita GDP between Vietnam and other countries has been gradually closing, as can be seen in table 2.

Table 2
VIETNAM AND ASEAN COUNTRIES: THE GAP IN PER CAPITA GDP
(Current Purchasing Power Parity in U$S)

	1990	1995	2000[1]	2002[2]	Current gap
Vietnam	**610**	**816**	**1,996**	**2,240**	**1.0 time**
Indonesia	537	720	3,034	2,990	1.3 times
Philippines	628	630	3,971	4,280	1.9 times
Thailand	1,291	1,843	6,400	6,680	3.0 times
Malaysia	2,301	3,108	9,068	8,280	3.7 times
Singapore	9,877	13,451	23,356	23,090	10.3 times
The gap in GDP per capita Vietnam /Singapore	6%	6%	8.5%	9.7%	Lessening

Notes: (1) PPP data: UNDP's 2001 data.
(2) PPP data: World Bank (2004).

Sources: World Bank (2004) and UNDP (2003).

The increasingly flexible policies implemented in agriculture, industry and trade have liberated production forces, and this has resulted in a visible improvement in the amount and quality of development. The economy has grown rapidly; in the last ten years the average annual rate of growth has been over 7.5%. Agriculture has maintained its annual rate of growth at around 5%, thus ensuring food security and enhancing agro-product exports. Industry, in general, and the manufacturing sector in particular, have developed rapidly, with a high proportion of exports in total sales. This is seen as reflecting major progress due to the industrialization and modernization policies. As a result, the standard of living of the general public has risen. In the last 10 years the number of poor households has fallen by 50%, and the proportion of poor people, as defined by World Bank standards, decreased from 58% in 1992-1993 to 29% in 2001-2002. At the same time, income has become more evenly distributed. The GINI coefficient has been holding steady at 0.37, while the level of income of the poorest 20% accounts for 8% of total income. The level of per capita monthly income in urban areas in 2001-2002 was U$S 45, which is 2.3 times higher than in rural areas.

In 1997, the national economies of the region were hit hard by financial and economic crises, which were sparked in Thailand. In 1998 Vietnam's economy faced major problems, with the full negative impact of the regional crisis occurring in 1999. This brought the economic growth rate down to its lowest level in the 1990s (4.8% *per* year). However, the economy has gradually recovered in the last years. The average annual rate of GDP growth was 6.9% in 1996-2000, and in 2001-2003 it rose to 7.1%, the highest rate in South East Asia. With the move towards in-depth international integration, Vietnam's economy has better opportunities for strong development.

The economic structure has been shifting towards a fall in the share of agriculture, forestry, and fishing in total GDP, and a rapid increase in the share of industry and services. The change in the economic structure that has taken place over the last 18 years, however, has not been as great as the period of economic growth in Taiwan (1955-1973) before the oil crisis (see table 3). All the same, it has been quicker and stronger than the structural transformation in Korea

in the years of accelerated industrialization (1970-1988)[4]. This reflects not only the great effort made by the Vietnamese people but also the multi-faceted impact of reconstruction.

Table 3
VIETNAM AND ASEAN COUNTRIES:
STRUCTURAL CHANGE OVER 18 YEARS
(share of GDP in local currencies in percentage)

	Agriculture	Industry	Services	Change[1]
Vietnam				
1985	40.2	27.3	32.5	7.6
2003	21.8	40.0	38.2	
Taiwan				
1955	32.9	21.1	46.0	11.7
1973	14.1	43.8	42.1	
Taiwan				
1970	18.0	34.5	47.5	2.9
1988	6.0	45.5	44.8	
Korea				
1970	26.5	28.9	44.6	6.0
1988	10.5	43.9	45.6	

Note: (1) "Cosine" of the angle between two GDP structural vectors.

Sources: GSO of Vietnam, Statistical Yearbook 2003; Statistical yearbook of Taiwan 1990; Statistical yearbook of Republic of Korea 1990; UNIDO (1985).

As a consequence of the changes in policies and the achievements in development, in 2003 Vietnam's Global Competitive Index (GCI) was ranked by the World Economic Forum (WEF) as 62nd out of 103 countries, better than Indonesia, the Philippines or Russia, and six places up on Vietnam's rank in the previous year. In 2003, Vietnam's economy, when ranked by the UNDP according to socio-economic development indicators and the Human Development Index (HDI), was placed 109th out of 175 countries, and it falls in the group of countries with an "average" rank in terms of HDI. If ranked in terms of GDP, Vietnam comes in 21 places higher.

4 Computed using the UNIDO formula.

2. MAJOR CHALLENGES, AND MEASURES TAKEN IN RECENT YEARS

Although Vietnam has made remarkable progress it is still a low-income developing country. The most important factors hindering its further development are the following:

i. **Low economic development and low labor productivity**: GDP per capita in 2001 was just over U$S 400, and in 2003 the figure was still below U$S 500 (income per capita in the lowest income countries (LIC) in 2001 was just under U$S 735, according to the World Bank's World Development Report 2004). The risk of lagging behind other countries in the region is relatively serious because in 2001 GDP per capita in the Association of South East Nations (ASEAN) was U$S 1,100. Vietnam's labor productivity was, on average, less than U$S 900 per head in 2001, and the technological content of many products is still low. This means that the possibility for expanding its markets is limited, and profitability is low.

The impact of science and technology on Vietnam's national competitiveness can be considered as very moderate: the country ranks 38th out of 80 countries. Although there is a relatively high level of technology transfer to enterprises, especially to FDI firms, the overall application of high technology to production is low. As a consequence, rapid development in the future is still considered to be limited.

An analysis of the Input-Output (I-O) table for 2000 shows that, in terms of scale, 55% of industries have increased costs. Costs in the industrial and construction sectors increased 66%, the increase in agriculture was 29%, and while the increase in services has not been measured, it was also large. Some of the industries registering high increases in production costs (intermediate costs), both in percentage and as regards scale, are poultry (in which costs rose 160%, from 13.8% to 35.9% of product price), sugar cane with a 75% increase, fishing with 56%, and pig farming which had an 8% increase. There have been very large cost increases in many other industrial sectors,

mainly in the costs of intermediate capital goods. For example, the production costs of oil and gas exploration increased by 85% over four years (from 13.9% to 25.8% of product price), and at the same time output was going up steadily so this is one of the industries in which production costs increased most (the jump was equivalent to U$S 400 million per year). Sugar cane production costs increased by 75% (from 13.7% to 24.1%), and production costs for leather and alcohol products and for aqua-product processing rose by 42% and 15%, respectively.

As a result, overall costs in the economy continue very high, especially in manufacturing since it is heavily dependant on imported inputs. Production costs [(Gross Output-GDP)/Gross Output] in the economy as a whole went up from 48% in 1996 to 53.5% in 2000, an increase equal to 3.65% of the economy's gross output (GO) in 2000. Production costs in industry and in services in general have increased, with the exception of agriculture, forestry and fisheries, where input costs fell from 41.6% to 35.4%, thanks to intensive farming, productivity improvements and crop and animal structure changes. On the other hand, costs rose by 5.4% of product price in the industrial sectors and by 15% in services (although the quality of services did improve), and this has led to increases in the cost of inputs for other products.

ii. **Agriculture and the rural economy are still less developed, and there is still a big gap between the rich and the poor**: In 2003, the share of agriculture in GDP was only 21%, but it employs 60% of the labor force. In 2004, 75% of the population lives in rural areas where productivity is only 1/3 of the average level in agriculture. Although physical and spiritual life in rural areas has indeed improved, the gap with urban areas has widened and this needs to be controlled. The main factors here are under-employment (it is estimated that nearly 25% of working hours are not utilized in productive activity), and there is an annual addition of 1.5 million young people into the labor force, mainly in rural areas. The gap in regional development is also relatively wide, and there are disadvantaged regions

throughout the country. Some 20% of the highest income earners in the Southeast enjoy incomes that are 10-12 times higher than that of the 20% lowest income earners in the Northwest. Income discrepancy between the highest and the lowest income groups increased from 7.6 times higher in 1999 to 8.1 times higher in 2001-2002. The outskirts of the urban areas have been affected by rapid urbanization (urbanization account for 25% of the population). Farmers who have little or no land left have not been trained to keep pace with the changes, and therefore their income and quality of life have been affected negatively.

iii. **The competitiveness of the economy is still low**: The WEF assessment reports that although Vietnam's GCI has improved, it still ranks 62nd out of 102 countries, and is below the other countries in the region. When ranked in terms of HDI, Vietnam came 109th out of 175 countries in a 2003 United Nations Development Program (UNDP) ranking.

An in-depth analysis suggests that the high level of the ratio of inputs to output is due to the fact that measures undertaken to make savings in energy and materials have not yet yielded good results. This can be partially explained by the fact that the policies used as a means of implementing structural changes still have many shortcomings. One of these is that the emphasis is on the value of output rather than on value added. The service sector is developing slowly, especially in high value added and rapidly developing fields such as banking, credit, and insurance. As a result, the burden is being put on industrial development, but as the level of consumption of inputs in this sector is high, the process is leading to an imbalance in the development of the economic structure. In addition, corruption, red tape and waste are putting a brake on the *momentum* of development. All these factors taken together are weakening the economy, especially as regards Vietnam's efforts to integrate into the international economy.

The Communist Party of Vietnam is now faced with major economic challenges. However, its strength lies in the strength of the entire population, and as it has established sound lines of policies and action,

it has fostered the production potential of public and private economic sectors, and of domestic and foreign enterprises.

Major changes in the economic policies for industrialization and modernization have been made in recent years. They have contributed to enabling the country to overcome difficulties and to push these processes forward efficiently. The changes can be summarized as follows:

i. In the design of development policies, more attention has been paid to the quality than to the rate of growth, despite the fact that the level of economic development level is still low. The quality of growth has to do with economic efficiency (reduced production costs and fees of services such as telecommunications, transportation and storage, and increased competitiveness), but it also has to do with development being harmonious as regards its social, economic and environmental dimensions. The efforts to attain a high annual rate of growth, a rate of over 7-8%, have also included the need to alleviate poverty and improve social equity. Thus, these policies should contribute to reversing the trend towards polarization between the rich and poor sectors of the population. Human development indicators can be used to show the advantages and disadvantages of Vietnam's development process compared to other East Asian countries (table 4).

ii. To ensure sustainable development it is necessary to promote a rapid increase in domestic savings, and to use external resources efficiently so as to obtain synergic resources for development. In the reconstruction process, domestic savings have increased from less than 3% of GDP in 1990 to over 25% in 2000 and to 30% of GDP in 2004. This is seen as an important sign. At the same time, a large flow of external capital has been attracted, and it now accounts for 30% of total capital. Although the incremental capital-output ratio (ICOR) has increased from just over three in the early 1990s to nearly five in recent years, there has been strict participatory monitoring of the efficiency of investment, especially, that made in the public sector. This monitoring was conceived as a means of

Table 4
EAST ASIAN COUNTRIES: HUMAN DEVELOPMENT INDICATORS

	Vietnam	China	Thailand	Malaysia	Singapore	Korea	Japan	Conclusion
Life expectancy (years)	66.8	70.6	68.9	72.8	72.8	72.5	81.3	
Compared to Vietnam	100%	106%	103%	109	109%	109%	122%	**Worse**
Literacy rate (%)	92.7	85.8	95.7	87.9	92.5	97.9		
Compared to Vietnam	100%	93%	103%	95%	99.8%	106%		**Better**
Higher secondary education (%)	64	64	72	72	75	91	83%	
Compared to Vietnam	100%	100%	113%	113%	117%	142%	130%	**Worse**
GDP by PPP[1] (U$S)	2,070	4,020	6,400	8,750	22,680	15,090	25,130	
Compared to Vietnam	100%	194%	309%	423%	1,096%	729%	1,214%	**Worse**
GDP rank	130	102	72	56	21	37	14	**Worse**
HDI rank	109	104	74	58	28	30	9	**Worse**
HDI rank higher than GDP rank	21	-2	-2	-2	-7	7	5	**Better**
Advancement in HDI				**Human resources development**				
1975		0.521	0.612	0.615	**0.722**	**0.701**	**0.851**	
1980		0.554	0.650	0.658				
1985	0.582	0.591	0.673	**0.692**				
1990	0.603	0.624	**0.705**	**0.721**				
1995	0.646	0.679	**0.739**	**0.759**				
2001	0.688	**0.721**	**0.768**	**0.790**				
Compared to other countries in terms of HDI	**Present**	**5 years ago**	**15 years ago**	**20 years ago**	**30 years ago**			**Worse**

Note: (1) PPP = Purchasing Power Parity.

