



Institute of Social Studies

Graduate School of Development Studies

**EXPLAINING RECENT TRENDS OF VIETNAM'S
CURRENT ACCOUNT**

A Research Paper presented by:

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(VIETNAM)

In Partial Fulfillment of the Requirements for Obtaining the Degree of:

Master of Arts in Development Studies
Specialization:

ECONOMICS OF DEVELOPMENT

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The Hague, December 2006

This document represents part of the author's study programme while at the Institute of Social Studies;

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ACKNOWLEDGEMENT

My special gratitude to **Howard Nicholas**. Thanks for your inspiration and patience in guiding me from the very beginning steps till the maturity of the paper. I have been in your debt since the first time I had the pleasure of hearing you lecture. Thank you for being more than my academic supervisor, Howard!

I would like to sincerely thank **Lorenzo Pellegrini**, my second reader. Thank you for your valuable comments and support!

I greatly appreciate the warm help from **Hans, Cathelijne** and other library staff members. Thank you all!

To all of my friends who made this year unforgettable to me;
Koen, thank you for your discussions and inputs! And more, being such a caring friend!
Isik, Aikaterini, Carla, Melina, Chiara, Xuan, thank you for being my “home”!
Khanh, Ha, Nga, Tuan, thank you for always encouraging me and being with me wherever I am.

Greg, you are the person who endured the most when this paper came into the final phase. I thank you for being so special to me.

Finally, this paper is dedicated to my mom **Hoa**, my dad **Tuyen** and my brother **Kien** who always believe in me and give me unending support on my journey.

TABLE OF CONTENTS

ACKNOWLEDGEMENT	0
TABLE OF CONTENTS	1
Chapter 1: Overview of the research	3
1.1. Focus and justifications	3
1.2. Approaches and limitations	3
1.3. Main arguments	5
1.4. Paper organization	5
Chapter 2: Main debates on current account in modern economy	6
2.1. Monetary approach to the current account balance	6
2.2. Criticism on the Monetary approach	8
2.3. Structuralist approach to current account balance.....	11
Chapter 3: Vietnam's economy and current account reflection	15
3.1. Economic profile	15
3.2. Current account profile	18
3.3. Vietnam's exchange rate regime	21
3.4. WTO's accession.....	22
Chapter 4: Explaining the recent trends in the current account.....	25
4.1. Defining current account and its sub-accounts	25
4.2. Main hypothesis	26
4.3. Increase in money supply	26
4.4. Structure of trade	28
4.4.1. <i>Low and volatile in prices of agricultural and primary exports</i>	<i>29</i>
4.4.2. <i>Inelastic price and demand with respect to imports</i>	<i>33</i>
4.4.3. <i>Low share of manufactures in exports.....</i>	<i>35</i>
4.5. High costs of production	37
4.6. Income account deficit.....	40
4.6.1. <i>High ratio of income payments</i>	<i>40</i>
4.6.2. <i>Inefficiency in capital utilization</i>	<i>42</i>
4.7. Impact of uncompetitive exchange rate.....	45

Chapter 5: Conclusions and policy implications	49
5.1. General implications for improving current account	49
5.2. Policy implications with respect to accession in the WTO.....	50
5.2.1. <i>For agricultural and primary products</i>	51
5.2.2. <i>For manufacturing and industry</i>	51
REFERENCES	54
APPENDICES	58
1. FDI inflows 1988-2005: Viet Nam – China	58
2. Vietnam’s FDI and GDP growth rate	59
3. Trends of exchange rates and inflation rates	59
4. Average percentage changes in manufacture exports and trade balance	60
5. Changes in prices of Vietnam’s leading exports	60
6. Producer Price Index percentage changes.....	62

Chapter 1: Overview of the research

1.1. Focus and justifications

Vietnam shifted to a more liberalized economic growth path in the mid-1980s in the context of the adoption of Doi Moi or Reconstruction growth strategy. This liberalization continued and then gained momentum in the mid-1990s with the ending of the US trade embargo on Vietnam, and promises to continue further with Vietnam's prospective accession to the WTO. One recent disturbing side-effect of Vietnam's economic progress appears to be a weak current account (CA) situation. The current account is possibly the most important component of the balance of payments (BoP), particularly for an export oriented economy like Vietnam, as the current account effectively records all non-capital related money flows into and out of a country. Since the most important of these flows tend to be trade flows, current account is often seen as reflecting a country's competitiveness.

The focus of the present paper is the current account, and explaining why Vietnam has been experiencing weakness in its current account balance of late and how this weakness might be impacted upon by the accession to the WTO. The ensuing policy implications of the study will then look at what measures might be taken to strengthen the current account balance particularly in light of the WTO accession.

The justification for this focus comes from the fact that it is widely recognized that no country can afford to run a current account balance indefinitely. Countries have been known to run current account deficits in the context of rapid growth and massive capital inflows, but such imbalances are supposed to be self-correcting after some time. In the case of Vietnam, the current account weakness appears to have persisted for quite a considerable period of time, hence the focus of the paper.

1.2. Approaches and limitations

The paper is conducted by the combination of literature research and descriptive comparative analysis based on secondary data on the balance of payments of Vietnam and related macro economic indicators. From the debates between a monetary approach (Neoclassical) and a Structuralist approach (Keynesian) on current account's movements, the study applies certain criteria of these two mainstream views to the case of Vietnam's current

account in order to explain its weaknesses. From the findings, the application of these two theories to the evaluation of Vietnam's current account will be compared and contrasted with the goal of enlightening policy decisions for improvement of the current account

To gain an understanding of current account trends (trade account and income account) as well as its impact on the overall economy, the author conducts analysis based on secondary data provided officially by national and international agencies. Vietnam's General Statistic Office is the only governmental agency that records and provides macroeconomic figures. However, due to the different statistical system before the Reconstruction period and relatively closed policies on that time, data on the current account and other related statistical information before 1990s are quite scarce and irrelevant to the popularly recognized standards. The author shares this difficulty with many others who have been conducting research on Vietnam, such as: D. Dollar, P. Glewwe and N. Agrawal on *Economic Growth, Poverty and Household Welfare in Vietnam* (World Bank, 2004); D. Dapice (2000, 2003, 2004) on a series of studies prepared for The Development Strategy Institute of Vietnam; and Thanh et al. (2001) on *Exchange Rate Arrangements in Vietnam*.

Not until very recently did Vietnam's statistical and accounting systems all follow international standards and become more available and reliable. Still, there is another problem arising: gaps between national records and international records. The figures provided by Vietnam General Statistical Office are mostly higher or more positive than those concluded by the IMF, ADB or the World Bank (Dapice, 2003). Despite the attendant limitations on precision resulting from this disparity, both data sets illustrate similar trends in the current account.

The current account is a singular concept that attempts to encompass the interaction between a numbers of economic activities in Vietnam. Owing to limitations in scope and time, the thrust of this paper will be directed not at minutia outside the realm of this research but to explaining recent trends in Vietnam's CA and drawing comparison between other economies in the regions.

This study managed to skim the surface of the CA's issues and discuss important causes and can function as a pilot study to be used for more in depth research on the topic in the future. The preciseness and consistency in information as well as the significance of policy implications are further enhanced by comparisons with current account's movements of other relevant economies in the region.

1.3. Main arguments

The main argument is that Vietnam has experienced considerable weakness in its current account balance primarily due to weakness in both its trade performance and income accounts. Weakness in the trade account is mostly explained by the composition of the trade flows and in particular exports, while adverse developments in the income accounts are mostly understood by the extent and nature of capital flows into the Vietnamese economy.

1.4. Paper organization

The structure of the remainder of this paper is as follows. Chapter 2 presents the different approaches between Monetary and Structuralist towards current account movements. It lays down the analytical framework for the paper's focus. Chapter 3 introduces some brief background information on Vietnam's economic development in relation with the trends of current account. Chapter 4 analyzes the causes of the trends, investigating the deficit of the account. The final chapter presents some policy implications based on the main findings of Vietnam's recent trends of CA. The findings are be highlighted in the context of WTO's accession in order to foresee its improvements in a long-term and sustainable manner.

1. The first part of the document is a list of names and addresses of the members of the committee.

Chapter 2: Main debates on current account in modern economy.

The BoP theory has a rich history. As a point of departure, David Hume (1752) the monetary approach to the BoP, which sees fluctuations in the BoP as a consequence of changes in the money supply. In response to the complex development of international trade and other economic activities, this theory was revised by Mundell (1968, 1971) and Johnson (1972). The elasticity approach developed by Joan Robinson (1937) explains BoP movements through the responsiveness of imports and exports to a change in exchange rate. Enriched by the absorption approach of Harrold (1947) and Alexander (1952), BoP is argued by the difference between how much a country produces and consumes. However, this paper will confine itself to relatively more contemporary studies of the last decade.

In modern economics, there are two schools of thought which explain changes in the current account and sub-accounts from different point of views. Interestingly enough, these two seemingly contradictory theories both contribute to the development of theoretical economic frameworks for policymakers. These theories are discussed in the section below.

2.1. Monetary approach to the current account balance

*Balance of payment problems are a monetary phenomenon
which can be corrected by monetary adjustment*

Frankel and Johnson, 1976

In explaining the trade balance of a country, Neoclassical economists forward either deterioration in the current account balance, or a fall in the exchange rate (which in turn affects the current account). Both are induced by an increase in the money supply. If there is a rise in the money supply, there will be a rise in (import) expenditure, as well as a rise in the aggregate price level, which makes exports more expensive. The economy, as a consequence, becomes less competitive. The resulting imbalance in trade will cause a market determined exchange rate to depreciate (Johnson, 1976). In this theory, money is defined as the cash in circulation and the current account deposits in banks. The monetary base (cash base) is

controlled by the central bank and will come into the system through budget financing channels.

The most widespread and important monetary identity is the money supply function:

$$\Delta DC + E\Delta R^* = \Delta M \quad (1)$$

where DC is the net domestic credit, E is the exchange rate, R* depicts the net foreign assets in foreign currency, and M is the money supply.

In controlling money growth (ΔM), the International Monetary Fund (IMF) or World Bank (WB) recommends constraining the growth of DC. The changes in foreign assets ($E\Delta R^*$) are unquestionably omitted from the equation, which explicitly implies a one to one relationship between domestic credit and money supply (Easterly, 2002). Thus, changes in money supply are determined by changes in credit. Current account problems are thus caused by changes in DC. The argument for the omissions of $E\Delta R^*$ is the assumption that R (net foreign assets) is exogenous, while M is an endogenous variable, because it is determined by DC policy (Idem, 2002).

There are two components to DC, namely domestic credit for private sectors (ΔDC_p) and domestic credit for public sector (ΔDC_G), which interact as follows:

$$\Delta DC = \Delta DC_p + \Delta DC_G \quad (2)$$

In the Monetary view, domestic credit to the government is assumed not to increase output because it is solely for financing the budget deficit. Because there is no productivity gain, prices will increase and inflation will accelerate. Inflation, in turn, negatively impacts the trade and current account. In contrast, domestic credit to the private sector results in investment, expansion of production and increases in output, which strengthens the trade balance.

Countries that encounter current account deficit problems are advised to control and even reduce government expenditure and “make every effort to limit the access to domestic financial savings by the combined public sector” (Easterly, 2002:12).

In explaining exchange rate regime’s impacts on country’s current account, particularly trade account, the theory suggests that exchange rate regime can influence economic growth through investment or increased productivity, reflected by the growth in external trade (A.Ghosh et al., 1996; Thanh et al., 2000).

Regarding the ER, neoclassical theory states that changes in the ER will directly reflect changes in the BoP flows (net inflow causes appreciation and net outflow causes

depreciation). There are no mentions of effects on output, etc. The change in the exchange rate will simply cause any imbalance in the inflows and outflows of money of an economy. Neoclassical theory assumes that the ER does not have an impact on the production.

Under a flexible exchange regime, the depreciation of local currency comes about through increases in the money stock. The country is cheaper to foreigners who choose to buy their products in that country. This will lead to a balance of payment surplus.

However, this will consequently raise demand for resources, which will put pressure on the domestic currency. This will make the country less attractive to foreigners again, and will cause the BoP to balance again. This is known as the automatic adjustment of the market.

Monetarist argue that fixing the exchange rate might eliminate an important adjustment mechanism; increase protectionist pressure; distort price signals and prevent the economy from efficient allocation of resources across sectors (Ghosh et al., 1996). Ghosh et al. (1996) concluded that under fixed exchange rate, a country suffers from slower productivity growth and has more problems with trade deficits than those with flexible exchange rates. The idea behind this is that if the country faces BoP problems (including current account deficits), floating exchange rates are a solution as they induce an automatic adjustment mechanism determined by market forces.

Another solution given by Monetarists to reduce the trade deficit is devaluating the domestic currency. By devaluating domestic currency, in this case the Vietnam Dong (VND) relative to the foreign currency (the USD), the VND will become cheaper than USD. This means that the exchange rate (VND/USD) will depreciate which make Vietnam's exports to US more competitive. Meanwhile, imports will be relatively more expensive which leads to the reduction in imports. All in all, it will imply a improvement of the trade balance (Robinson, 1947; Marshall, 1923).

2.2. Criticism on the Monetary approach

However, the theoretical foundations upon which the Monetary approach is based are questionable. Additionally, there is a lack of empirical evidence. Money supply¹ (M) can either be M1 – the monetary base controlled by central bank – or M2, which is M1 plus

¹ The money supply is the total amount of money in circulation in a country. It can be M1 – all coins, notes and personal money or M2 (Dictionary of Banking and Finance, Second Edition, P.H. Collins, 1991, Peter Collins Publishing)

credits². Neoclassical theory links the money stock, as measured by M1, to DC which implies the assumption that all money is spent immediately. However, many empirical studies use M2, because it better fits the reality, which is for a large part credit based nowadays. It is noted that the use of M2 is “theoretically incompatible with the orthodox theory, which links money stock changes (not credit) to changes in the balance of payments” (Nicholas, 2006). This inconsistent use of definitions of money supply causes confusion in analysis and policy making.

Clearly, in the modern economy, the increase in M1 barely impacts buyers’ spending behavior due to the increasing expenditure by credits³. Besides, money supply M1 can not cover all the complexities – monetary related – facets like credits, bonds, deposits, securities, etc.

Considering M2 as a broad money supply which better captures the real international financial market, monetarists advocate a country with current account deficit to control the rise in credit (DC), the country itself can prevent the current account balance from being trapped in deficits. However, the wisdom is based on a number of questionable assumptions outlined as follows.

First, Neoclassicists assume that the productivity of the economy is fixed and fully utilized. However, this assumption does not hold in reality, given the case of China, India where the increase in investment lead to the rises in output and exports (presumably capital is efficiently used). Second, there is confusion in understanding money and credit. Credit itself is normally being circulated in the bank with different business activities. Especially, in developing countries, credits are given for the purposes of “working capital outlays”⁴, or expanding production rather than speculating, which are in turn ensured with rise in outputs. Therefore, under this case, it is not clear if the increases in money supply will lead to inflation and worsen the current account balance.

There have been quite a lot empirical studies on these controversial issues. One of these is Easterly (2002) who finds that the changes in domestic credit are determined by other variables in the identity rather than money supply. The author shows that there is no

² Broad money supply, in addition to currency in circulation plus sight deposits held by domestic non-banks, also include time deposits as well as savings deposits at short-notice held by domestic non-banks (The OECD Economic Outlook: Sources and Methods.)

³The money does not physically circulate in market but is rather transferred among banks per purchase. Also, there are many other definitions for money supply, but this paper will restrict itself to M1 and M2.

⁴ H.Nicholas, 2006, Lectures on Macro Policies and Adjustment, ISS, The Hague, The Netherlands

link between changes in the money stock and changes in the domestic credit. The research also finds no significant relation between domestic money creation and the budget deficit. However, Gilberto (1987) did some empirical studies on domestic credit and the balance of payment with reference to Philippines case. The study concluded domestic credit affects directly the balance of payments.

Also, there is an array of empirical literature⁵ on the theoretical interlinks between the exchange rate and the current account. However, there is no consensus on the interactions, especially in the case of developing countries like Vietnam. Ghosh et al. base their analysis on data from 145 countries over 30 years to test whether “the exchange rate regime can influence economic growth [assumed that this will lead to trade surplus and positive balance in current account] through investment or increased productivity” (Ghosh, 1996). They find that the relation between floating exchange rates and growth does not always hold, and that it differs from sample to sample. “Growth was actually fastest under the intermediate regimes, averaging more than 2 percent a year. It was 1.4 percent a year under pegged exchange rates and 1.7 percent under floating rates” (Ghosh, 1996). The result, once again, confirms that “...no single currency regime is right for all countries or at all times” (Frankel, 1999).

Another study on the exchange rate of Vietnam by Thanh et al. (2000) found that the monetary and exchange rate policies have limited explanatory power for the output and prices of the economy and both freely floating or rigid exchange rate regimes are not suitable options for the country.

Regarding the effects of exchange rate devaluations on the trade account, the exchange rate impact on the current account presumably works through the trade balance. A case study on Columbia conducted by Hernan Rincon (1998) proved that devaluations did have a positive relation to the equilibrium in the trade balance.

In light of discussion, it is necessary to confirm that there is causal relationship between the real exchange rate and the current account deficit. However, the impacts of this relation on the overall economy are more significant in a flexible exchange rate regime than in a fixed or managed regime. With regard to the case of Vietnam, where the exchange rate

⁵ F.Milton (1953) and Frankel and Johnson (1977) for further references.

managed-floating⁶ and with its particular economic structures, exchange rates do explain the moves of current account somehow but do not determine the trends as such.

2.3. Structuralist approach to current account balance:

*In advanced economies, Keynesian economics is
the bread and butter of economic forecasting and policy making.*

Joseph E. Stiglitz

The Structuralist approach is often seen as an alternative to the Monetary approach in the analysis of current account problems. The difference is that the Structuralist approach finds explanations for BoP trends, not from monetary related issues, but from comprehensive economic, political and other structures in a society (Nicholas, 2006). In explaining the CA problems that developing countries often face, the theory tracks the main decompositions of the current account and its sub-accounts.

The trade account deficit is explained by changes in aggregate demand. Keynesians assume that the market is imperfect, labor is not fully employed and productive capacity is underutilized. When the advanced countries' economies go into recession and reduce demand for imports, the developing countries will lose their export revenues and the trade balance will deteriorate, and vice versa.

As for the developing world, Structuralists argue that during a crisis, demand for imports tends to be inelastic and the rate of increase or decrease in imports is much slower than for exports, thereby causing a trade imbalance. Keynesian economists also claim that relative interest rates or exchange rate moves play a role in the current account imbalance. However, the impact is most significant with a flexible exchange rate regime and no capital flow controls. According to Keynesians, setting a competitive exchange rate regime in combination with controls on capital flows will enhance the competitiveness of exports and imports, improving the current account balance⁷.

⁶ From February 1999, the State Bank of Vietnam set the central rate daily at the average of interbank exchange rates on the previous transaction day with narrow band of $\pm 0.1\%$ (Ohno, 2003)

⁷ The arguments are extracted and summarized from different books, articles on balance of payment, namely: Thirlwall & McCombie (1994); Blejer & Skereb (eds), 1999, Stiglitz, 2001 (edited with commentary by Chang); Easterly (2002) and lectures notes of Nicholas (2006)

In the long run, for primary goods producers the problems lie in the terms of trade, particularly. For those producing manufactured goods, the unit costs of production are most important, which in turn determines profitability. If relative input prices rise, the producers become less competitive and will export less. CA movements, consequently, are explained by changes in relative producer prices, rather than changes in the money stock.

Commonly understood as the purchasing power of a country's exports in terms of its imports, the terms of trade are said to deteriorate when the price of exports rises more than the price of imports. This will negatively impact the trade balance. Broda & Tille (2003) argued that most developing countries are subject to negative terms of trade due to the "heavy reliance on commodity exports" (Broda & Tille, 2003). The trade structures of developing countries are characterized by exporting primary and agricultural commodities with the price "dictated by world markets" (idem, 2003), while importing all essential and capital goods.

A study by Baxter & Kouparisas (2000) shows that the terms of trade of developing country fuel exporters and commodity exporters are the most volatile. Mendoza (1995) and Kose (2002) find that changes in terms of trade account for approximately half of the output volatility in developing countries (Broda & Tille, 2003). If a country has a narrow export base or exports raw materials mainly, the fluctuation is much higher and the ability of financing deficits is weakened, resulting in negative impacts on economic growth (Milesi-Ferretti & A.Razin, 1996).

While in agreement with the Monetary approach that devaluations might have some impact on the current account balance (Joan Robinson, 1937), Structuralists seem more cautious with flexible or fixed exchange rate regimes which potentially have different substitution and income effects. Rincon (1998) clarified this argument as follows.

There are two possible effects of devaluation. First, there is a substitution effect if the domestic currency is devaluated. Specifically, domestic goods are relatively cheaper than imported goods. On the one hand, this will "cause a shift in the composition of demand from foreign goods towards domestic goods" (Rincon, 1998:12); while on the other hand increasing the competitiveness of domestic goods in the foreign market, leading to an overall

rise in exports. The net impact is an improvement of the trade balance (assumed that world demand for domestic exports is elastic⁸)

Secondly, there is “an *income effect* which increase[s] absorption, and then reduce[s] the trade balance” (H.Rincon C, 1998:12). The income effect is explained by the Keynesian *foreign trade multiplier*, which argues that countries need to import production inputs in order to improve outputs. This relationship between inputs and outputs will induce terms of trade problems if the decrease in the price of exports is greater than the decrease in the price of imports.

Thirlwall and Gibson (1992) argued that the terms of trade will worsen or improve with devaluations depending on whether elasticity of supply of imports and exports is greater or less than their elasticity of demand for imports and exports. However, a test conducted by Easterly (2002) on the import elasticity (e) with respect to growth shows that there is no strong causal relation between imports and outputs suggesting that there are “some important factors causing structural shift of import demand relative to GDP omitted out of that simple import elasticity”.

In summary, the impact of a devaluation on the trade balance can never explain on its own trends of the trade balance. Instead, the impact depends on the combination of certain economic situations and other economic policies.