Source: UNDO (2003).

fighting against losses and wasted resources in construction, taking into account that investment is needed mostly in large scale infrastructure projects such as roads, ports, power plants and power transmission lines, schools and hospitals.

iii. It is necessary to accelerate the development of agriculture and the rural economy as a whole, and also the process of speeding up industrialization and modernization. Two thirds of Vietnam's labor force is engaged in agriculture and 75% of the population lives in rural areas. With this is mind, it is necessary to ensure national food security and to improve the standard of living by shifting the agricultural and rural economic structure towards modernization. Vietnam always had an agricultural economy and agriculture used to be a leading sector, but now the position of paddy rice has been eroded. However, food production is still very important and food is produced in a sound way[5]. In the agriculture, forestry and fisheries sectors, fishing has the highest rate of growth (11% per annum) and is developing as fast as aquaculture.

iv. Another important question is the dual nature of industrial development. While attention has been paid to constructing an economy that leans towards industrialization and modernization, the government of Vietnam still attaches great importance to the development of small and medium scale industries. That is to say, concern has been focused not only on the construction of large scale industrial plants for oil, gas, electricity, coal, cement, steel, etc., based on the philosophy of socio-economic efficiency, but also on creating more employment and on producing goods to meet market demand. In order to do this, it is necessary to combine industrialization with gradual modernization while affecting the transfer of technology and improving the quality of human resources to meet adequate standards of efficiency and competitiveness. The recent and rapid development of information technology and telecommunications, especially in the software industry,

5 In other words, cultivation currently accounts for only 2/3 of agricultural output value, and animal husbandry accounts for 32%.

is an indication that Vietnam's industrialization and modernization processes are succeeding.

v. Attention is being paid to accelerating export sales, to opening up the economy, and to international economic integration. This is one of the important points in the "open door" policy and other active policies for attaining economic integration. Vietnam has a self-sufficient economy, it has improved economic efficiency and competitiveness, and it is therefore capable of rapidly expanding its markets even under conditions of fierce competition. Fully processed commodities account for over 50% of export value, and in 2003 agro-products only accounted for around 20% of the total value. Vietnam has been implementing the Asian Free Trade Association (AFTA) schedule, lowering tax rates for many items to a level between 0 and 5%, and the plan to complete the tax reduction schedule it is committed to by 2005-2006. The signing of bilateral agreements on trade and investment protection with the United States (US), Korea and other countries has also resulted in changes in the structure and value of imports and exports. Tourism, aviation and other services have developed strongly, thus generating further foreign currency revenue for the country.

The above-mentioned changes in development policies have enabled Vietnam to achieve increasingly high quality growth, to overcome problems and weaknesses, to take advantage of new opportunities to develop, and thus to make progress towards closing the gap with other countries.

3. THE NEW CONTEXT AND CHANGES IN DEVELOPMENT POLICIES

Entering into the 21st century, the Vietnamese economy enjoys new opportunities, but it also faces new major challenges. What will be the characteristics of Vietnam's development in the years ahead?

3.1 The Country's Reconstruction Period

After 20 years of implementing reconstruction and development policies, the country has overcome difficulties and met challenges, and now Vietnam is in the period of implementing the "10 year socio-economic development strategy (2001-2010)". The country has created a new position and new strengths, gradually narrowing the gap with its neighbors in the region and in the world. Vietnam has a new position and the power to advance into the new period with miraculous breakthroughs.

In 2003 the scale of the economy measured by GDP (at the official exchange rate) was U$S 40 billion, five times higher than the 1990 figure. If the 5-year plan (2001-2005) is successfully completed, the economy's scale will be above U$S 50 billion. If this is computed in Purchasing Power Parity (PPP), Vietnam's GDP will exceed U$S 200 billion. A comparison with official data from the World Bank's World Development Report 2004 shows that Vietnam's economy will be twice as big as Singapore (96 billion), virtually the same as Malaysia (201 billion), half the size of Thailand (411 billion) and 1/4 the size of Korea's in 2002 (785 billion). If the high rate of growth of the past 15 years is maintained, Vietnam can be confident of rapidly narrowing the gap with her neighbors in terms of the scale of the economy, and of making gradual progress in terms of GDP per capita.

The country's strengths (political and social stability, a dynamic and high rate of growth) and its sound position (the relatively large scale of the economy and of the industrial and export sectors), have created good conditions for attaining further goals. The experience of other countries like China and New Industrialized Countries (NICs) indicates that once GDP per capita exceeds U$S 500, and if suitable policies to reduce the development gap are taken, the country will be able to make further progress with a high average annual rate of growth of 15% (computed in PPP). This means that Vietnam's GDP in dollar terms could double in five years. Thanks to the restructuring of the economic system and the overhaul of its regulations in the 1991-1995 period, per capita GDP increased from U$S 124 in 1990 to U$S 286 in 1995. Even during the economic crisis, the average annual rate of GDP

growth was over 7%. The new 5-year plan will create a breakthrough and a strong start-up for the country's rehabilitation, merely by matching the achievements made in the previous 15 years. Thus, before 2015-2020, the economy will be able to catch up with and gradually advance beyond the overall level of development of the ASEAN countries[6]. If this goal is defined in terms of PPP it may be attained even sooner.

However, in terms of HDI (including economic development, education and healthcare), Vietnam currently lags fiveyears behind China, 15 years behind Thailand, 20 years behind Malaysia and Singapore, and over 30 years behind Korea and Japan. The response to this should be to define development objectives and to take the appropriate steps to attain them. The Vietnam's Millennium development goals (MDG) compared with China and Thailand are presented in table 5.

In the years ahead, Vietnam will implement numerous new and difficult programs to build socialist-oriented market institutions and to improve infrastructure. By doing this it will ensure sustainable socio-economic development, with economic, social and environmental objectives in harmony. It will also take shortcuts towards industrialization and modernization, improving the economy's efficiency and competitiveness. Vietnam is enjoying great opportunities in the period of peace, with construction, reconstruction and development. Therefore the present time can truly be called the country's reconstruction period.

3.2 The Comprehensive Economic Integration Period

This is the period in which Vietnam will be implementing industrialization and modernization in a context of real economic integration. The country is not just being passively affected by international conditions; it is actively undertaking industrialization and modernization. This is being done while Vietnam is fully implementing many bilateral and multilateral agreements on

6 In 2001 the per capita GDP of the ASEAN countries was over U$S 1,100, twice the current level in Vietnam.

Table 5
MILLENNIUM DEVELOPMENT GOALS

	Vietnam	China	Thailand	Comparative			Advantage
				Vietnam	China	Thailand	
Rich-poor							
Persons living on less than U$S 1 a day 1990-2001	17.7%	16.1%	2.0%	100%	110%	885%	
Income share of 20% poorest households	8.0%	5.9%	6.1%	100%	**74%**	**76%**	**Poverty alleviation**
Education							
Literacy rate (youth)	95.4%	97.9%	99.0%	100%	103%	104%	**No advantage**
Gender equity							
Female/male ratio Primary school	91.0%	92.0%	94.0%	100%	101%	103%	**No advantage**
% National Assembly female representatives	27.0%	22.0%	9.0%	100%	**81%**	**33%**	**Gender equity**
Mortality rate							
Children under 5 years	3.8%	3.9%	2.8%	100%	**97%**	136%	**Better than China**
Child mortality rate	3.0%	3.1%	2.4%	100%	**97%**	125%	
Maternal mortality							
Per 100,000 mothers	95	60	44	100%	158%	216%	**No advantage**
Disease (HIV, infectious)							
Children in general	9	0	8	100%		113%	
Children under 5 years	1	0	9	100%		**11%**	
Environment							
GDP by PPP/kg of energy	4.2	4.1	5.1	100%	**98%**	121%	**Attention given to environ-mental protection**
Rural clean water	72%	66%	81%	100%	**92%**	113%	
Urban clean water	82%	69%	96%	100%	**84%**	117%	
Partnership							
Debt service ratio (DSR)	6.5	4.2	7.9	100%	155%	**82%**	**Debt manage-ment**
Telephone lines/100 persons	5.3	24.8	22.2	100%	468%	419%	
Internet /100 persons	1.2	2.6	5.8	100%	217%	483%	
Computer/100 persons	0.9	1.9	2.8	100%	211%	311%	

Source: UNDP (2003).

international economic integration: AFTA, Asia Integration Agreement (AIA), Asia Pacific Economic Co-operation (APEC), ASEN, the Vietnam-US BTA, the Vietnam-Japan agreement on investment, the Vietnam-EU framework agreement, etc. Also the country is officially joining the World Trade Organization (WTO). These are opportunities and challenges for active economic integration and national rehabilitation. The world is developing rapidly, there are advantages and disadvantages in the current situation, there are opportunities and challenges. If Vietnam's advantages as regards key positions and strengths are well exploited, opportunities will be easier to grasp, and flexible and rapid responses to weaknesses and difficulties will be possible. Domestic and external synergy can be used to develop and reconstruct the country.

A sound policy will probably have great impact. Domestically, the power of Contractual System No. 10 is evident, and the effectiveness of the Enterprise Law has been demonstrated in the four years since implementation. As to foreign relations, in the two years since the Vietnam-US BTA was implemented, exports to that market have increased at such a rate that the United States has rapidly become Vietnam's leading export market. This in turn has had a big impact on domestic production and business. In addition, relations with other trade partners such as Japan, the EU, etc., have improved. Every year, Vietnam receives nearly U$S 3 billion, much more than the annually implemented ODA or FDI. This indicates that if sound policies are adopted, additional human and financial resources, including funds from Vietnamese people living abroad, can be mobilized. Internal and external strengths have been combined to create a synergy for development, and a lot of other development potential has been promoted.

At the same time, as the country moves into this new period the legal system and the quality of public servants must be improved to keep pace with and be suitable for the conditions of rapid economic integration. It can be seen that sound policies and mechanisms (both internal and foreign) will be important factors for development. Therefore it seems that the coming years will be a period of comprehensive economic integration.

3.3 The Period of Bringing into Full Play the Synergic Strengths of the Nation and the Times

Vietnamese resources for breakthrough development are made up of the synergy of the entire nation, all social classes and races, Vietnamese people abroad, and all their spiritual and physical strengths. This is the most determinant factor. Internal strength is of decisive importance when it comes to making use of the opportunities that will be created by economic reconstruction and integration, and a great leap forward can be made in the development of the nation. A new example of the national factor is the joyous spirit that has reigned since the Severe Acute Respiratory Syndrome (SARS) was successfully eliminated, and SEAGAMES 22, an event that stirred national pride, was organized. The national pride factor has made possible achievements that seem miraculous, not only as regards the number of medals in the Games but also in sound resettlement and quick construction work, better urban discipline, and order and happiness for all, and this has contributed to higher efficiency in production and business. This, in turn, will contribute to rolling back such negative factors as corruption, red tape and waste. In a broad sense, the physical and spiritual strengths of people of all classes and all races, including Vietnamese abroad, will be a giant resource for bringing into full play the strengths of the nation in the years ahead. Significant progress can also be attained in scientific and technological areas, as well as in the development of production forces, and the strengthening of efficiency and competitiveness.

Chapter VI

VIETNAM'S ECONOMIC REFORM AND DEVELOPMENT: ACHIEVEMENTS AND ISSUES

CIEM[1]

Introduction

Vietnam's development has been unusual, perhaps unique among developing countries. After a 30-year struggle for independence and reunification, in 1975 Vietnam's focus shifted to reconstruction and socio-economic development. However, replicating a centrally planned system in peace time led to a failure in economic development which forced Vietnam to undertake reforms at the end of 1970s. The economic reforms implemented over the last two decades were gradual and were essentially a process of "learning by doing". The radical reform package launched in 1989 was different, and it is considered the most successful attempt to date because the basic conditions were created for a changeover to a market economy[2]. There have been great socio-economic achievements, especially in the 1990s, but a lot of difficulties and obstacles were encountered along the way. In many cases, the Vietnamese people themselves initiated the reforms.

1 This paper was written by a research group of the Centrla Institute for Economic Management of the MPI (CIEM). The views expressed here are those of the authors and do not necessarily reflect the views of the institute in question.

2 Since the radical reform in the spring of 1989, Vietnam has brought inflation under control while maintaining high rates of economic growth. The results of the 1989 reform were very impressive in comparison to the experiences of many transitional economies in Eastern Europe, although the liberalization and stabilization measures involved were similar to theirs (Riedel and Comer, 1996). But the success did not come overnight. Unlike China, which has had relative success in implementing piecemeal and partial reforms (Chen *et al.*, 1992), Vietnam has had to pay a price for this kind of economic reform: high inflation haunted the economy throughout the 1980s.

In this paper we will review the factors underlying economic growth in Vietnam since 1975. We will also attempt to identify the challenges and obstacles Vietnam has faced in her efforts to sustain high economic growth (with equity) in the first decade of the 21st century. This study is divided into four sections: (1) economic reform from 1975 onwards, (2) socio-economic achievements, (3) structural changes and major problems, and (4) challenges and issues of reform and development.

1. ECONOMIC REFORM, 1975-2003

The changes in Vietnam's economic policy and development since reunification in 1975 can be divided into three periods: (i) prior to the 1980s, when Vietnam had what was essentially a centrally planned economy (CPE), (ii) the period from 1980 to 1988, in which Vietnam's economy can be regarded as a modified planned economy (MPE) where some micro-reforms were undertaken but there were no significant changes in macroeconomic management, and (iii) from 1989 onwards, when Vietnam's economy has been in transition[3], striving for industrialization and international integration.

1.1 The Period Prior to the 1980s

Prior to the 1980s, Vietnam's economy was essentially a traditional centrally planned economy. It was generally characterized by large distortions in resource allocation, poor incentives, and poor information. Although central planning had worked well during the war, it failed in peace-time because it had at least two disadvantages: (i) there are few effective checks on planners' mistakes, even on major ones, and (ii) most competition between enterprises was eliminated, which meant there was no pressure to raise productivity, which is a source of rapid development.

In the agricultural sector cooperatives and state farms were dominant. However, due to lack of incentives when working in the

3 The IX Party Congress (April, 2001) confirmed that Vietnam was building and developing a market economy with a socialist orientation.

cooperatives, farmers shifted their focus to their own small plots of land (5% of the total area), which, along with livestock, provided over half of farmers' income. The remaining, smaller part was earned from cooperatives that had cheap inputs and 95% of the land (David and Cao, 1994). The inefficiency of the agricultural cooperatives in the North, combined with a weak response to agricultural collectivization in the South, further undermined collective ownership.

In the industrial sector, manufactures and services were dominated by the state, although this sector was much smaller than that in other socialist countries. In addition, most manufactures were biased toward relatively capital-intensive heavy industries, which meant that the state sector had a small share in terms of the total labor force (just 8% of the total).

This form of productive organization caused many difficulties. During the period, investment was inefficient. There was a downward trend in the economy and growth was slow, with an annual rate of 3.6% despite the extremely high Gross Domestic Product (GDP) growth in 1976 (16.8%). Growth in the manufacturing and construction sectors, regarded as the driving motors of the economy, declined and became negative in 1979-80, while agriculture, which was the largest sector, recorded modest growth.

By the end of the 1970s, the stagnation of production forced Vietnam to import large amounts of rice, and the balance of payments position worsened. Domestic production was only enough to satisfy 80-90% of domestic consumption. This put great pressure on government resources, especially given the fact that external sources that supported the North and the South during the war had dried up, new aid to the South stopped, and aid flows from the socialist countries gradually dwindled. In addition, Vietnam was also adversely affected by border conflicts with China and Cambodia in the late 1970s and early 1980s, as well as by the US embargo that has been in force since the war. The failure of the centrally planned system was clear for all to see, and pressure for reform mounted steadily.

1.2 The Period 1980-1988

At the end of the 1970s Vietnam was under great pressure to reform its economy, and some microeconomic reforms were undertaken in 1981. In fact, those reforms were only steps to further recognize and legalize certain operations, so called fence-breaking activities, which began at the end of the 1970s in a particular framework. The reforms meant the economy could be characterized as a "modified" central planning system.

In the state-owned enterprise (SOE) sector, the so-called "Three-plan system" was introduced in 1981. Under this system there was a SOE production plan in three parts: (i) state-assigned output manufactured with state-supplied inputs (Plan A); (ii) output surpluses above the levels required by the plan was sold to the state but inputs were procured by the enterprise itself (Plan B); and unplanned 'minor' output which was free from outside control and could be sold on the free market (Plan C).

In 1981, Vietnam also revised its agricultural policy. The main outcome of this was the "Directive 100" in which a "contract system" was officially established. Under this Directive, cooperative land was distributed to farm families for short term use and farmers were responsible for planting, harvesting and manuring, while cooperatives were still responsible for land preparation, water management, pest control and the provision of seed and chemical fertilizers. The "contract yield" was negotiated at a public meeting for each plot, and the farmers were obliged to hand over a certain amount of the yield to the cooperative. The rest of the output belonged entirely to the farmer and could be sold at the "free" market price. Directive 100 created new incentives for farmers to raise agricultural output during the period 1982-85.

As a result of the micro-reforms, official prices increased sharply in 1981, narrowing the gap between official and free market prices. The government also lowered the official exchange rate and raised wages, salaries and payments to the public sector. Market forces were enhanced, resulting in an increase in voluntary and decentralized interaction between individual agents in the dual price system, and in the strengthening of the parallel economy.

The economy became more dynamic, and as a result the rate of economic growth in the first half of the 1980s was quite high. Food production grew faster than population, which led to a gradual increase in average food per capita. For the first time, Vietnam achieved food self-sufficiency. Manufacturing also contributed substantially to aggregate growth from 1983 to 1985. The non-state sector made a contribution to good growth in manufacturing. Consequently, the role of the private sector increased. In the period 1981-84 the service sector performed well as a result of changes in the way this sector was seen. While previously it had been regarded as not producing material welfare for society, it came to be viewed as a force for creating momentum and facilitating the development of the economy as a whole.

However, overall economic growth was not sustainable and tended to decline. The main reason for this was that the partial microeconomic reforms were basically undertaken only within the framework of a CPE without any significant changes in macroeconomic management, particularly in the triangular relationship involving the state budget, the central bank and the SOE sector. In 1984 the reforms were partially reversed and there were attempts to strengthen planned control and to dampen down the private sector.

The financial reform (the so-called "price-wage-money reform") in 1985 was aimed at reducing state subsidies, at giving greater autonomy to the SOEs in setting their prices, at increasing or at least maintaining the level of real wages and salaries, and at the same time stabilizing the economy by implementing a kind of confiscatory monetary reform. However, the 1985 reform did not address the fundamental problems of bad resource allocation and macroeconomic imbalances in the economy[4]. As a result, the expansion of output weakened and inflation accelerated to several hundred percent with

4 The reform replaced the old dong (Vietnamese currency) with the new dong at the rate of ten to one. This measure destroyed the dong assets of the SOEs, which held a lot of cash for the purchase of scarce inputs from parallel markets. As a result, the government had to continue providing "soft" funding for the SOEs. Besides this, capital expenditure rose sharply to meet the objectives of the plan. Moreover, the drop in real wages due to high inflation in 1985 (191.6%) forced the government to return to a rationing system as of 1986, and state subsidies rose again to high levels in 1987-88. The budget deficit was high during the 1985-88 period, and about two-thirds of it was financed with loans from the State Bank, which caused the government to print money. The predictable outcome was that inflation soared to unprecedented levels in 1986-88 (Leung and Vo, 1996).

the peak of 774.7% in 1986. Furthermore, farmers' net incomes fell slightly because the contributions required from rural households rose faster than the growth rate of agricultural production. Compulsory quota contributions accounted for 80% of output, compared to only 50% to 60% before. In addition, high inflation caused the real income of the majority of government employees to fall considerably, and price adjustment usually lagged behind. Major social indicators such as school enrolment rates and the quality of health care services deteriorated a lot compared to the previous period.

Last but not least, in a new business environment, the autonomy and business rights of economic units obviously needed to be suitably expanded. Moreover, the stagnation in agricultural production catalyzed a more fundamental reform of the agricultural sector. The failure of the 1985 price-wage-money reforms led to serious macroeconomic instability in the subsequent period including hyperinflation and decelerated growth in 1986 and 1987, which put extremely heavy pressure on the reforms.

However, significant changes in the orientation of this policy occurred only after the Sixth Congress of the Communist Party passed the *Doi Moi* (Reconstruction) program in December 1986. Under this program, the existence and the essential role of a multi-ownership structure in Vietnam's economy was recognized. Moreover, expanding people's opportunities and choices was recognized as a way to promote economic development and improve the standard of living of the population.

By the end of 1987, the changes included removing checkpoints on internal trade, increasing the autonomy of the SOEs, and the passing of the Law on Foreign Investment. In April 1988, the Party issued Resolution 10/NQ-TW, which defined farming households as autonomous economic units in rural areas. They were entitled to purchase, sell, and transfer the means of production in the market. The land of the cooperatives was allocated to farming households for long-term use. Output-rating contracts were stable for five years. Farmers were allowed to enjoy 40% of contracted output. In 1988, the functions

of the central bank and the commercial banks were separated. All these policy measures, adopted after the Sixth Congress of the Communist Party, paved the way for a new wave of radical reforms in the subsequent period.