It is worth noting here that a few Structuralist studies also emphasize the importance of looking at other components of the current account rather than only the trade account to have a complete understanding on the current account balance, such as the income account. The argument given here is that many developing countries experience massive outflows of income as a result of excessive borrowing without efficient utilization, or inflows as result of grants and migrant remittances, both of which do not necessarily contribute to economic expansion. (Nicholas, 2006).

To the limited understanding of the author, there are not many studies on the situation of recent current account of Vietnam. Most of the studies focus on the

⁸ Elasticity refers to the changes in demand/supply in response to the changes in price. Goods are considered as demand/price elasticity when the increase/decrease in price will lead to the decrease/increase in demand. In reality, essential goods like fuels, energy, foods, raw materials...are considered as demand/price inelasticity as whatever the prices on those goods will be, their demands will changes very little. Export products of developing countries are subjected to this demand/price inelasticity.

sustainability of Vietnam current account deficit in the period before 2000, such as Hong (1999); Thanh et al. (2001), but not discuss in depth the recent trends in the light of Monetary and Structural approaches. This paper, thus, enriches the literatures on Vietnam's current account in the same line with previous studies of the others.

Summary

Theory functions as the framework to explain the real world. Due to the complexities and dynamics of reality, normally theory has to be based on different assumptions in order to make the arguments becoming valid. Monetarists and Structuralists differ primarily in their assumptions of temporally and geographically varied economic situations. Viewing the real economy with the optimism of full employment, full capacity of production and a perfect market situation, Monetarist economists claim that manipulating the current account deficit is simply a matter of increasing the money supply in the domestic market through adjustment of flexible exchange rate regimes, devaluation instruments, or controls on public expenditure. The theory, however, is not backed by strong empirical evidence especially in the case of developing countries. Approaching the problems of a deficit in the current account through the opposite perspective of unemployment and imperfect markets, Structuralists view the deficit in light of trade structure and capital inflows. By disaggregating the types of goods and types of capital inflows, Keynesians point out that the core problems lie in the terms of trade, volatility of export prices and the costs of production together with the inefficiency in foreign capital utilization. The theory finds relatively strong empirical backing especially when applied to countries in the developing world. It is important to reiterate that this paper does not aim to judge the validity of these theories, but rather attempts to utilize them at face value to assist in answering questions related to deficits of Vietnam's trade and income accounts.

1. The first part of the document discusses the importance of maintaining accurate records of all transactions and activities. It emphasizes that proper record-keeping is essential for ensuring transparency and accountability in financial reporting.

2. The second part of the document outlines the various methods and techniques used to collect and analyze data. It highlights the need for a systematic approach to data collection and the importance of using reliable sources of information.

3. The final part of the document provides a summary of the key findings and conclusions. It reiterates the importance of maintaining accurate records and the need for a systematic approach to data collection and analysis.

Chapter 3: Vietnam's economy and current account reflection

Vietnam's economic structures will be introduced as the context in which the current account movements have been taken place. In this chapter, section one will describe the present situation of the economy with emphasis on the performance of industry and agriculture. Some main landmarks which provide justification for the time period chosen in this paper will also be identified. General information on the exchange rate regime arrangements of Vietnam over the last twenty years is covered in section two. The third and final section discusses the potential effects on Vietnam's current account pertaining to WTO accession.

A detailed and in-depth analysis on the decomposition of each account as well as rationale for their movements is addressed in chapter four.

3.1. Economic profile

The year of 1986 is often referred as the important landmark for Vietnam's economy, partly because this was the year when Vietnam's government officially announced its economic reform policies, but mostly because of significantly socio-economic changes gained from that end.

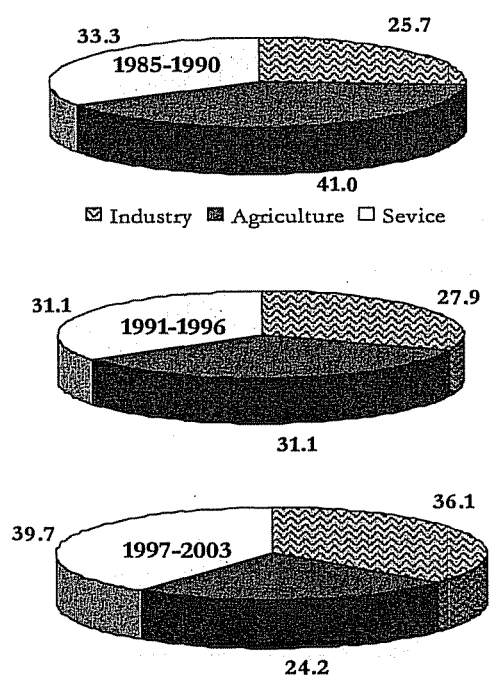
Table 1 - Vietnam's economic performance 1985-1995; 1996-2005 (average)

<i>Economic indicators</i>	<i>1985-1995</i>	<i>1996-2005</i>
Economic growth (%)		
GDP per capita (PPP, US\$ acurrent price)	999	2196
Inflation rate	142.4	4.2
Exports (fob, million US\$, calendar year)	1983	16260
Imports (cif, million US\$, calendar year)	2906	19222
BoP balance (Mn, US\$, calendar year)		
FDI (Mn, US\$, disbursements)		
Foreign exchange reserves (Mn, US\$)		

Source: Direction of Trade Statistics Yearbook, 1985-2005; WDI 2006; IFS, 2006

Before 1986, the economic system was characterized by “centralized, bureaucratic and subsidized” (Dinh, 2003) with inflation accelerated, almost no industrial production and

Graph 1: Economic sectors as % GDP, value added (period average)



Source: *World Development Indicators, 2006*

basic food imported. Realizing the urgency of the internal situation as well as the changes in international condition⁹, by 1986, Vietnam carried out some major macroeconomic reforms focused on supplying food and improving exports. Along the timelines, each step was taken to develop further and to integrate it more into the world economy. After 20 years, Vietnam is known as the one of the largest rice exporters, attracting huge FDI inflows, and being considered as one of the highest economic growth in the region. The remarkable progresses over two decades are being summarized on Table 1.

Evidently the economy has gained remarkable achievement: GDP per capital based on purchasing power parity tripled in the last 10 years, inflation reduced to the unit level, FDI in 2005 increased 19 times

compared to 1989. Those achievements are mostly explainable by the changes in economic structures that Vietnam has been through during the last 20 years.

First, the reunification period (1975-1980), with the devastated aftermaths of the war, Vietnam adopted the state controlled domestic prices and markets for goods; abolished the private trade and manufacturing; collectivized agricultures (Masina 2006: 54) which resulted in “a systemic crisis”¹⁰ (Masina 2006:54). During this period, the economy was structured by

⁹ By the second half of 1980s, Soviet Unions and East European socialist countries were on their economic and political crisis

¹⁰ With an effort to reunify North and South of Vietnam, a bunch of radical reforms were implemented without awareness of the diverse economic structures remained between the two parts: North – heavy industry and agriculture oriented, South – services oriented, especially commerce and administration.

unproductive heavy industry and surviving agriculture which could not provide sufficient food for domestic consumption. After different changes aimed at confronting with the crisis witnessed their failures, in 1986 a comprehensive renovation was launched emphasizing a socialist market economy, remarked by removing the state monopoly of foreign trade and allowing private commercial activities (Idem, 2006: 59). The reformation then was pushed further in 1990 (after the collapse of Soviet Unions) and economic structure was more in shape. Agriculture played the leading role and important exports, industry share in total increased but still relied a lot on minerals and heavy industry, services accounted for a large amount in total GDP but the percentage of services for business was very low. In 1988, agriculture accounted for 46.3% in total output, while manufacturing took 17.9% and only 2.11% business services (transport, storage and communication) (Dapice, 2003). About 70% labors working in agricultural sectors and nearly 50% of exports are agricultural products (Masina, 2006:68). Recently, the structure has been changing quite positively in the sense that industry is slowly taking pivotal position, share of services also improves while agriculture proportion in GDP has been declining. Remarkably, after 17 years (1988-2005), agriculture share has halved to 20.9%, industry rolled up to 41% (with 20.7% manufacturing) and service made a share of 38.1% in total (WDI, 2006). And as a matter of fact, value added in industry and service grows as fast as the overall output with 9-10% and 5-7% respectively, leaves agriculture far behind at 3-4

In order to understand better how actually Vietnam's current account performance over years, it is better to put Vietnam in comparisons with other countries that shares similar backgrounds, especially countries with higher economic growth in order to figure out what is missing or failures in Vietnam's situation. Sharing a similar backgrounds on business cultures of Asia, almost the same international conditions and particularly the interdependent relations on each others in Asia region, Philippines; Indonesia; Malaysia; Thailand, China can be used as mirrors for Vietnam. The aim is not at analyzing in details each country's economic activities but more interested in how these countries "responded to problems similar to those that Vietnam is facing" (Masina, 2006:15) and how their trends of current account react in reflection to Vietnam's. In which, China is given more credit in compared to others as the country "shares with Vietnam a peculiar transition towards a

Together with the international isolation by that time, the social-economic crises happened. The planning system showed the weakness in economic management and resources allocation which led to the urge of reform (Masina, 2006)

‘market-oriented economy with socialist characteristics’ ...and that the Vietnamese transition is more closely related to the experience of China ...” (idem, 2006: 15). Those changes in economic structures have been reflecting clearly on the balance of payment, especially current account and forming their trends over the past decades.

Table 2: Comparative economic indicators, 2002

	Vietnam	Indonesia	Philippines	Thailand	China	India
GDP (US\$ bn)	35	173	78	126	1,287	502(a)
GDP per head (US\$)	435	807(a)	939(a)	1,991	1,002	479(a)
Consumer price inflation (%)	3.8	11.9	3.1	1.7	-0.8	3.2
Current-account (US\$ bn)	-0.6(a)	7.5	4.2	0.6	35.4	4.5(a)
Exports of goods (US\$ bn)	16.5(a)	58.8	34.4	66.9	325.7	50.7(a)
Imports of goods (US\$ bn)	17.6(a)	35.6	40.0	57.1	281.5	57.1(a)
Foreign trade (% of GDP)(b)	97.4(a)	54.6	95.4	98.4	47.2	21.5(a)
Foreign debt (% of GDP) (a)	37.9	76.3	68.7	46.1	14.3	19.3

(a) Estimates. (b) Merchandise exports plus imports., Source: Economic Intelligence Units, 2006

In a comparative view, Vietnam seems have the poorest economic performance from the table. Yet, further analysis will give clarify the difference.