1.3 The 1989-2003 Period

The Sixth Congress of the Communist Party (December, 1986) can be considered as a turning point in Vietnam's economic policy. The existence and the essential role of a multi-ownership structure in the Vietnamese economy were now recognized. After the *Doi Moi* (Reconstruction) program was passed by Congress, significant changes in this same direction continued. In March of 1989, Vietnam adopted a radical and comprehensive reform package aimed at stabilizing and opening the economy. It further intended to enhance competition and freedom of choice for economic units so as to fundamentally change the economic management system in Vietnam. The reforms included:

- Almost complete price liberalization.
- A huge devaluation and the unification of the exchange rate.
- Increases in interest rates so as to attain positive levels in real terms.
- Substantial reduction in subsidies to the SOE sector.
- Agricultural reforms.
- Encouragement of the private sector, including foreign direct investment (FDI).
- Removal of domestic trade barriers and increased degree of openness of the economy.

Macroeconomic stabilization (including a reduction of the government budget deficits) was successful in conjunction with price liberalization, changes in interest rates and exchange rate policies. Monetary policies were also improved, and this allowed different instruments to be used which turned out to be more effective in combating inflation.

A number of measures were taken to increase the private sector's participation in production and distribution, including the creation of a legal framework for private business. The recognition of the farming household as a basic economic unit, and the right to the long-term use of land (provided by a new land law in 1987, amended in 1993), created big incentives for farming households to make long-term investment and expand production. Agricultural production has become much more diversified with market and foreign trade development. The reform of the agricultural sector was essential for reducing poverty as it is the largest sector of the economy and provides the income of some three-quarters of the population.

The rapid growth in services and construction during the 1990s came mainly from a quick response of private entrepreneurs. Nearly 2 million newly established household businesses in urban areas helped to enhance the performance of the economy and improved the retail sales and services network considerably. During the 1990s, about 45,000 private enterprises were registered under the Law of Private Enterprises and Company Law, which was passed in 1991. The private sector became a major source of employment in the economy.

In an attempt to make the operation of the SOEs viable, the government reduced subsidies considerably, reduced "cheap" credit to these enterprises, and gave them greater autonomy. Furthermore, inefficient and money-losing enterprises were liquidated. From 1990 to 1994, the number of SOEs fell from 12 thousand to 6.3 thousand, and 1.5 million SOE workers (out of the total of 4.05 million) retired or were put on part-time work. These reforms led to some positive improvements in the performance of the SOE sector in the first half of the 1990s.

Vietnam has substantially liberalized its trade and investment policies since the late 1980s. In an attempt to integrate its economy with the rest of the world, the country has entered into trade agreements with about 60 countries and has trade relations with some 170 countries. Since 1992 it has implemented a preferential trade agreement with the European Union. In addition, Vietnam has been a member of the Association of South East Asian Nations (ASEAN) since June 1995 and the Asia Pacific Economic Co-operation (APEC) since 1998.

The climate of liberalized investment resulted in a rapid growth in foreign investment between 1993 and 1997. Vietnam received foreign investment from some 60 countries. The Law on FDI which was promulgated in 1987, and its subsequent amendments, has attracted a large volume of capital to renew technology and expand markets. FDI has indeed become an integral part of the Vietnamese economy, and was an important factor in her economic growth in the 1990s.

To facilitate the development of trade and investment, the government also introduced reforms in the banking sector. The mono-banking system was replaced by a two-tier system. This came into full operation in 1990 when the laws on banking authorized the State Bank of Vietnam to assume traditional central bank functions, such as the conduct of monetary policies and the supervision of the financial system. Also, sectoral restrictions on specialized banking activities and entry barriers were abolished. At present, in addition to the five state-owned commercial banks (SOCBs), a number of joint-stock banks, credit co-operatives/funds, joint-venture banks and foreign banks are operating in the country.

Despite wide-ranging and fast liberalization, it was recognized that significant restrictions remained in a number of areas including trade and market entry. The reform of the SOEs and the financial sector were limited and were not keeping pace with economic development. There was also serious concern about the sustainability of economic growth and development, especially during and after the Asian crisis in 1997-98. The challenges and difficulties Vietnam was facing called for further reconstruction. However, in the 1997-1999 period, Vietnam was still reluctant to undertake a decisive and comprehensive reform program. In 2000-03 there was a policy to stimulate demand so as to revitalize the economy, which had suffered the negative impact of the Asian crisis, and there were new commitments to continued reform. Some progress was made, especially in the development of the private sector and trade liberalization. Meanwhile, the reforms of the SOEs, the banking system and the public administration were slower than expected, and this limited the effectiveness and efficiency of other reforms.

Among the measures in the demand stimulus policy were public investment in infrastructure projects, financial supports for SOEs to deal with their mounting inventories, budget injection for poverty reduction programs, higher wages and salaries, encouragement for consumers, and partial support for enterprises to expand exports (Le Xuan Sang, 2003). This package of demand stimulus policies had a positive impact on the economy and helped to combat deflation and economic stagnation, but somehow it worked against the process of structural and administrative reform.

Since 2000, there has been a surge in the development of the private sector thanks to the New Enterprise Law. From 2000 to September 2003, 72,600 private enterprises were registered under the new Law with a total capital that amounted to VND 145,000 billion, equivalent to U$S 9.5 billion[5]. Another problem to be tackled was the creation of "a level playing field" for business activities. Although there have been some improvements in the environment for attracting FDI (the amendment of the Foreign Investment Law in 2000), there are still major obstacles such as cumbersome administrative procedures and corruption, an inconsistent and barely transparent system of legal documentation, and the high costs of infrastructure services to facilitate business.

However, the pace of reforms in the SOEs and the banking sector is still not as fast as expected, although there have been Party Resolutions on SOEs and an Overall Program for restructuring the commercial banking system. In the period 2003-2005, 3000 SOEs out of a total of about 5000 are scheduled to restructure, and 1640 of these would be restructured in 2003 (including equitizing of 967 SOEs). However, in the first half of 2003 only 286 SOEs were restructured, of which 163 were provided with equity capital. The fragile banking sector still causes a lot of concern, with large non-performing loans, and a high risk of an expansion of credit to big and high cost projects.

Trade policy has become more transparent and predictable (Decision 46/2001/QD-TTg in April, 2001). In some areas trade reform has been undertaken faster than the planned schedule (for example, the extension of trading rights to all economic sectors, the removal of some quantitative

5 This figure is much higher than the amount of FDI during the same period and four times larger than that of private enterprises established in the 1991-1999 period.

restrictions and export focal points, etc.). The international economic integration process has been stepped up. The Vietnam-US Bilateral Trade Agreement (VN-US BTA) became effective in December 2001. Vietnam has almost fully complied with its commitments to the ASEAN Free Trade Area (AFTA), and will join the WTO in 2005.

However, the pace of administrative reform has still been slow, and it seems that there has not yet been a breakthrough in this area, in spite of 2002 was set as the year for the correction of rules and discipline in the administrative system, but only limited results were achieved. Hence, administrative reform is considered a vitally important project for 2003-05.

1.4 The Nature of the Reforms and Key Lessons

Some conclusions can be drawn from the process of economic change and development in Vietnam, and they can contribute to practical knowledge about the changeover from a centrally planned economy to a market-based economy.

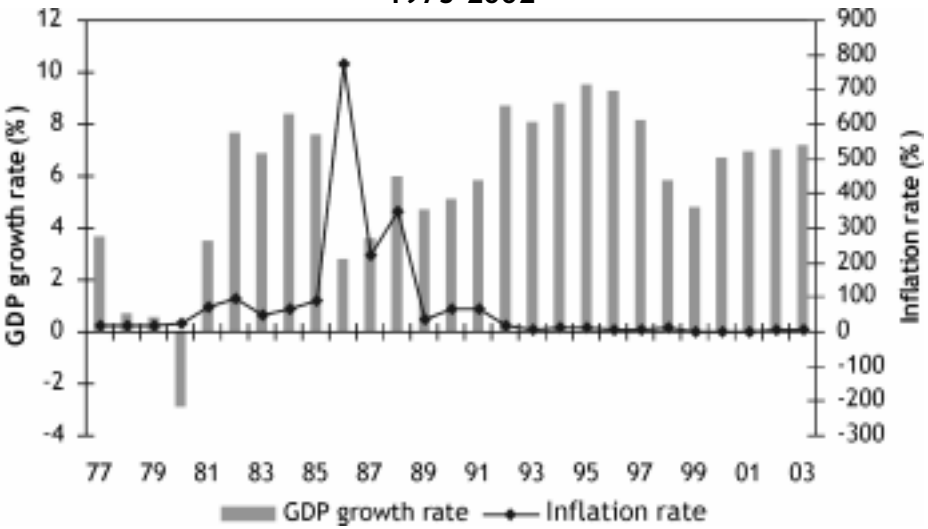
- In Vietnam, reforms can be defined as changes in ways of thinking that reflect real life dynamics, and as a process of expanding (economic) opportunities and choices for people. Economic opportunities and choices for people were enhanced as a result of changes in the way the country's leaders regarded the private sector. Market-oriented reforms confirmed the state's recognition of the non-state sector, including private firms and enterprises with foreign investment. The economy was opened up, mostly as regards the terms of trade and FDI, but these market-oriented reforms could only be sustainable if macro and social stability was ensured.
- The sluggish performance of the economy in some periods after 1976 meant that partial reforms have yielded good or even remarkable achievements, but in the long run, if the effects of those reforms become exhausted, the situation would be reversed. They should be undertaken in a framework of comprehensive micro and macro reforms.

2. SOCIO-ECONOMIC ACHIEVEMENTS

Graph 1 shows trend in GDP growth and the inflation rate for the period 1975-2003. The rate of growth of GDP slowed from 1977 through 1980, and in 1980 it was even negative. From 1981 up to the middle of the decade, the rate of growth improved considerably compared to the previous period, but it suddenly dropped in 1986, providing an impetus to more far-reaching reforms. The radical and comprehensive reforms implemented in 1989 marked a turning point in the process of economic development. From 1990 to 1997, the rate of growth of GDP remained high, at around 7% per annum, but it declined between 1997 and 1999, due partly to the financial crisis in East Asia and partly because of the effects of the gradual changes in economic policies. From 2000 to 2003, Vietnam's economy regained its high growth rate of 7% per annum, the same as in the 1990 to 1997 period.

Graph 1

VIETNAM: GDP GROWTH RATE AND INFLATION RATE, 1975-2002



Source: GSO and authors' own calculations.

After 1986 the inflation rate dropped dramatically from approximately 774% to only about 70% in 1990. The inflation rate has remained at a one-digit level since 1993, and in 2003 it was only 3.0%. During this period, fiscal deficits were contained at acceptable levels. Reported "bad" bank loans fell to manageable levels, less than 10% of the total credit outstanding. The level of foreign debt is now acceptable in terms of the ratio of debt to GDP (less than 40%) and the debt service ratio (about 6-7%).

Parallel to strong economic development, international trade has also improved considerably. With a total trade/GDP ratio of over 100% in 2002, Vietnam has become one of the most open economies in the world (table 1). In addition, the country has integrated increasingly into the world economy; it has signed trade agreements with 60 countries and has trade relations with 170 countries. In 1992, Vietnam and the EU concluded a bilateral trade agreement. In 1995, the country became a member of ASEAN and made a commitment to implement the Common Economic Preferential Tariff (AFTA). Besides this, Vietnam became a member of APEC in November 1998. After the normalization

Table 1
EXPORTS AND IMPORTS OF GOODS, 1991-2003
(U$S billons and % of GDP)

Year	Exports		Imports		TOTAL (% of GDP)
	U$S billions	% of GDP	U$S billions	% of GDP	
1991	2,087	24.0	2,338	26.9	50.9
1995	5,449	26.2	8,155	39.2	65.4
1996	7,256	29.4	11,144	45.2	74.6
1997	9,185	32.6	11,592	41.1	73.7
1998	9,360	31.6	11,500	38.9	70.5
1999	11,540	39.8	11,622	40.1	79.9
2000	14,308	45.6	15,200	48.4	94.0
2001	15,027	46.2	16,000	49.0	95.2
2002	16,706	47.5	19,730	56.7	104.6
2003	19,500	49.0	24,000	60.4	109.4

Source: GSO and authors' own estimations.

of diplomatic relations with the United States in 1995, a bilateral trade agreement was signed in 2000. The legislatures of both countries passed this in December 2001. Vietnam is currently making every possible effort to join the world's biggest trade institution, the WTO, and hopefully, will be an official member of this organization in 2005.

Vietnam has made great progress in trade diversification. Exported and imported goods have become more diversified, and this includes manufacturing products and even high tech products such as computer chips. Prior to *Doi Moi*, markets for Vietnamese exports were mainly countries in the CMEA, but now Vietnamese products go to a hundred countries. In this period, the US market has emerged as the biggest export destination for Vietnamese products.

The private sector, including peasant households and private companies, is still playing an important role in economic development. Especially since 2000, after the enactment of the Enterprise Law, the formal private sector has regained its position as the most dynamic engine of economic growth and the most important source of job creation. Industrial production has grown nearly 20% per year under this form of ownership, although we should bear in mind that it started from a small initial base.

The period after 1990 also saw a remarkable achievement in poverty reduction. Poverty rates measured by international standards declined from 70% in the middle of the 1980s to 58% in 1992-93, and then 37% in 1997-98 and 28.9% in 2002. Although inequality is increasing, it is still quite low by international standards.

Vietnam has also achieved notable results in human development. There has been a significant improvement in the Human Development Index (HDI)[6]: it grew from 0.623 in 1994 to 0.688 in 2001, and the country rose from 121st place in the world ranking in 1994 to 109th in 2001. Vietnam now ranks 5th among the ASEAN countries (after

6 According to the UNDP (various issues), the HDI is based on three basic indicators: longevity, as measured by life expectancy at birth; educational attainment, as measured by a combination of adult literacy and the combined gross primary, secondary and tertiary enrollment ratio; and standard of living, as measured by real GDP per capita adjusted according to purchasing power parity (PPP$). The higher the HDI of a country, the better its human development is rated.

Singapore, Malaysia, Thailand, and the Philippines). Compared to many other countries at the same stage of development, Vietnam now ranks among the highest when it comes to providing social services for the general public. Over 90% of the population are now literate, and by the year 2000 Vietnam achieved universal primary education. The net enrollment rate in primary education was 94% in 1999-2000, up from 70% in 1994-95. Enrollment at the junior secondary level doubled to 68% in 1999-2000, and net enrollment rates at the upper secondary level jumped to 32% in 1999-2000 from a mere 13% in 1994-95. Enrolment ratios in secondary schools continue to grow. Health indicators have improved, with life expectancy now over 68 years, and infant mortality falling from 41 to 27 per 1000 births between 1995 and 2000. All of this, added to the progress in reducing malnutrition, points to widespread gains among broad groups of the population, even if the benefits are not always distributed evenly.

3. STRUCTURAL CHANGES AND PROBLEMS

Since 1991, the economy has been undergoing a steady if not remarkable structural change, and this is coupled with steady economic development. Prior to the early 1990s, the main source of growth was the agricultural sector, but in that decade the industrial sector, including manufacturing and services, gradually replaced the agricultural sector to become the leading source of growth. Agriculture contributed only 22.3% of GDP in 2003, a decline of 18.23 percentage points from 1991 (table 2). In the same period, the contributions of the industrial and service sectors increased to 39.9% and 37.8% of GDP respectively, from 23.8% and 35.7%. The share of manufactured exports in total commodity exports also increased from about 8% in 1991 to about 40% in 2003. This pattern of industrialization is similar to that of Indonesia, Malaysia and Thailand between 1970 and 1990. However, the share of the service sector has declined noticeably since 1995, and many high value added services sub-sectors are still not developed.

Table 2
VIETNAM: STRUCTURE OF GDP BY ECONOMIC SECTOR
(% at current prices)

Year	TOTAL	Agriculture	Industry			Services
			Total	Manufacture	Other	
1991	100.0	40.5	32.8	13.1	19.7	35.7
1995	100.0	27.2	28.8	15.0	13.8	40.0
1996	100.0	27.8	29.7	15.2	14.5	42.5
1997	100.0	25.8	32.1	16.5	15.6	42.1
1998	100.0	25.8	32.5	17.2	15.3	41.7
1999	100.0	25.4	34.5	17.7	16.8	40.1
2000	100.0	24.3	36.6	18.7	17.9	39.1
2001	100.0	23.3	37.7	19.6	18.1	39.0
2002	100.0	23.0	38.5	20.4	18.1	38.5
2003	100.0	22.3	39.9	20.7	19.2	37.8

Source: GSO and authors' own estimations.

After the reform measures were implemented, the savings ratio increased considerably from just 10.1% of GDP in 1991 to 29.3% in 2003 (table 3). Gross capital formation doubled to 34.6% of GDP in the same period. Consequently, the gap between domestic savings and investment narrowed, especially between the second half of the 1990s and 2003. This means that the problem that Vietnam now faces has changed from how to obtain enough capital resources for growth to how to use the available capital in the most efficient way. This problem becomes clearer when the pattern of changes in the incremental capital output ratio (ICOR) is examined.

Vietnam's ICOR ratio rose very quickly in the 1990s. It started at a low 2.8 in 1992 and reached 6.2 in 1999, which was the highest and fastest rise in Asia (Chi and Duc, 2003). Although ICOR went down slightly to 4.5 in 2000, and was around 4.9 in 2001 through 2003, it is still considered high, especially when it is borne in mind that Vietnam is still a less developed country. This indicates that economic growth in the 1990s received a big contribution from capital-intensive investment.

Table 3
VIETNAM: SAVINGS AND INVESTMENT
(share of GDP, %)

Year	Gross Capital Formation	Gross Domestic Saves	Save - Investment Gap	ICOR
1991	15.0	10.1	-4.9	2.8
1995	27.1	18.2	-8.9	2.8
1996	28.1	17.2	-10.9	3.0
1997	28.3	20.1	-8.2	3.5
1998	29.0	21.5	-7.6	5.3
1999	27.6	24.6	-3.1	6.2
2000	29.5	27.0	-2.5	4.5
2001	30.1	29.0	-1.1	4.9
2002	32.1	29.0	-3.1	4.8
2003	34.5	29.3	-4.6	4.9

Source: GSO and authors' own estimations.

The increase in investment in the 1990s was due to an increase in state investment and FDI (table 4). The non-state sector, both domestic and foreign, dominated total investment during the period 1991-1997, accounting for 64.98% of the total. Prior to the financial crisis of 1997, the contribution of FDI to total investment increased steadily from 15% in 1991 to 31% in 1997. But the FDI share in total investment declined afterwards, accounting for 18% of total annual investment. In the meantime, the share of the domestic private sector in total investment declined from 50% in 1991 to a mere 19.5% in 2000, due to difficulties in doing business and biases in the state sector against private enterprise. However, the implementation of the new Enterprise Law in 2000 has facilitated the development of the private sector, leading to an increase in this sector's share in total investment, which rose to 26.9% in 2003. The state sector contributed a limited share in total investment in the early 1990s, but it has gradually taken over as the leading source of investment. Since 1998, the state sector had dominated total investment, and in 2000 its contribution peaked at 61.9% of the total. This was partly due to the government's policy of strengthening the role of this sector in the economy, and partly to the effort to offset the decline in FDI. However, the government's

contribution gradually declined to 54.9% in 2003 as the private sector came to feel that the business environment was opening up.

Table 4
VIETNAM: INVESTMENT STRUCTURE BY OWNERSHIP
(% of total)

Year	TOTAL INVESTENT	State	Non-State	Foreign Investment
1991	100.0	35.0	50.0	15.0
1995	100.0	38.3	29.4	32.3
1996	100.0	45.2	26.2	28.6
1997	100.0	48.1	20.6	31.3
1998	100.0	54.0	21.0	25.0
1999	100.0	61.6	20.2	18.2
2000	100.0	61.9	19.5	18.6
2001	100.0	58.2	23.5	18.3
2002	100.0	56.2	25.3	18.5
2003	100.0	54.9	26.9	18.2

Note: The State sector includes the state budget, credit, and outlay owned by the state-owned enterprises (SOEs).

Source: GSO.

Surprisingly, there was a downward trend in the contribution of the domestic private sector -both informal and formal- to the economy, with a fall from 69% in 1991 to 48% in 2002. On the other hand, the public sector, which was usually considered inefficient, increased its total contribution to the economy from 31% in 1991 to 38% in 2002 (table 5). The question here is how long this trend will continue in the context of market reform, given the fact that the SOE sector and public investment are inefficient. In the same period, firms with foreign investment steadily increased their contributions to GDP, from virtually nil to 13.2%. This means that FDI is playing an increasingly important role in the Vietnamese economy.

Table 5
VIETNAM: STRUCTURE OF GDP BY OWNERSHIP
(% at current price)

Year	TOTAL	STATE		Non-State	Foreign Investment
		Total	SOEs		
1991	100.0	31.2	22.2	68.8	0.0
1995	100.0	40.2	30.3	53.5	6.3
1996	100.0	39.9	30.5	52.7	7.4
1997	100.0	40.5	31.4	50.4	9.1
1998	100.0	40.0	30.9	48.0	10.0
1999	100.0	38.7	30.4	49.0	12.1
2000	100.0	39.0	30.5	47.8	13.2
2001	100.0	39.2	27.3	47.0	13.8
2002	100.0	38.3	27.2	47.8	13.9

Source: GSO and authors' own estimations.

The structure of employment by ownership has not changed much since the reforms were carried out (table 6). The non-state sector still plays the dominant role in providing employment for the labor force, accounting for about 88% of total employment. Although the sector receiving foreign investment has invested heavily and contributed an increasing share to GDP, it employs only a limited number of workers. This is due to the fact that investment has gone increasingly to capital-intensive industries. The state sector absorbs the lion's share of total investment, but it is still unable to provide the jobs that would give it a greater share in employment than it had in 1991. There has only been a slight change, from 10.1% of the labor force employed in this sector in 1991 to 10.4% in 2003.