3.2. Current account profile

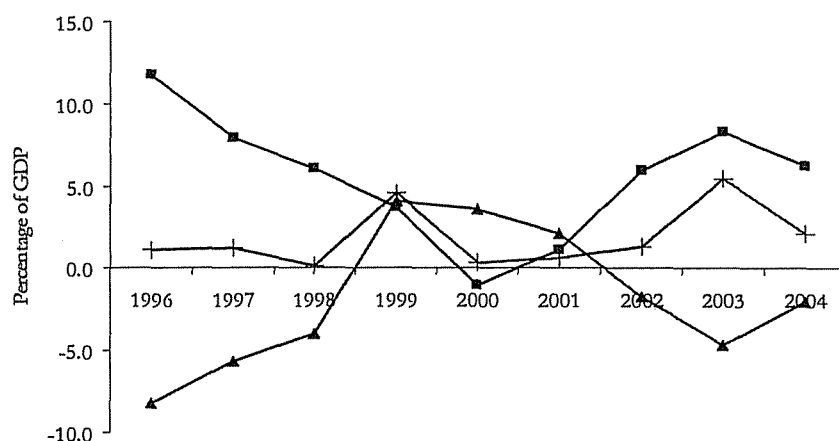
In order to understand why current account is so important in monitoring and evaluating Vietnam’s economy, one first needs to acknowledge the role of balance of payments in mirroring the economy’s performance and the contribution of current account in overall balance of payments.

Balance of payments is simply a record of all financial influx/efflux between a country with the rests of the world, thereby it is a good indicator to measure all the economic activities operating between Vietnam and its foreign partners. Before 1986, determined by the situation of highly dependence on debt and poor economy, Vietnam’s

balance of payment was seriously deficit with the huge debts¹¹ and imports of consumption goods. Exports earned 352 US\$ million while imports took about 1352 US\$ million in 1981 (Dinh, 2003). The economy was slowly recovered and so did balance of payment.

Looking at Graph 2, the moves of balance of payment in the first half of 1990s were close to the changes in current account. Current account made a big improvement from minus 9.3% to minus 4.0% which raised balance of payments from minus 3.5% to minus 2.2%. However, the relationship diverged after year of 1996 onwards, implying the involvement of the financial account.

Graph 2: Trends of BoP and its sub-accounts 1996-2004



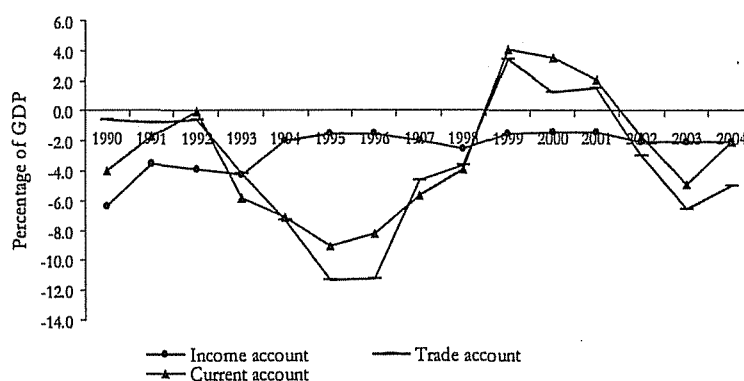
Source: ADB Key Economic Indicators, 2006

The current account moves in opposite direction to the financial account, resulting in a moderate balance of payment. Enjoying the positive impacts of more comprehensive reforming economic structures and policies in beginning of 1990s, the other half of 1990s witnessed some of the first moments of balance of payment recovering and slowly gaining its surplus position. The removal of US's embargo on Vietnam's economy in 1995 paved the way for the country's integration and incoming foreign capitals. Those inflows played a very important role in financing current account deficit and balancing the overall payments as shown in the graph.

¹¹ "1966 to 1975, foreign grants and loans averaged 63.2% of the non-military budget" (P.Masani 2006: 55)

Vietnam's current account gained its first time surplus during 20 years since Doi Moi in 1999 to 2002 (renovation). The trends, like almost other developing countries, is influenced the most by trade account, and partly guided by income account. Transfers which are mostly remittances of Vietnamese oversea do help to finance somewhat the current deficit but not significantly affects. The openness has resulted in the high growth of exports and imports as well as FDI and other kinds of loans like official development aid (ODA) or loans through private channels. Both exports and imports' shares of outputs have grown rapidly: Exports from 2.9% GDP in 1988 boosted to 61.4% in 2005, while imports rose from 5.6% in 1988 to 63% last year.

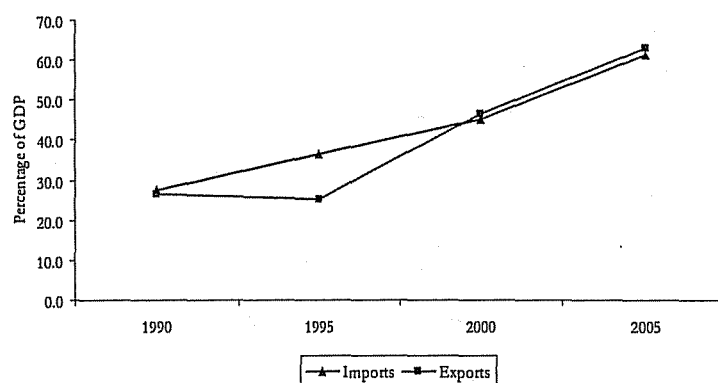
Graph 3: Trends of current account and its trade and income accounts



Source: ADB Key Economic Indicators, Vietnam, 2006

The long term trends of current account moves quite closely with the movement of trade account indicates that foreign trade balance does play the most important role in Vietnam current balance. Income account has a relative lower level of impacts on current trends at the first sign, yet it definitely gives hints to understand some awkward movements of current account as well as its coming prospects. Current account improved nicely after the second stage of reform in 1989 including trade liberalization and devaluation of exchange rate.

Graph 4: Trends of exports and imports as percentage of GDP



Source: ADB Key Economic Indicators, Vietnam, 2006

It is thanks to the sharp improvement in exports from 2.9% of GDP in 1988 to 39% in 2002 and 61.4% in 2005. However, the share of exports in GDP still quite small in compared with other fast-growing economies of East Asia (60% for most countries, while Malaysia reached 125% of GDP) (Martin, 2003). The trends then faced the sharp decline in 1992 and experienced deficit for 7 years after that.

The reason for an abrupt plunge in current account is: import growth rate on average was much higher than export growth rate. Concerning the severity of the deficits and the declining in FDI, the government had some interventions in constraining imports, such as applying strict quantitative restrictions and temporary import prohibition on certain consumption (Kokko, 1998). The gradual depreciation of Vietnamese Dong also helped to push up exports and reduced imports. All these efforts resulted in the recovery of current account and its surplus the second time in 1999. The trends again were weakened two years after, basically due to the imbalance between imports and exports which will be further discussed in Chapter 4.

3.3. Vietnam's exchange rate regime

Along the history of economic development, Vietnam's exchange rate regime has been experiencing three main changes: before 1989; from 1989 to 1999 and from 1999 to present.

The period before 1989 was identified by the “multiple exchange rate” system (Thanh et al, 2000) which set three different exchange rate for different business activities: for foreign trading, for non-trading exchange rate and internal exchange rate¹². The exchange rate then did not reflect at all the real situation of the economy by that time (refer to *Economic profile session*). The first effort was made to “stabilize currency” by devaluating and unifying to one exchange rate in 1989 which helped to stable the price and reduced inflation for a certain time (from 34.7% inflation in 1989 to 5.2% in 1993¹³). The devaluation of VND and unification yielded a positive impact on exports and current account in period of 1990-1992. However, the exchange rate started appreciating slowly after 1993 which raised some concerns about the competitiveness of the country, especially with the Asian crises which led to sharp devaluation of crisis countries’ currencies, whose are the main competitors of Vietnam in world market.

In response to the changes in regional situation and export-oriented policies of the country, the overvalued Dong was being devaluated steps by steps since 1999 by managed-floating exchange rate mechanism. By that, the central bank set the daily rate based on the average of inter-bank exchange rate on the pervious transaction day with a band of $\pm 0.1\%$, which helps the Dong depreciate slowly (Ohno, 2003).

In general, Vietnam’s state bank put control on financial flows and the exchange rate is relatively fixed, thereby it is quite complicated to base on the exchange rate to explain the situation of deficits in current account and it is beyond the scope of this study. The author will use the moves in Vietnam’s exchange rate regime as a compliment indicator to reaffirm the arguments rather than involve in deep analysis.

3.4. WTO’s accession

Being one of few outsiders of World Trade Organization, Vietnam is “exposed to arbitrary treatment and discrimination by trading partners” (Masino, 2006: 112). The country’s exports particularly will be discriminated by different kinds of tariffs or non-tariff measures. All other foreign economic activities will face similar problems as the country

¹² The gaps in ER among these three different business relations were big. In 1988, for trade transactions the exchange rates ranged from VND250/USD to VND900/USD; for all other transactions it was from VND368/USD to VND3500/USD. In 1989, the two rates were unified to VND4500/USD (Thanh et al, 2000)

¹³ Vietnam’s General Statistic Office, website: www.gso.gov.vn

itself is not playing in the same field with the same rules as WTO's members. Hence, the question is no longer joining WTO or not but more concerned with joining "under which conditions".

"...To access the WTO a candidate country must not only accept all the existing agreements, but must also be subjected to lengthy negotiations during which current members can demand extra concessions, with clauses that are more binding and painful than those valid for the countries already members of the organization. If the candidate country does not accept conceding to these "WTO Plus" requirements, then powerful countries may put a veto on the accession indefinitely." (Idem, 2006: 112)

Above quote is one of ample critics on WTO, obviously the more delays of accessions, the more disadvantages the country has to take. Vietnam started its applications for WTO membership in 1995; the Working Party was established in a short time after that. After all the efforts made over the last 11 years on bilateral and multilateral negotiations; reforming laws, rules and regulations complied with WTO agreements, Vietnam has become official member of WTO on 7th November 2006. This is a success with many threats. Being WTO's member means Vietnam has to reduce 30% on current import tariffs, in which 63% on garments and textiles-one of the major exports; 38% on fish and fish products-currently emerging as one of leading export items and quite competitive of Vietnam¹⁴. In 2015, Vietnam has to reduce its import tariffs to 0-5% to AFTA, China, and Korea. It is also committed to eliminating export subsidies on agricultural products by the date of its accession and to reduce its agricultural export subsidies to zero in its Schedule of Concessions and Commitments on Goods. Domestic industrial market is more opened to foreign products and so does service sector. Those are just small examples of changes listed in 560-page-drafts of commitments on goods and other lengthy regulations and commitments on services and other things that Vietnam need to implement when it fully become WTO's member. All these will make a big changes in current account, either better or worse.

¹⁴ Figures are derived from different articles on Vietnam's accession to WTO on WTO's official websites, www.wto.org

Summary

Chapter three illustrated that Vietnam is an economy in transition with a high percentage of agriculture and only moderate share of industry and services. Most of the agricultural products exported are of the “cash-crop” variety while exports of industrial products are primarily based on natural resource extraction. Recently, a trend toward increased investment in the manufacturing sector produced positive signs for future economic growth, although most of the manufactured products require only unskilled labor and have little value added. The structure of the economy described in chapter three shapes Vietnam’s imports and exports as well as the form of foreign investment and the usage of loans. The country imports many essential goods and the intermediate products of capital goods while exporting mostly primary products, raw materials, and labor-intensive manufactured goods; these factors combined primarily serve to explain the trade deficit. Furthermore, the managed-floating exchange rate regime does not reflect the real competitiveness of the economy. Although the balance of payment was performing much better after reconstruction, many issues remain owing largely to the weaknesses of the current account, particularly since Vietnam's acceptance into the WTO.

Chapter 4: Explaining the recent trends in the current account

Utilizing the Monetarist and Structuralist theories explained previously without comparing them further, this chapter explores in detail the recent current account movements. The following analysis is divided into three sets of arguments explaining why the current account is plagued by deficit and periodic volatility. The first set of arguments examines the trade account in a disaggregated fashion by observing the aspects of Vietnam's trade structure that produce volatility and depression in the price of exports: insignificant share of manufactured goods and inelastic demand of imported goods. The second set of arguments discusses the production cost in Vietnam and its negative impact on the current account. The third one traces the income account trends through evaluating capital inflow and its utilization. Additionally, a study of the influence of exchange rate regime on the current account further enhances the analysis. Utilizing the aforementioned analysis, future trends in Vietnam's current account will be projected in the following chapter.

4.1. Defining current account and its sub-accounts

In the beginning of 1990s, Vietnam officially based its accounting system on the System of National Accounts (SNA), an internationally standardized accounting framework introduced by the IMF and the World Bank. According to these financial institutions, the current account has three facets as follows:

- Trade account: covers all types of goods and services that residents export to or import from nonresidents: from general merchandise and goods for processing to transportation, travel, and communication services.
- Income account: includes income receipts and income payments covering employee compensation and investment income
- Current transfers: consists of general government transfers and worker remittances.

For an export oriented economy like Vietnam, trade and income accounts are the most significant contributors to movements in the current account balance. On the other hand, the proportionally small current transfer aspect plays a relatively insignificant role.

4.2. Main hypothesis

With only three years of surplus (1999-2001), current account has been deficit for almost 20 years, raising serious concerns about productivity and competitiveness of Vietnam's economy. There are four main hypothesis outlined below that explain this deficit.

First, in spite of the contention of a number of international economic institutions, the current account problems of Vietnam are not a consequence of changes in the money supply. Instead, the trade account deficit induced by the export and import structures is primarily responsible owing to both inelasticity in price and demand of foreign trade combined with high production costs. Third, the income account deficit continues to raise over time as the payment for debts and debts services increases, adversely impacting current account. Finally, the real exchange rate value has some bearing on the current account balance as suggested by studies of other countries, although this finding is of questionable significance in the case of Vietnam.

4.3. Increase in money supply

Applying the Monetary approach to explain Vietnam's current account deficits, the author extracts a widely used monetarist identity:

$$MV=PQ \quad (2)$$

where M is money supply; V is velocity, a behavioral parameter; P is the price level; and Q is real output (real GDP).

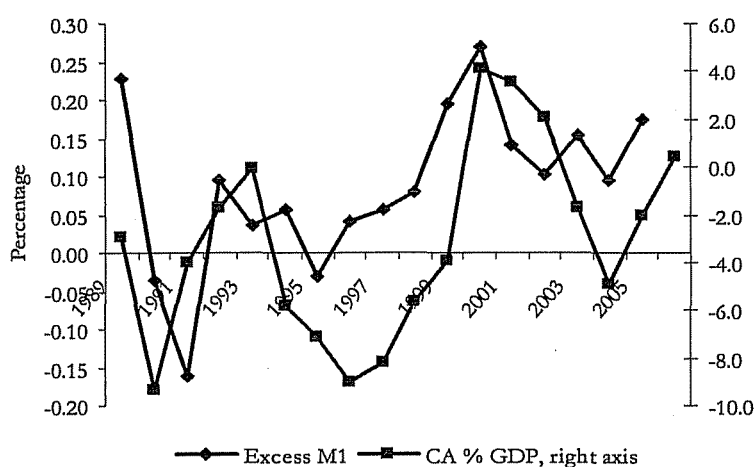
Adapting to the formula used by Easterly (2002), the author takes a logarithm of the equation (2) to see how the changes in one variable affect the others. The function then becomes:

$$\Delta \ln P = \Delta \ln V + \Delta \ln M - \Delta \ln Q \quad (3)$$

From this equation, inflation rate (change in price) is determined by the excess of money supply changes over GDP changes. If V is assumed to be constant, $\Delta \ln M - \Delta \ln Q$ represents the excess money supply equation. If M grows, inflationary pressures will result, making Vietnam's products more expensive relative to foreign products while diminishing the competitiveness of domestic products compared to foreign alternatives. This leads to trade deterioration and worsening of the current account as described by most Monetarists. In order to capture all possibilities of this relationship, the author will examine both changes in narrow money (M1) and broad money (M2) relative to changes in the real GDP of

Vietnam. The author computed excess M1 and excess M2 by taking $\ln M1$ and $\ln M2$ minus the $\ln GDP$ (absolute value, current price) and plotting it with current account (percentage of GDP) to see if the movements of these two variables support Neoclassical claim.

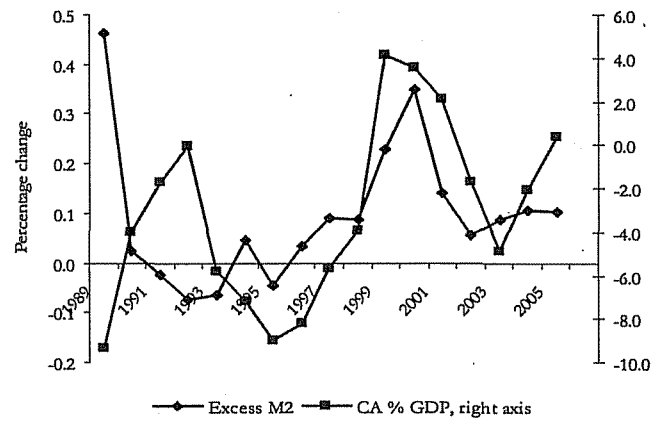
Graph 6: Excess M1 vs. Current account changes



Source: ADB 2006, author's calculations

Graph six captures the movements of excess M1 (annual changes) and the current account as a percentage of GDP. Apparently, there is almost no evidence for the causal relationship between excess M1 and CA. During sixteen years, the increases in excess M1 moves virtually in lock step with the current account except for a weak signal in 1993 and 2004. In the current account, at least for Vietnam, one can conclude that there is no plausible explanation for the excess in M1 caused the deficits in current account. In testing the same hypothesis with excess M2, there appears to be an even greater correlation between the measurements of broad money (M2) and movements of the current account.

Graph 7: Excess M2 vs. Current account changes



Source: ADB 2006, author's calculations

From 1989 -1995, there appears to be a significant link between excess M2 and the current account deficit. In fact, the fall in excess M2 might lead to a disproportionate improvement in current account deficit. It should be noted, however, that the link does not automatically imply causality, although Neoclassical theory does prescribe this (Nicholas, 2006). In contrast, the trends after 1995 indicates a positive relationship between an excess M2 and the current account balance.

In short, a simple graph is by no means a conclusive critique of Neoclassical economics, however the Monetary explanation does not provide a very sound framework for understanding the movements of Vietnam's current account deficit, thus requiring disaggregation of each current balance account.

4.4. Structure of trade

Vietnam's exports depend heavily on raw materials and agricultural products. At first glance, the agricultural share of Vietnam's total exports is highest compared to China and other Asian countries as listed in Table three. Although manufactured products comprise a large share of Vietnam's exports, they are growing at a slow pace and represent a comparatively smaller fraction of exports relative to most other Asian economies (see Table 3).

Table 3: Comparative structure of merchandise foreign trade

Share in total	Export (100%)						Import (100%)					
	Agriculture		Fuels and mining		Manufacturing		Agriculture		Fuels and mining		Manufacturing	
	1997	2003	1997	2003	1997	2003	1997	2003	1997	2003	1997	2003
<i>Vietnam</i>	34.8	22.9	19.3	14.7	45.9	53.3	7.7	6.2	12.9	14.7	79.4	78.3
<i>China</i>	8.6	5.1	5.9	4.1	85.5	90.8	10.3	7.4	12.1	12.7	77.5	79.9
<i>Philippines</i>	9.3	6.6	4.2	3.3	86.5	90.1	9.2	8	11.3	12.5	79.5	79.5
<i>Indonesia</i>	18.3	16.4	33.6	31.6	48.1	52	13.6	16.7	13.3	26.7	73.1	56.6
<i>Malaysia</i>	13.2	11.1	9.4	11.1	77.4	77.7	7	6.4	6.4	8.7	86.6	84.8
<i>Thailand</i>	23.2	19.3	3.4	3.7	73.4	76.9	8.1	7.7	12.5	15.5	79.3	76.8

Source: WTO's statistical dataset (website) and GSO; author's calculations

Regarding imports, the structure shares similarities with other countries with a high proportion of manufacturing, a relatively low agriculture production and a moderate level of fuels. Vietnam's imports range from essential goods like refined oil and gas or intermediate materials to capital goods like machinery and equipment. It seems that the difference in trade structure between Vietnam and Asian countries lies mostly with exports, and this could be responsible for the divergence of Vietnam's current account as compared with China, Indonesia, Malaysia, and Thailand.

4.4.1. Low and volatile in prices of agricultural and primary exports

Studies by Mendoza (1995), Milesi-Ferretti and Razin (1996), Kokko (1998), Baxter and Kouparitas (2000) and Broda (2003) have shown that terms of trade is one of the main detrimental sources to the trade account of a developing country like Vietnam. High dependence on exporting primary products is the reason why Vietnam has the problems with terms of trade problems. Primary products are well known for their low returns, while manufactured exports are considered as the most consistent high yield of income. In detail, the principal items of Vietnam's exports include crude oil, textiles and garments, footwear, marine products, rice, coffee and tea.

It is important to note that the degree to which the terms of trade affects the trade account depends mainly on the level of elasticity of prices and demands of both export and import goods. Elasticity in price and demand of product A is that a decrease in the price of

product A leads to an increase in then demand for product A; the reverse is also true. On the other hand, most of Vietnam's export products are subject to demand inelasticity; when the price of goods fall, the export demand for those goods does not rise accordingly.

Table 4: Decompositions of leading exports

Year	1993		1997		2000		2004	
Total (mill \$US)	2985		9145		14449		26504	
Items	value	% of total	value	% of total	value	% of total	value	% of total
<i>Oil</i>	844	28.3	1423	15.6	3503	24.2	5671	21.4
<i>Coal</i>	70	2.3	111	1.2	94	0.7	355	1.3
<i>Rubber</i>	74	2.5	192	2.1	166	1.1	597	2.3
<i>Rice</i>	363	12.2	870	9.5	668	4.6	950	3.6
<i>Coffee</i>	110	3.7	498	5.4	501	3.5	641	2.4
<i>Marine products</i>	427	14.3	782	8.6	1478	10.2	2401	9.1
<i>Garments</i>	239	8.0	1503	16.4	1892	13.1	4386	16.5
<i>Footwear</i>	68	2.3	927	10.1	1559	10.8	2692	10.2
<i>Electronic goods</i>	N/A	N/A	440	4.8	789	5.5	1075	4.1

Sources: *Vietnam – Country's Report, IMF 1998; 2005*

First of all, crude oil always contributes approximately 20 - 25% of total export turnover. Oil prices have been rising continuously over the last few years, and have doubled since the beginning of 2004, resulting in improvements in Vietnam's trade account during the same period. The global demand for oil has also been growing rapidly, from 61.8 million barrels per day in 1980s to 86 million of barrels per day in 2006¹⁵ with no end of the growth in sight (UNESCAP, 2006). Exporting increasing amounts of crude oil at a higher price should continue to bode well for the trade balance of Vietnam.