The significant structural change, however, did not translate into a corresponding change in the structure of employment (table 7) because it did not do much to exploit Vietnam's comparative advantages. The situation has not improved much since the enactment of the new Enterprise Law in 2000. With this law, the private sector has poured a lot of investment into labor-intensive industries. However,

Table 6
VIETNAM: EMPLOYMENT STRUCTURE BY OWNERSHIP
(% of total)

Year	TOTAL (000' people)	STATE		Non-State	Foreign Investment
		Total	SOEs		
1991	30,572	10.1	6.5	89.9	0.0
1995	33,667	8.7	5.1	90.9	0.4
1996	33,978	8.8	5.1	90.6	0.6
1997	34,352	8.8	5.2	90.5	0.7
1998	34,800	8.7	5.2	90.5	0.7
1999	35,680	9.0	4.8	90.2	0.8
2000	36,205	10.1	5.0	89.1	0.8
2001	39,489	9.1	5.0	89.0	0.9
2002	40,694	10.2	5.0	88.7	1.1
2003	41,179	10.4	-	88.3	1.3

Source: MOLISA and authors' own estimations.

two problems or paradoxes have appeared. First, more jobs are being created without a significant improvement in employment quality. The skill level of Vietnamese workers is still low in comparison to that of workers in other countries. Currently, only 11.8% of the total labor force are graduates from high secondary vocational training schools or higher levels of education. Second, the "modern" sector, that includes areas such as manufacturing and higher-level services, dominated by SOEs and FDI, has not been able to absorb labor from traditional sectors such as agriculture.

The reforms have resulted in remarkable progress towards reducing poverty in Vietnam (table 8). However, the benefits are unevenly distributed over the country, a situation that might lead to socio-economic instability.

Table 7
VIETNAM: EMPLOYMENT STRUCTURE BY ECONOMIC SECTOR
(% of total)

Year	TOTAL	Agriculture	Industry	Services
1991	100.0	72.7	13.6	13.7
1995	100.0	69.7	13.3	17.0
1996	100.0	69.2	10.9	19.9
1997	100.0	65.8	12.4	21.8
1998	100.0	63.5	11.9	24.6
1999	100.0	63.6	12.5	23.9
2000	100.0	63.0	13.2	23.8
2001	100.0	62.6	13.1	24.3
2002	100.0	60.7	15.1	24.2
2003	100.0	59.0	16.4	24.6

Source: MOLISA and authors' own estimations.

Table 8
VIETNAM: POVERTY REDUCTION
(%)

Region	1992/93	1997/98	2001/02
Entire country	**58.1**	**37.4**	**28.9**
Red River Delta	62.7	29.3	22.4
Northern Uplands	81.5	64.2	43.9
North Central Coasts	74.5	48.1	43.9
South Central Coasts	42.7	34.5	25.2
Central Highlands	70.0	52.4	51.8
South East	37.0	12.2	10.6
Mekong River Delta	47.1	36.9	23.4

Sources: Data provided by GSO based on VLSS1, VLSS2 and VLSS3.

4. CHALLENGES AHEAD

The Strategy for Socio-Economic Development 2001-2010, which was passed at the Ninth Congress of the Communist Party (April, 2001), sets out Vietnam's objectives for socio-economic development (CPV, 2001). The overall goal is to accelerate industrialization and modernization in order to bring the country out of under-development and lay the foundations for Vietnam to become "*a modern-oriented industrialized country*" by 2020. In this section we will give a brief outline of the current characteristics of Vietnam's economy, and the challenges that the country will have to meet in order to reach the overall goal of development.

4.1 Present Characteristics of Vietnam's Economy

Vietnam is an economy in transition. The country is undergoing a process of liberalization and stabilization. Its socio-economic institutions are also going through fundamental changes and tending to become more market-based:

- Unlike other transitional economies, Vietnam started its economic reforms from a low-income base. Thus, it can be said that Vietnam is in the process of industrialization, i.e. Vietnam has made every effort to increase the share of the manufacturing sector in terms of GDP, and to disseminate knowledge and (more) advanced technology to all economic activities.
- Vietnam is also in the very first stage of integrating into the world economy. It is committed to undertaking international agreements and to policy consistency. In addition, Vietnam is implementing policies to minimize its vulnerability to external shocks.
- Although Vietnam is geographically located among the Asian "tigers", it still lags behind them in many respects. There are still wide gaps in income, openness, IT, infrastructure, and knowledge between Vietnam and many other economies in East Asia.

- Some of the evolution and development that has taken place is not consistent with an effective and efficient market-based economy.
- The country has recently revealed weaknesses and/or vulnerability in several areas, such as the SOE sector, the banking system, education and training, and government. Besides this, problems of poverty and income distribution have exacerbated threats to socio-economic stability and economic development.
- It can be seen from the above analysis that gains from price liberalization, the removal of entry constraints and the unilateral 'open-door' policy seem to be coming to an end. The reform process has now become more complicated and difficult.
- This is because it is now necessary:
  - to have market-based institutions to deal with the factors of production (labor, land), the SOE sector and the financial system;
  - to be consistent with the process of international integration and international commitments; and
  - to make fundamental changes in the way in which policies are made and resources are allocated, that is, to transform state-led institutions into business-friendly and efficiency-enhancing institutions.

4.2 Key Components in the Forthcoming Round of Reforms

The question of whether Vietnam can attain its development objectives in the 2001-2010 period is very much dependent on how far the country can consistently implement a comprehensive reform program at an accelerating pace.

The reform program includes the following key components:

- Institutional reforms (which comprise the reform of the legal framework), the reform of the public administration, and the

strengthening of people's participation (including the voice of the poor).

- Improvement in macroeconomic policies in conjunction with trade liberalization and the gradual opening up of the capital account.
- Structural reforms, which consist of reforms in the SOE sector, the reform of the banking system, and trade reform. Private sector development and the efficient attraction of FDI are also essential structural reforms.
- Agricultural development and poverty reduction in rural areas: it is necessary to focus on strengthening farmers' rights with respect to the use of land, expanding choices for farmers to diversify their production activities, reducing the risks associated with uncertainties in agricultural product markets, and ensuring food security and basic services at the household level.
- Reform of the Education and science and technology systems. It is important to overcome negative aspects rooted in the attitude towards education, its philosophy and the social institutional arrangements. The role of the government is crucial in expanding access to information and in strengthening research and technology (adaptation) capacities, and it is also essential to create an effective link between research institutions and business practice

Chapter VII

VIETNAM'S EXPORT INTEGRATION AND THE COMPETITIVE STRENGTH OF KEY EXPORT PRODUCTS

Ho Quang Minh[1]

1. OVERVIEW OF VIETNAM'S EXPORT PERFORMANCE

After the *Doi Moi* reforms launched in 1986, earnings from total Vietnamese exports tripled, reaching U$S 2.4 billion in 1990. This figure has increased more than sevenfold since then, it exceeded U$S 16.7 billion in 2002, and stood at U$S 20 billion in 2003. This means that in the 1990s exports grew at an annual rate of around 17%, which is considered a significant achievement for the Vietnamese economy, especially when compared to the international average in the same period. In the 1996-2000 period, total import–export revenue amounted to U$S 113.4 billion, with an annual average growth rate of 21.5%. This has been very helpful in bringing into play the nation's internal strength, in earning capital for investment in new technologies, in creating more jobs, and in speeding up the process of industrialization and modernization. Export earnings in this period tripled in comparison to 1991-1995 (total revenue in 2000 was six times the 1990 figure), and this has boosted Vietnam's external economic growth. The share of exports in gross domestic product (GDP) increased from 5% in the 1980s to 21% in the 1990s, 39% in 2002, and 54% in 2003, the highest in the region.

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Vietnam's key export sectors –those with an annual average sales value of between U$S 2.2 and U$S 3.8 billion- include crude oil, sea products, garments and textiles, and footwear. Sectors that register above U$S 500 million include rice, coffee, and assembled electronic products. Besides this, some Vietnamese products have been very successful in foreign markets, and the country has risen to first in the world in peppercorn exports, and second in rice, cashew nuts and coffee, after Thailand, India and Brazil, respectively. Vietnam's traditional market for exports is Asia (which accounts for 50.6% of total exports - U$S 8.45 billion in 2002). The share going to the Association of South East Asian Nations (ASEAN) is 14% (U$S 2.42 billion). Other important markets are Japan and the European Union (EU), with 14.6% (U$S 2.43 billion) and 18.9% (U$S 3.1 billion) of total Vietnamese exports, respectively. The country has recently succeeded in entering to the lucrative North American market, and in 2002, 15.7% of her exports (U$S 2.62 billions) went there. Currently, efforts are being made to gain access and develop exports in the Middle Eastern and African markets.

The structure of Vietnamese exports has also improved in that the revenue generated by non-traditional exports such as light industry products (textiles, footwear), agricultural products (coffee, rice, tea, rubber) and sea products, has now become significant. In the year 2000, thirteen groups of merchandise accounted for 76% of export revenue (more than U$S 50 million per year). On the other hand, the share of raw and primarily processed products in total exports has fallen, although it is still fairly high.

In 2003, the international situation had a negative impact on the performance of Vietnamese exports. First, the effects of the war in Iraq on the worldwide economy reduced forecasted global GDP by 0.5%, which had a direct effect on the overall demand for Vietnamese exports and also a direct effect on Iraqi-Vietnamese trade. Second, the Severe Acute Respiratory Syndrome (SARS) epidemic spread all over the world and its effects on Vietnam are considered to have been worse than those of the war in Iraq. Domestically, natural disasters including a prolonged drought over a wide geographical area affected the production of many export products, especially agricultural ones.

Despite all of the above, Vietnamese export revenue in 2003 reached U$S 20.17 billion, an increase of 20.8% over the pervious year. Sea product exports were faced with numerous problems in the US market but they still grew at an excellent rate, an increase of 8.8% over the previous year. Unfortunately, the US authorities recently made an unfair ruling on lawsuits dealing with Vietnamese dumping, and this has frozen the sales of fillet and catfish products, which has reduced the rate of growth of these exports from 5.5% to 1.8%.

All in all, in 2003 the volume of exports amounted to more than 50% of GDP, and this reflects the high degree of openness of the economy.

2. EXPORTS AND INTERNATIONAL ECONOMIC INTEGRATION

Vietnam is pledged to reduce and rationalize still further its tariffs on imports in line with its commitment to Asian Free Trade Association (AFTA), to the Vietnam-United State (US) Bilateral Trade Agreement, and (once the admission process is completed) to the World Trade Organization (WTO). In the framework of AFTA, Vietnam has complied with the steps for implementing its road map. Average tariffs for most ASEAN imports will fall to 8% in 2003 and 4% in 2006, which will boost the circulation of goods in Vietnam's current markets[2]. WTO and world economic specialists have forecasted that in 2004 the value of world trade will increase by 6%, and the world's economic growth rate will reach 4.1%, which exceeds the 3.2% figure for 2003. This is seen as the result of the increased level of demand for imports in the US, the EU, Japan, China and Australia.