Unfortunately, due to the fact that Vietnam itself imports refined oil and oil products, the prospect of trade balance improvement is not very profound. A recent survey conducted by UNESCAP on the economic and social situation of the Asia and Pacific region in 2006 warned that the rising oil prices will have a negative impact on growth, inflation, and trade balances. To be sure, an increase in ten dollars per barrel in the price of oil will dramatically effect the growth of countries in the region owing to their extensive

¹⁵ Economic and Social Survey of Asia and the Pacific – 2006

dependence on oil (UNESCAP, 2006). In the case of Vietnam, domestic production of oil moderates the adverse effects of increasing oil prices on the world market despite the importation of refined oil products for domestic consumption.

Table 5: Oil exports – imports of Vietnam, 2001-2004

Year	2001		2002		2003		2004	
Items	Value		value		value		value	
	(mil \$US)	% changes	(mil \$US)	% changes	(mill \$US)	% changes	(mill \$US)	% changes
<i>Crude oil exports</i>	3126	-10.8	3270	4.6	3821	16.9	5671	48.4
<i>Refined oil imports</i>	1828	-11.7	2017	10.3	2441	21.0	3574	46.4
<i>Net revenues</i>	1929	-10.4	1253	-3.6	1380	9.2	2097	34.2

Source: Vietnam - Country's report, No. 06/52, IMF

As we can see from Table five, oil exports from Vietnam grew by 4.6% in 2002 while imports of refined oil products increased to 10.3%, thus leading to a fall in net oil revenues. While the situation improved somewhat in 2004 owing to an increase in the price of oil on the world market, the 46.4% increase in expenditures for refined oil products diminished the positive impact from the 48.4% rise in crude oil export revenues.

Besides, the State subsidies to control fuel costs represent an additional fiscal burden which in turn negatively impacts overall productivity and economic competitiveness. Indeed, at the current record prices, crude oil plays an important role in diminishing the trade deficit, but over the long term will contribute only a modestly positive effect to the trade balance.

Secondly, it is noteworthy to mention that Vietnam is recognized as the world's largest exporter of pepper, the second largest exporter of rice and coffee, and the third largest exporter of cashew nuts (IMF, 2006b). Those are remarkable achievements when viewed in light of the fact that Vietnam was still importing rice and other staple foods prior to 1986.

Unfortunately, the price of these commodities has an inverse correlation with the amount Vietnam exports, and the compensation received per kilogram continues to decrease. Price aside, coffee is a typical example of Vietnam's recent export success. Once an insignificant exporter of coffee prior to 1986, Vietnam has grown within a decade to become the world's second largest coffee producer and the primary producer of Robusta coffee

beans. The coffee tree was sometimes referred to as the "dollar tree" in Vietnam for the first half of the 1990s, and it brought the country significant foreign exchange earnings. As a result, coffee production continued to expand in the following years.

As the study of Greenfield (2001) shows, over the six year period from 1995 to 2001, the harvested area expanded from 155,000 hectares to 550,000 hectares; the export of coffee accordingly bloomed from 4 million to 14 million bags (12.3% of world coffee exports) As with commodities with a highly inelastic demand, the price of coffee dropped sharply from the oversupply; in fact, Vietnam is called the "culprit of plummeting world coffee prices"¹⁶. Indeed, Vietnam did suffer greatly, with the coffee price dropping sharply over a six year period from 2,633 USD/Mt in 1995 to only 823 USD/Mt in 2000. Even though Vietnam's coffee exports tripled in volume over the same six year period, the earnings in 2000 were actually less than in 1995 (see Table 6).

Table 6: Coffee price and volume (1994-2000)

Crop year	Export(ha)	Average price (USD/MT)	Total value (USD)
1994/95	212,038	2,633	558,296,054
1995/96	221,496	1,815	402,015,240
1996/97	336,242	1,198	402,817,916
1997/98	395,418	1,521	601,430,778
1998/99	404,206	1,373	554,974,838
1999/00	653,678	823	537,976,994

Source: Vietnam's coffee and cocoa Association's website: www.vicofa.org.vn

Marine products are emerging as a "lifejacket" saving the downtrends of agricultural export earnings. Revenues gained in 2005 is 2738.7 \$US million compared with 621.4 \$US million in 1995. Still, marine products are facing many difficulties in getting access to foreign markets due to different kinds of non-tariff barriers. Vietnam has experienced many anti-dumping lawsuits from the US. Given the cases on catfish and shrimp, the US imposed anti-dumping tax rates of 4.13% to 25.76% on Vietnamese exporters in the shrimp lawsuit and

¹⁶ G.Greenfield, 2001 quoted the President of International Coffee Organization (ICO).

36.84% to 63.88% on catfish producers. Vietnamese aquaculture exports to the EU faced similar taxes and duties¹⁷.

Apparently, exporting agricultural and primary products provides low returns, which in turn negatively impacts current account movements.

With a realization of the pitfalls facing raw material exportation, Vietnam has been pushing hard to change the export structure by increasing manufactured goods and value added products. However, delays in transformation and high production costs in manufacturing are placing additional barriers on the performance of the trade and current accounts

4.4.2. Inelastic price and demand with respect to imports

Elasticity refers to the changes in demand in response to the changes in price. Certain goods are considered demand or price inelastic in that demand for these good changes negligibly with changes in their price; these goods, such as fuels, food, and certain input materials, tend to be essential to a country's economy. The imports of Vietnam, unlike the exports, are mostly intermediate materials, manufactured goods, machinery, and equipment which are subject to demand and price inelasticity. In 2004, the value of machinery and spare parts accounted for 32.2% of total import turnover, up by 24.8% compared to 2003. Oil and raw materials such as raw cotton and grain accounted for 61.3% of total imports. On the other hand, motorbikes, cars, and other consumer goods represented a mere 6.2% of imports in 2004. Compared to 2003, even with an increase in the average import price of 11%, import volumes still posted a 12.6% increase in 2004.

Table 7: Decompositions of leading imports 1988 – 2004

Items	1993		1997		2000		2004	
	value	% of total	value	% of total	value	% of total	value	% of total
Total (mil USD)	3924		10423		15200		31954	
Petroleum products	614	20.6	1123	12.3	2070	14.3	3574	13.5
Fertilizers	189	6.3	440	4.8	508	3.5	824	3.1
Steel and iron	210	7.0	510	5.6	824	5.7	2573	9.7

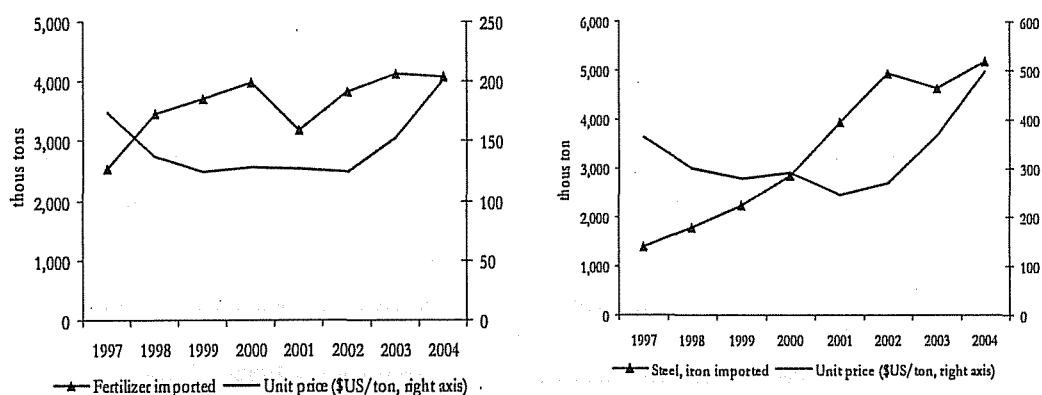
17 (Vietnam News Agency online, www.vietnamnet.vn)

<i>Motorcycles, cars, trucks</i>	N/A	N/A	371	4.1	916	6.3	452	1.7
<i>Garment materials</i>	N/A	N/A	1173	12.8	1422	9.8	2253	8.5
<i>Machinery, equipment (including aircrafts)</i>	922	30.9	1777	19.4	307	2.1	5249	19.8

Source: Vietnam – Country's Report, IMF 1998; 2005

In the process of moving toward increasing industrialization and modernization, the domestic demand for iron, steel, and energy continues to increase rapidly regardless of the price. Refined petroleum products consistently comprise a large portion of Vietnam's imports, accounting for approximately 14% of the total. As a crucial component of efficient agriculture production and with what many consider as an over-reliance on agriculture exportation, fertilizer imports will continue to expand in tandem even with attendant price increases. As seen from Graph eight, the import trends of fertilizers, steel and iron are moving upwards with the rise in prices of those commodities.

Graph 8: Trends of price and imported volume of fertilizers and steels



Sources: IMF Country's Report, Vietnam 2006

As reported by Vietnam's Central Institute of Economic Management, for the year 2004, the price of petroleum rose by 30.4% while its importation increased by an even greater amount; materials for garments and textiles grew by 8.9%; and steel import volume was up 45.7% despite a 37% price increase (CIEM, 2004).

Imports in services are another burden for Vietnam balance trade of trade. Most business services are imported, particularly in the sector of telecommunication, international transportation and financial services (MPI; UNDP, 2005). The recent growth in economic

production and exports places additional pressures through requirements on an already weak importation sector. The study conducted by the UNDP and Vietnam's Ministry of Trade entitled *Options and Recommendations for a Comprehensive Development Strategy for the Services Sector in Vietnam up to 2020* stated that "service sector is now relatively backward and not competitive...accounts for less than 40% of GDP, much lower than the average of 50% in low income countries". Vietnam's main source of service income is domestic, particularly the tourism industry, which does not directly contribute to economic production. Main business services like transportation, legal and financial services are imported while telecommunications are provided by state owned monopolies with poor quality and high prices. The weakness in business services puts pressure on the current account in different ways. First, the revenues earned from exports are reduced due to the importation of services. Second, the low quality and high cost of service inputs lowers the competitiveness of export products, and in turn worsens the balance of trade.

All in all, the trade deficit problems will not improve in the short-run as revenues from exportation are not even sufficient to pay for imported goods. Indeed, policy and production approaches in the near term point to a worsening deficit owing to a more "ambitious development program" toward domestic industrialization and modernization (Masino, 2006).

4.4.3. *Low share of manufactures in exports*

While the share of manufactured exports is increasing, it comprises only a modest fraction of Vietnam's total exports (50%) when compared to neighboring countries: China: 90%, Philippines: 90%, Thailand: 77% (refer to Table three). The most important difference between Vietnam and regional economies with better current account performance pertains to the types of exports. Listed below in Table 9 are a number of principle export items in order of their economic share.