In general, international economic integration has had a major effect on Vietnamese exports. It has brought competition to the local market, which is likely to force prices down and reduce the level of profits in sectors that were previously protected. As a result, the relative profitability of exports has risen, and other important payoffs

2 There are, however, a few items that will be excluded as they are on the sensitive and exclusion list.

for the overall efficiency of the national economy are evident. First, domestic producers and consumers will have access to intermediate inputs and consumer goods in international markets. Those who produce export goods will be able to buy their inputs at lower prices and with better quality than in the domestic market, thereby enhancing their competitiveness. Second, greater import competition will spur domestic producers to find better ways of producing their goods and services, thus generating improved productivity in domestic enterprises, and this in turn will favor exports.

Not only will import liberalization improve the relative profitability of Vietnamese exports, but it will also give Vietnam greater access to other member countries. Vietnam's current exports to ASEAN countries are concentrated in sectors such as agriculture, forestry, processed agricultural goods, coal, oil and gas. Exports to these countries are expected to increase by around 14%, with the largest gains expected from agricultural and processed agricultural products. Since the Vietnam-US Bilateral Trade Agreement came into effect in 2000, trade between the two countries has dramatically increased. Vietnam's exports to the US reached U$S 2.62 billion in 2002, accounting for 15.7% of total national export revenue. The key exporting sectors are garments and textile products, footwear, crude oil and sea products. It should be noted that exports of computer and electronic assembly goods, and bicycles and bicycle spare parts, have grown rapidly, although the volumes involved are still small. Up to November 2003, earnings from exports to the United States amounted to U$S 3.65 billion, more than one fifth of total export income, and that market moved up into the top ten for Vietnamese exports. In the 2002-2003 period it was the market with the highest rate of growth (183%).

3. MAIN EXPORT COMMODITIES, THEIR COMPETITIVENESS, AND MEASURES FOR EXPORT PROMOTION

3.1 Crude Oil

In 2004, earnings from crude oil exports account for 20% (U$S 3.82 billion) of the country's export revenue. Forecasts for 2005 indicate that crude oil export volumes will reach approximately 12 million tons. By 2010, it is expected that production will satisfy nearly 80% of domestic demand for oil products and gas (with a value of more than U$S 3 billion), thus considerably reducing the amount of gasoline that is imported. If this comes about, the annual output of crude oil will be 30 to 32 million tons. Annual gas exploitation and consumption will be somewhere between 12 and 19 billion cubic meters *per* year. In the past five years Vietnam's petroleum and gas industry has exported 75.5 million tons of crude oil. Revenues from oil and gas are an important item in the state budget (about 20-25%), but this has not been stable in the long term.

In the world market, crude oil is not considered a competitive product because its price is not based on production costs but depends mostly on international quoted prices. Moreover, oils produced in different fields generate different costs, so there is no standard cost. Therefore the main factor that dictates the price of crude oil is the international price quoted at a certain time. Prospects for this product are hard to predict while it remains dependent on international pricing. Furthermore, in the near future, the Dung Quat Refinery will go out of production, so crude oil that has previously been exported will have to be used instead as an input for the production of gasoline for domestic consumption. The volume of exports from the mining industry will also fall. All of this suggests that an analysis of the long term efficiency of oil production and the energy sector in general should be undertaken.

3.2 Sea Products

3.2.1 Description

Prospects for the development of sea products in Vietnam are good as there is massive potential for production and growth. Export values increased from U$S 90 million in 1985 to U$S 818 million in 1999, and to U$S 2.2 billion in 2003. The annual average growth rate for the 1988-2000 period was 20%, and Vietnam currently ranks 29th among sea product exporters in the world. The items exported are mainly preliminarily processed (dried and frozen) products. Sea products are exported to 45 countries, and the main markets are Asia (58%), the US (34.2%) and Japan (28%). There are 40 Vietnamese enterprises on the European Union's List No. 1 and 60 enterprises are authorized to export to the US.

3.2.2 Competitiveness and disadvantages

Vietnamese sea products are tropical and diversified and therefore much appreciated by world importers. Vietnam's natural conditions are favorable for producing high value sea products. At the moment, the intensive cultivation level is not high so potential output is still huge. Vietnam is a latecomer and can learn from other countries that are experienced in production and market organization, technological improvement and environmental protection. Processing and quality control technologies are gradually improving and being upgraded.

Earnings from sea product exports in the 2001-2005 period have been estimated at U$S 10-11 billion, with an annual growth rate of 15%. By 2005, an output of 3.7 million tons is expected, with a profit that could reach U$S 3 billion.

Overall assessment: this is a very promising industry with good potential, and it is progressively gaining sustainable competitive advantages.

3.2.3. Measures for export promotion

A number of measures have been proposed to promote exports.

These include the following:

- To upgrade processing factories in order to ensure food safety standards as required by importers.
- To invest in building an effective offshore fishing fleet, and to provide capital for specific ship owners.
- To focus on the main fishing ports serving offshore fishing fleets (berthing, loading and unloading, maintenance, information, transport, trading and transactions, etc.)[3].
- To improve maintenance techniques by applying new technology for live and fresh sea products, to purchase quick-freezing equipment, using NH_3 instead of CFCs as a freezing agent, and to focus on the exploitation, maintenance and processing of tuna, cuttlefish and bottom fish.
- To use "clean" technologies for sea product processing establishments, including for waste treatment.
- To increase investment in fish breeding by studying and pro-actively supplying breeds of various kinds, and also to protect fish and prawns from disease. There are master plans to exploit growing areas while protecting the environment.
- To focus on high-value and big-demand sea products.
- As for growing aqua products, priority should be given to high-valued mature fish such as perch, awa, groper, snapper, etc., and freshwater fish like tilapia, mudfish, and catfish. Prawn growing should concentrate on the sugpo prawn.
- To expand investment in encouraging fish-culture, to provide equity founding for one half of enterprises processing sea products, and to provide information on markets and technologies suitable for application.
- To increase aqua product imports to be re-processed and exported.

Table 1 shows planned investment in the aquiculture industry for the years to come.

3 Vietnam has already built seven fishing ports financed by Asian Development Bank (ADB) loans.

Table 1

VIETNAM: PLANNED INVESTMENT IN AQUICULTURE INDUSTRY 2000-2010

(billions of VND)

Period	2000 - 2005	2006 - 2010
Total investment	**1,526**	**1,586**
Sea culture	1,156	1,247
Sea product exploitation	279	206
Sea product processing	91	133

Source: Author's own estimations.

3.3 Garments and Textiles

3.3.1 Description

In the 1990-2000 period, this sector enjoyed a satisfactory growth rate, 10.7% per year, and export volumes increased by 59%. Export revenue increased from only U$S 43 million in 1988 to U$S 1.6 billion in 1999, and in 2003 the figure rose to U$S 2.2 billion, accounting for 9% of the country's total exports. This has directly created jobs for nearly 500,000 workers and has also generated indirect jobs in other industries such as cotton wool, mulberry culture and silkworm breeding. The value of exports in 2001-2005 has been estimated at around U$S 15 billion, with an annual increase of 16%, and it is expected that by 2005 export sales will be worth U$S 4 billion. The main markets are the EU (20.1%), Japan (18%) and, more recently, North America (37.3%).

3.3.2 Competitiveness and disadvantages

This industry enjoys low domestic labor costs, but most of its workers are skilled, disciplined and well trained. Besides this, the natural and social environment is favorable for natural silk production. Vietnam's knitwear exports are of world-class quality. The garment industry has won stable markets and loyal clients, it has invested and

been modernized with new equipment (above 50%), and is able to manufacture some hi-tech products.

On the other hand, there are some negative points. In the textile industry, the quality of silk and textile factory output is for below international standards. Domestic sources can supply only 30% of the textile materials needed for producing garments for export, and cotton wool for textile materials is still imported and thus heavily dependent on the world price. Furthermore, the production phases (fabric making, weaving and completion) have not been synchronized, and approximately 70% of the equipment is more than 20 years old. Up to now, there has been fairly low productivity in the garment industry, and unit costs are high. Design capability and industrial stitching technology are underdeveloped, and the cutting work, which has not yet met quality standards, is still done manually. Under the "buy materials, sell finished products" system, the proportion of exports in total sales is still low. Although Vietnam's export values are fairly high, its imports of textile fabrics and materials are also high. Consequently, the country's net export earnings are very low. About 80% of the garment industry's exports are handled through third parties.

Overall assessment: competitiveness in the textile industry is still low, but in the garment industry it is much higher.

3.3.3. Measures for export promotion

Measures aimed at promoting exports include the following:

- To make in-depth investments in the industry in order to upgrade equipment and technologies to raise the capacity, quality and productivity of existing enterprises by using their own capital (by extending credit and by supplying equity founding, etc.).
- To invest heavily in the garment and textile sector, especially to enlarge synchronized equipment, and to make new investments (about VND 2,500 billion). By 2005, the overall capacity will be 480 million product units, which will be sufficient to satisfy foreign demand.

- To quickly change the export structure into a FOB price model (buying raw materials and selling finished products) is the most important measure, replacing 50% of low value export products. Besides this, the equitization of garment and textile enterprises should be aggressively stepped up.
- Investment is needed in market surveys and market studies, and also in fashion and design, in order to satisfy market demand and tastes, and there should be a gradual reduction in outwork production for export.
- The focus should be put on big new investment areas (i.e. fabric, weaving, printing and dyeing factories), on producing garment inputs and auxiliary products, on synchronizing all the production phases, on enhancing product quality, on increasing the rate of domestic manufacture, and on strengthening the competitiveness of export products using the firms' own capital or through foreign investment.
- The Government will encourage non-state economic sectors or foreign sources to invest in this industry, especially in the textile sector. What is more, the state ownership of firms in the garment and textile enterprises should be diversified as soon as possible, particularly in the garment industry.
- The Government should assist trade promotion in potential markets such as North America, East Asia and Eastern Europe, and reentering markets which they formerly had exported.
- The Government should provide support for breeding research and development, insect pest prevention and elimination, the design of plans for programming in specific areas, stimulating agricultural system building, etc., with the general aim of developing a raw materials zone (cotton-wool, silkworm) for the textile industry.
- Part of official development aid (ODA) loans should go to the textile industry with long-term preferential interest credits. This should favor fiber and synthetic fabric production since the fabric-weaving-dyeing process requires enormous investment and high technology.

3.4. Rice

3.4.1 Description

The leading rice exporters in the world are Thailand, the US and Vietnam. The leading rice importers are Indonesia, the Philippines, Brazil, the EU and Iran. According to a Food and Agriculture Organization (FAO) forecast, demand for world-traded rice will be higher than supply for the next 20 years. Vietnam ranks as the world's second rice exporter (after Thailand) and the country's export volume has increased rapidly year after year. In 1996 rice exports amounted U$S 868 million, and by the end of 1999 the figure was more than U$S 1 billion (4.5 million tons). The main markets are Asia (60%-70%), Africa, the Middle East and the Americas. However, the war in Iraq and the sharp fall in the international price of rice have adversely affected the value of Vietnamese rice exports: in 2002 the 3.24 million tons of rice exported generated U$S 726 million, but the 3.81 million tons exported in 2003 were valued at only U$S 721 millions.

Table 2 shows the competitiveness of exported rice for Vietnam and Thailand.

Table 2
VIETNAM AND THAILAND: COMPETITIVENESS OF EXPORTED RICE

Comparative norms	Vietnam	Thailand
Productivity (Vietnam's tends to be 30% higher than Thailand's)	39.6 quintal/ha	22-23 quintal/ha
Production costs / ton	U$S 220/ton	U$S 250/ton
Average output per capita	382kg/capita	365kg/capita
Selling price in the world market	U$S 265/ton	U$S 325/ton (30% higher)

Source: Author's own elaboration.