Table 8: Comparative principal export commodities

Malaysia	Thailand	Vietnam
Thermionic valves, tubes, photocell,	Computer and parts	Textile products
Parts and accessories and automatic data processing equipment	Textile products	Marine products
Telecommunications equipment	Electrical appliances	Rice

Petroleum, crude and partly refined	Integrated circuits and parts	Coffee
Palm oil	Vehicle parts and accessories	Wood and wood products
Liquefied natural gas	Canned food	Rubber
Articles of apparel and clothing accessories	Plastic products	Frozen shrimp
Saw logs and sawn timber	Rice	Coal
Sound recorders and reproducers	Precious stones	
Rubber	Jewelry, goldsmith	

Source: ADB Key Economic Indicators, 2006

Clearly, the exports of Malaysia and Thailand consist primarily of a variety of manufactured goods while Vietnam's principal exports are mostly basic agricultural products. This composition of exports translates into trade account performance illustrated in the following chart.

Table 9: Average percentage changes in manufactured exports vs. trade balance

(M= Manufacture share in total exports, T = Trade balance as percentage of GDP)

Average period	China		Malaysia		Thailand		Vietnam	
	M	T	M	T	M	T	M	T
1988-1993	74.2	0.2	57.0	7.2	63.6	-4.6	23.8	-2.4
1994-1999	85.4	3.3	77.4	10.5	74.0	2.5	40.1	-5.8
2000-2004	89.9	3.3	79.4	22.4	77.4	7.7	47.8	-2.4

Source: ADB Key Economic Indicators 2006, author's calculations

The table shows the changes in the export shares of manufactured goods and the improvements of the trade account over three 6 year averages from 1988 to 2004. Evidently, countries with the high percentage of manufactured exports always run a trade account surplus. Among those countries listed, Vietnam has the lowest share of manufactured goods and the worst performing of trade account. Comparatively, the trade accounts of the other three Asian countries in the chart continue to increase over time while simultaneously increasing the proportion of manufactured goods they export. The explanation for Vietnam weak trade account is the delay in transitioning to an increasingly manufacturing oriented economy coupled with an enduring dependence on natural resource exploitative exports. In the case of China, there are a number of parallels that can be drawn to Vietnam as well, as both countries developed from agricultural based, centralized socialist economies.

In 1985, the manufactured share of China's exports was 26.43%. Two years later, the share nearly doubled and continued to increase over the following six years to 80.61% (ADB, 2006). Twenty years later, manufactured products comprise greater than nine tenths of China's exports. Over the same period, Vietnam was only able to less than double its export share of manufactured goods from a similar baseline. The difference in the trade balance is evident as well, with China running a 6% surplus in 2005 compared with the 1.6% deficit of Vietnam. Aside from the late transition to a manufacturing economy, industrial sectors are facing another problem in the form of production costs, a topic discussed in the following section.

4.5. High costs of production

Although known as a stable country with minimal domestic terrorism and a high rate of economic growth, Vietnam's rankings in international competitiveness do not appear to reflect these attributes. On both the recent Global Information Technology Report and the Global Competitiveness Report released by the World Economic Forum in late September of 2006, among Asian nations, Vietnam is the poorest performer in both a sense of competitiveness and pertaining to network readiness. In producing these reports, the World Economic Forum utilized over 100 indicators covering key economic aspects to provide a comprehensive assessment on each economy's competitiveness. Some of the indicators include institutions, infrastructure, market efficiency, labor market flexibility, and transparency of financial markets. Of the 125 countries surveyed in 2006, Vietnam's economy ranked 77, down three places from the prior year. The ability of Vietnam to engage in information technology activities also fell from the 68th position in 2004 to 75 in 2005.

Table 10: Network readiness Index (A); Global Competitiveness Index (B)

A	Score 2005	Rank 2005	Rank 2004	Changes	B	Rank 2006	Score 2006	Rank 2005	Changes
Singapore	1.89	2	1	-1	Singapore	5	5.63	5	0
Hong Kong	1.44	11	7	-4	Hong Kong	11	5.46	14	3
Taiwan	1.51	7	15	8	Taiwan	13	5.41	8	-5
Malaysia	0.93	24	27	3	Malaysia	26	5.11	25	-1
Thailand	0.35	34	36	2	Thailand	35	4.58	33	-2
China	-0.01	50	41	-9	Indonesia	50	4.26	69	19
Indonesia	-0.36	68	51	-17	China	54	4.24	48	-6

Philippines	-0.37	70	67	-3	Philippines	71	4.00	73	2
Vietnam	-0.47	75	68	-7	Vietnam	77	3.89	74	-3

Source: World Economic Forum's reports, www.weforum.org

Even with an average annual growth rate of 8% over the past few years, Vietnam is still considered by numerous indices as the least competitive economy among developing countries in the Asian region, a fact born out by a fall in FDI since 1998.

The explanation for the low rankings is due in part to higher production costs, especially costs associated with the business service infrastructure. Certainly while it is true that "better infrastructure appears to [go] hand-in-hand with higher export per capita" (Martin, 2003:25), there is a great upfront cost associated with infrastructure development that can negatively impact export competitiveness in the near term.

Business services such as telecommunications, transportation, port and shipping facilities, financial and banking services, and legal services are either subject to importation at high prices or are provided by State or military-controlled monopolies with inconsistent or poor quality¹⁸. Compared to foreign competitors, Vietnam's domestic producers must pay double for contacting their trading partners, triple for transporting their exports, or four weeks to receive approval from government agencies on trade contracts rather than just two hours in Thailand (JETRO, 2003). All these costs are eventually passed on to the consumer through increased prices or to the producer through a diminished profit margin, thus further diminishing the competitiveness of Vietnamese produced goods versus those from China or Thailand.

After conducting a survey on investment costs in twenty-one major cities in Asia, JETRO concluded that Hanoi and Ho Chi Minh City are the most costly localities for production. International telephone costs, domestic and foreign transportation expenses, and utility costs are greater in these two cities than of the others surveyed. Customs and other inefficient administrative procedures further complicate the situation.

¹⁸ Most of services are still being provided by two monopolies: state owned Vietnam Post and Telecommunication Corporation and military owned VIETTEL. The prices of Vietnam's telecommunications are much higher than China or Thailand, i.e. Vietnam's internet cost 19.9\$/month (China 10.1\$); 6.9\$/month for mobile while China 3.7\$; calling to US costs 1.95\$/min compared to 1.2\$/min on average in East Asia and Pacific; calling to Japan-main trading partner of Vietnam costs 8.52\$/min, while only 4.3\$ from Shanghai (JETRO, 2003)

The singular advantage of Vietnam in terms of production inputs is its extensive pool of inexpensive labor (see Table 11). With a legal minimum wage of just over 40 USD per month, Vietnam represents a competitive place to locate production facilities for labor-intensive exports such as textiles, garments, footwear, and processed foods.

While the cost of labor in Vietnam is relatively inexpensive compared to surrounding countries, the wage gap is not sufficiently wide to produce an absolute competitive advantage. On average, China, thanks to its large and growing population, is still the leading cheap labor market.

Table 11: Labor cost (\$US/month) comparisons within some big cities in Asia

	Beijing	Bangkok	Jakarta	Hanoi	Hochiminh
Workers	63~178	163	108	79~116	101~134
Engineers	144~268	296	205	184~345	188~458
Mid-level managers	169~604	671	540	484~573	524~661
Legal minimum wages	56.18	76	65.62	40.81	40.81

Source: JETRO, The 13th survey of Investment-related cost comparison in major cities and regions in Asia

Furthermore, especially in the case of high value-added exports from Vietnam, a cheap labor advantage is not sufficient for attracting quality long-term investments.

From another perspective, if the country's economic structure is moving more toward manufacturing and services, cheap, unskilled labor will actually have a negative impact on the productivity and growth of the economy. Manual workers do not contribute much to the value of industrial, manufactured products, unless they are equipped with technical skills and professional qualifications. Advanced Asian labor markets such as Japan and Korea - and increasingly China and India - have shown that skilled workers are necessary to advance and sustain economic growth. Report from a Vietnamese think-tank, the Central Institute for Economic Management, revealed that of the entire labor force, three quarters of available workers were untrained. Among the trained aspect of the labor force, only half - a mere 10% of the total work force of Vietnam - were skilled workers with higher education, while the remainder of workers received primary training, vocational training, or worked without certification. This data points to a major deficit of trained workers in Vietnam, and will undoubtedly prove to be a huge hindrance to the national strategy of industrialization and modernization targeted for the year 2020. Owing to this

deficit, many foreign investors are required to transfer or import highly skilled workers from other countries to bridge the gap.

Indeed, the country has an abundance of labor but a dearth of trained workers, a fact that does not bode well for long-term growth prospects while requiring a great deal of long-term investment to remedy the situation.

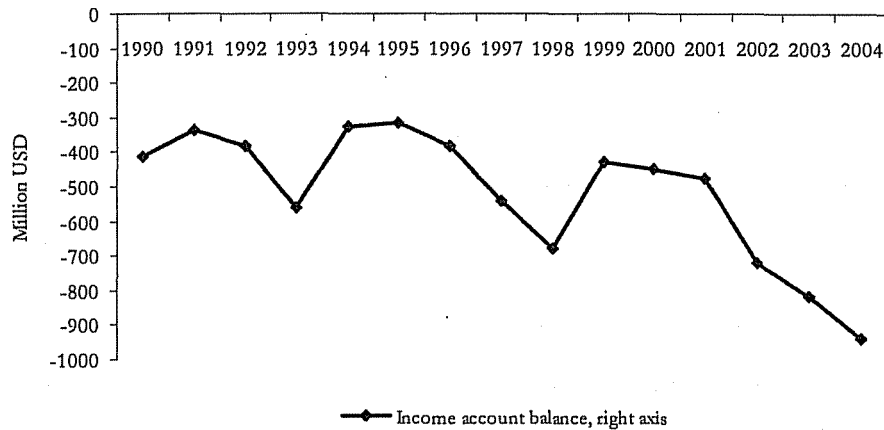
4.6. Income account deficit

4.6.1. High ratio of income payments

The second factor involving movements of the current account is the income account. Since Vietnam is plagued by a high ratio of external debts - 36% when compared to GDP, and 56% when viewed against exports (CIEM, 2004) - the income account is thus largely burdened by income payments and interest. Dividends comprise an insignificant portion of the total debt as this type of investment is unpopular owing to an underdeveloped stock exchange. Thus, most movement in Vietnam's income account deals with capital inflows in the form of FDI or loans rather than stocks or equities. Vietnam's income balance is always in deficit owing to ever increasing payments for interest and foreign investment returns along with capital inflows. Furthermore, the income balance is trending downward indicating that Vietnam is making greater payment in interest and profits to foreign investors each year. The more that capital flows into a country, the more it has to pay back in terms of interest payments or profit remittances. Of note is that a rising capital influx does not necessarily imply increasing productivity or economic growth; rather, it is the sectors into which capital flows that matters the most.

In Vietnam, receipts from interest on deposits of Vietnamese residents in non-resident banks are very small (Thanh et al, 2001). Therefore, the deficit in income balance is induced primarily by the accumulation of increasing FDI and loans every year. Nearly 90% of the inflows consist of just FDI and medium to long-term debt, with short term debt accounting for a small amount of the total debt. In response to the transformation of Vietnam's economy, capital inflows have increased rapidly since 1990. This trend is reflected in the rise of loan repayments and debt services, which serves to deteriorate the income balance as illustrated in Graph 9 below.