3.4.2 Measures for export promotion

The necessary measures to promote exports are the following:

- To put in practice the existing master plan for rice production areas in general and rice export production areas in particular. There are plans to develop export rice production in the Red River delta in 2004 (with a volume of 200-300 thousand tons/ year). According to the Ministry of Agriculture and Rural Development, the investment capital needed to start this program would be U$S 800 million, rising to U$S 1.2 billion afterwards. There will be investment in storage systems, infrastructure, processing and husking technologies, and export wharfs with good links to planned rice production areas.
- There should be increased research, more cross-fertilization, and more new and high-quality varieties of rice in order to ensure sufficient supply for farmers. Plant breeding capacity is fairly low at the moment. There are 61 breeding and crop plant companies, but the country can only meet 10% of the demand for rice breeds. The farmers themselves who supply the other 90%.
- The import and distribution systems for fertilizer, insecticides and other materials for rice production need to be reorganized in order to minimize production costs. This is in line with the policy to open up various economic sectors to trade.
- There should be synchronized investment in irrigation, processing and storage systems in the planned areas. This can be encouraged by using the non-state budget or under BOT form in order to develop the irrigation system in particular and rural infrastructure in general.
- There is pressing need to stabilize sustained partnerships in existing markets and to increase market share in the African, Middle Eastern (above 40%) and other markets. Other possible measures involve cooperation in joint ventures with Thailand, in both product processing and in rice export-market regulation. These measures should be geared to guaranteeing stable export markets and to ensuring credibility in contract performance, not only in

terms of price and product quality, but also as regards delivery dates. More marketing activity, market studies and forecasts for export promotion should also be encouraged.

3.5. Coffee

3.5.1 Description

Vietnam exports 90-95% of its coffee yield and most of this is unprocessed. Before 1980, annual export volumes never exceeded 10,000 tons, but this changed dramatically at the end of the 1990s. While in 1997, Vietnam exported some 392,000 tons of coffee and earned U$S 490 million, these figures rose to 734,000 tons and U$S 501 million in 1999, and to 749,000 tons and U$S 505 million in 2003. Vietnamese coffee is exported to 52 countries, and the main markets are Germany (16.7%), the US (15.8%), Italy (10.4%) and France (7.9%). In the 5-year period 2001-2005, the volume of exports is expected to reach 4.1 million tons (800,000 tons per year by 2005). Indeed, demand in the new US market is very high (in 2000 alone, the US imported around 150,000 tons of coffee from Vietnam).

Vietnamese coffee has a number of competitive advantages thanks to a very favorable natural environment which gives the product a natural and tasty flavor. Most of the coffee exported is Robusta, and there is also some Arabica but its total export value is not high.

3.5.2 Competitiveness and disadvantages

Table 3 shows the competitiveness of exported coffee for some world exporters.

The following measures are aimed at promoting exports:

- To improve the plans for promoting coffee production in the central part of Vietnam. Robustas should be planted in the southern provinces and Arabica in the north.

Table 3
PRINCIPAL WORLD EXPORTERS: COMPETITIVENESS OF EXPORTED COFFEE

Country	Average total production 1997-2002 (Unit: million of bags)	Average production cost/ton (U$S)	Average unit value of export/pound (FOB:1997-2002) (U$S)
Vietnam	7.05	650-700 (Kernel)	0.40
World	123.1	N/A	0.73
Asia	24.9	N/A	0.55
India	4.8	1,412 (Arabica)	0.74
Colombia	11.1	2,188 (Arabica)	0.99
Indonesia	6.8	922 (Robustas)	0.58
Brazil	34.0	909 (Robustas)	0.77

Note: 1 pound (lb) = 0.454 kg.
Source: ICO- Coffee Statistics.

- To invest in irrigation for coffee-producing areas, to instruct farmers on production techniques such as the use of fertilizers (mainly organic fertilizers), watering, harvesting, processing and preserving, so as to improve the quality of coffee for export and protect the soil and the environment.
- To increase the size of the Robustas plant and improve Arabica's aromatic flavor.
- To concentrate investment on kernel coffee processing plants, including technology acquisition and classification equipment, seed selection, and packaging for export.
- To build processing plants for high quality finished products so as to replace imported products.
- To promote exports by attracting foreign investment, joint-venture or private investment, by offering more incentives and by giving medium-term credits to all kinds of coffee producers in order to improve pre-processing technology.

- To intensify marketing so as to improve image and thus expand sales in regional and international markets.
- To assist coffee producers with price and market information.
- To build and organize quality control systems in line with international standards.

3.6 Footwear

3.6.1 Description

The footwear industry has grown quickly. In 1999, revenue from exports was U$S 1.3 billion, and by the end of 2003 the estimated figure was U$S 2.26 billion. In 2001-2005 exports are expected to reach U$S 12 billion, with an annual growth rate of 19%, and profits for 2005 are estimated at USD 3.5 billion. Most footwear exports go to Europe: in 1997 only 19% went there but in 1999-2000 it was 68%. Exports to Asian countries are gradually falling while those to other more demanding markets are rising. Vietnam currently ranks third among Asian footwear exporters (after China and Indonesia). America is a large market with diversified demand in terms of categories, styles and prices, and Vietnam has succeeded in gaining access to this lucrative area. The footwear industry has created direct jobs for nearly 300,000 workers, and other jobs have been created in connected sectors such as services and materials production.

3.6.2 Competitiveness and disadvantages

Vietnam's competitive advantages include low labor costs, skilled workers, internationally recognized quality and stable markets. Canvas shoes and sports shoes are the main export products. Many foreign investors in Newly Industrialized Economies (NIEs) have been attracted to invest in Vietnam, and this has strengthened the industry and helped it to replace the outdated footwear models previously exported to the EU, North America and East Asia.

The two biggest disadvantages are the lack of an integrated industry structure and the low quality of domestic tanned leather. These negative factors make the industry heavily dependent on imported materials (60% of materials are imported). Most firms have not yet been able to build up direct business relationships with customers, inadequate expertise, and weaknesses in design and modeling capabilities, are further obstacles to the industry's development.

Overall assessment: in spite of the problems faced by the industry, it is still reasonably competitive.

The following measures are aimed at promoting exports:

- To increase in-depth investment and to expand production (especially of canvas and sports shoes) by using the industry's own capital to improve product quality and to increase production capacity. The capital required for expansion is VND 662 billion, and that for new investment is VND 2,800 billion.
- To build new plants for materials and auxiliary products (soles, leatherette, etc.) financed by the industry itself and by other related industries (rubber, plastics, textiles, etc.) in order to increase the domestically produced components that qualify for preferences under the Generalized System of Preferences (GSP).
- To reorganize and restructure leather-tanning factories, which at the moment are small and scattered. At the same time, investment in new technology is needed so as to increase the production capacity of leather tanning firms and thus reduce the industry's dependence on foreign suppliers of materials. There should also be a rapid switch to the "definitive purchase, definitive selling" trading arrangements. The Government should provide assistance in areas such as developing cattle raising and supplying breed cattle, and in taxation and preferential loans.
- To continue to attract foreign investment and technology to leather tanning sectors and high-tech projects to meet the modern requirements of fashion and design. However, the Vietnamese share in these joint-ventures should be increased as appropriate.

- To reinforce the advanced training of qualified designers, technologists and skilled workers.
- The Government should support enterprises by providing market information and by promoting trade in order to establish a good reputation for footwear made in Vietnam. Each enterprise will have to build up its own market development plan and define primary products for effective investment (sports shoes, women's shoes, leather wear) while diversifying its products.

3.7 Electronics and Electronic Assembly

3.7.1 Description

Electronics is a relatively new industry in Vietnam but its average annual rate of output growth is a quite remarkable 20%. The industry has obtained considerable earnings from exports (U$S 783 million in 2000 and U$S 672 million in 2003), and its target to raise this figure to U$S 1 billion by 2005 (of which earnings from software exports are expected to be between U$S 350 and U$S 500 million). In 1997 there were about 70 state-owned enterprises, 50 private enterprises and 27 enterprises with foreign investment operating in electronics production.

3.7.1 Competitiveness and disadvantages

The industry is not vertically integrated. Consumer electronics play a dominant role and account for approximately 40% of total production. Tele-communications production equipment accounts for one third of sectoral output, while the shares of computer manufacturing and industrial electronics are 15% and 13%, respectively. The production of consumer electrical products, such as television sets, radios and cassettes has developed massively and now exceeds domestic demand. However, most other electronic products are imported. In recent years there were almost no Vietnamese electronic products to be exported, and foreign-backed enterprises exported only a limited volume of consumer electronics items. Most enterprises are operating at 30-40% of their real capacity.

The technological level of the electronics industry is low. Local technology is 15-20 years behind that used in other countries in the region. Electronics operations concentrate on assembly (mainly KDK assembly, only 10% is IKD), and assembly production makes up only a very small portion of the whole industry.

Local labor costs are only 15–20% of those in other countries in the region. However, productivity and product added values are still low (about 4-10% of product value) due to the lack of modern technology. Some hi-tech products are just emerging on a small scale, but they account for a very small proportion in the industry's output.

The workforce in domestic enterprises is dispersed and scattered, so it is not yet qualified to help develop the industry. Research and development is still nominal. The links between research departments and producers are not well coordinated, and as a result performance is low.

Overall assessment: the competitiveness of the electronic industry is weak to middling.

The following measures will help to develop exports:

- To offer suitable incentives for investment. In the current situation of relatively new industries (industrial electronics, IT system) investment would prompt key industries to take further steps for development.
- To establish privileged conditions suitable for high-tech projects that could benefit from the advantages of being latecomers in promising consumer markets, with the objective of exporting in the future.
- The government should allow the industry to use part of its contribution to the state budget. It should also provide equity funding to a number of enterprises, dissolve or liquidate certain small-sized and low performance ones to recover capital for further investment in others, and establish new enterprises operating in the important sectors of industrial electronics, IT system, and components and spare parts production.

- To encourage enterprises to produce components and spare parts in order to increase the rate of domestic manufacturing in areas such as civil electronics, information and communication equipment, radio broadcasting and broadcasting. The aim would be to gain competitive advantages in local markets and to promote exports. The industrial and civil electronics sectors need investment in assembly, after sales and repair services. Besides this, Vietnamese enterprises should cooperate with the large world corporations to produce and assemble industrial electronics equipment.
- In the IT system, there should be investment in technology transfer and systematic orientated software design, since this is an area in which there is local demand and good potential for software exports. The join-venture form is preferable for assembling and for producing components for hardware manufacturing. Investment incentives should be used to attract foreign investment in the components, spare parts and electronic materials production sectors. Encouragement should be given to companies possessing high technology from industrially developed countries.
- Tariff barriers should gradually replace the protection of local production by quota, and tariffs should be lowered in line with the roadmap to meet the commitments for 2006 proposed by Common Effective Preferential Tariff (CEPT) for members of ASEAN. An increase in the domestic production rate should be encouraged through the taxation system.
- To direct the electronics industry to cooperate with multinational corporations working in the networks specialized by regions, so as to strengthen production relations with other trading partners

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