Graph 9: Income account balance (absolute value)



Source: World Development Indicators, 2006 (software)

By decomposing capital inflows, FDI appears to be a significant source of financing the current account deficit, particularly after 1995. In the case of Vietnam, foreign capital is often invested in the form of a joint venture with a domestic partner. Most projects that are implemented have a minimum authorized capital with the remainder of capital borrowed from foreign creditors, thus resulting in a substantial foreign loan component (Thanh et al., 2001). Thanh noted that the interest rates from FDI loans are normally as high as the market rate, representing another burden for repayment. Additionally, a “substantial foreign loan component in FDI may allow investors to repatriate earnings even in the case of low profitability” (Shishido, 1996). Escalating interest payments, profit remittances, technical fees, and copyrights place additional pressure on the efficiency of FDI utilization and potentially weaken the current account.

Another factor contributing to Vietnam’s capital resource is medium-long term debt. Although Vietnam still ranks on the HIPS list, its external debt position has improved since reaching a debt rescheduling arrangement with Russia in 2000. After discounting its claims to Vietnam by 70%, Russia agreed to write off 50% of the remaining debt, leaving the remaining of \$1.7 billion repaid in 23 years. In total, Vietnam’s foreign debt is about 40% of GDP (ADB, 2004). Classified by the World Bank and other financial institution as a debt sustainable country with debt service ratio of about 10% of total exports, the country is no longer eligible for debt relief through the World Bank's HIPC initiative, resulting in an

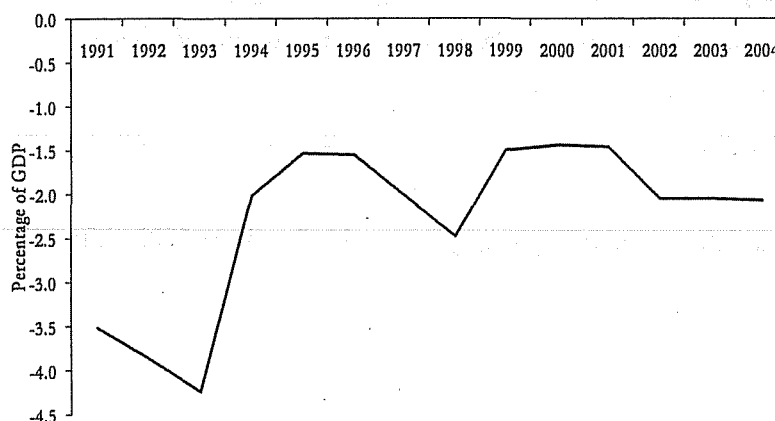
increased repayment burden on the country's foreign reserves. Additionally, the amount of debt is growing rapidly - by 20% over the year 2003 to 13% in the following year - and is placing additional pressure on income payments and the overall current account.

4.6.2. Inefficiency in capital utilization

Admittedly, the amount of investment does not always correlate with growth in economic proficiency and productivity, which determines the trade account status. GDP is commonly used as an indicator for economic productivity. Increases in GDP indicate that capital is being well utilized to maximize capacities of the economy. In this regard, a consideration of the ratio of the income account as a percentage of GDP will help to better determine how capital inflows affect both the economy in general and the current account in particular.

By observing the percentage changes in the income account to GDP ratio, one can understand if capital is being efficiently invested. If the GDP growth rate is faster than the rate of increase in profit repayments and interests, the ratio of income account to GDP will decrease, indicating that economic productivity and competitiveness is improving thanks to effective use of capital. In contrast, if the income account to GDP ratio is high, then the efficiency of capital utilization must be questioned. In the following graph, the upward trend indicates a faster growth of GDP than of income payments, while the downward trend implies the opposite.

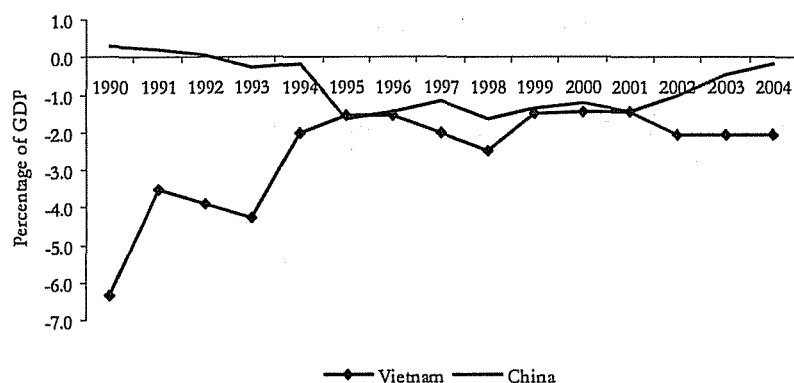
Graph 10: Vietnam's trends of income balance as percentage of GDP



Source: World Development Indicators, 2006 (software)

Obviously, in the period prior to 1995, although there was a temporary downturn in the period of 1991 to 1993, Vietnam's GDP grew much faster than income payments, implying an efficient use of capital. After this period, there was a slight downturn followed by a sharp decline in 1998 that could be explained by the massive capital and profit withdrawal from Vietnam owing to the Asian financial crisis in the prior year. Around the turn of the century, a period of sluggish growth of GDP relative to income payments represented a warning sign for inefficient capital utilization. The following brief comparison with China serves to explain the impact of such regional effects and serves as a point of contrast for domestic capital usages.

Graph 11: Comparative trends of income account between Vietnam and China



Source: ADB, IMF, WB

As evidenced by the above graph, the movements of China's income account are more positive and stable than those of Vietnam. After a decline in the period of the late 1990s owing primarily to the Asian financial crisis, the income account recovered since then indicating a productive use of invested capital in generating outputs. Additionally, China's income account is trending upward in a stable fashion, reflecting the sustainability of debt repayment in relationship to economic growth. On the contrary, despite major progress in capital utilization over the first half of the 1990s, Vietnam returned poor income account data since then and has not shown improvement as of late. Apparently, Vietnam's trade account soared rapidly after Doi Moi, however it seemed that the rise was due to expansion of the export market and investments rather than economic productivity (Thanh et al, 2000).

In spite of increasing capital flows, the performance of the economy as reflected in an increased ratio of the income account to GDP is still quite poor, raising questions over the efficiency of capital use. Indeed, the efficiency of capital utilization and economic productivity depends mostly on the sectors and industries in which the capital is invested. Using FDI as a sample to examine capital distribution, in the first half of the 1990s, most FDI went into heavy industries such as mineral exploitation, oil and gas extraction, and real estate.

On the other hand, manufacturing received only very modest amounts of invested capital. Capitals flowing into economic processing zones, which were built to attract FDI into export-oriented industries, received less than a mere 1% of total foreign investment. Vietnam's economy is in the infancy of its development; thus, selectivity of the sectors in which to invest is crucial for long run development.

Table 12: Vietnam - Disbursements of Foreign Direct Investment 2000-2003

Economic sectors (in percent of total)	2000	2001	2002	2003
Industry	44.5	41.2	46.3	51.0
Heavy industries	24.7	22.8	24.0	28.9
Export processing zones	0.7	0.7	0.6	0.2
Light industries	13.9	12.5	15.1	9.5
Food	5.2	5.1	6.6	12.3
Oil and gas	15.3	32.1	37.2	32.3
Construction	9.6	5.6	1.8	2.2
Transportation and communications	3.7	2.1	2.5	0.7
Real estate	13.8	5.0	3.7	4.0
Hotels and tourism	7.0	3.0	1.1	2.7
Office property and apartments	6.8	2.0	2.6	1.3
Agriculture, forestry, and fisheries	8.5	9.7	3.6	5.6
Services	4.6	4.3	4.9	4.1
Total	100.0	100.0	100.0	100.0

Source: IMF Country's Report Vietnam 2006

If Vietnam hopes to generate high levels of employment, then further increases in light industry FDI creates the greatest growth potential (Dapice, 2004). In fact, the distribution of capital by sector is slowly shifting to more light industries and manufactured goods, however the change is not that significant and the share of heavy industry, oil, and gas is still far higher.

All in all, it is an increase in borrowing and an inefficient utilization of the borrowed funds that leads to deterioration in Vietnam's current account.

4.7. Impact of uncompetitive exchange rate

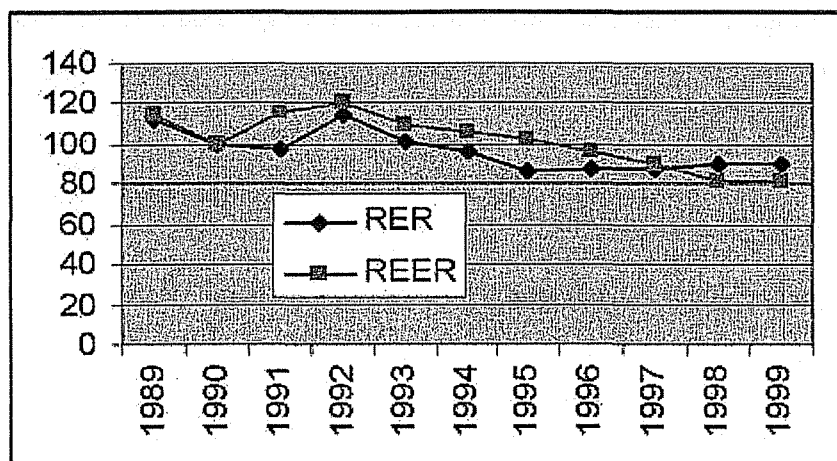
Most theoretical literature on balance of payments emphasizes and highlights the role of the exchange rate in influencing current account trends. Exchange rate is viewed an indicator for economic competitiveness (Ohno, 2003). However its value as a litmus test for competitiveness varies widely between countries. In the case of a country in economic and political transition such as Vietnam, the exchange rate is regarded as a policy instrument for "promotion of exports, control of import [to sustain] a viable balance of payments and a stable macro-economic environment" (STBV, 1996). These goals, however, are not substantiated by recent performance data.

The first devaluation of the VND toward the USD in 1989 improved the trade and current accounts. Prior to that period, Vietnam had maintained three different exchange rates for different business activities. At the start of the 1990s, the Central Bank of Vietnam unified these exchange rates so that 1 USD equaled 4500 VND, thus helping to stabilize domestic prices and reduce inflation. In fact, inflation decreased from 400% in the year 1988 to 17.5% in 1992¹⁹, resulting in a current account movement from -2.9% of GDP to -0.1% and an increase in the trade account from -2.7% to -0.6%²⁰ over the same period. As depicted in the following graph, the real exchange rate and the real effective exchange rate were virtually identical from the period of 1989 to 1990. The real effective exchange rate (REER) in the graph was calculated using the real exchange rate (RER) and a trade-based weight from trading partners (Thanh et al., 2000). As such, REER gives a relatively precise indication of Vietnam's competitiveness in the foreign market.

¹⁹ General Statistic Office of Vietnam, website: www.gso.vn

²⁰ Thanh et al, 2000

Graph 12: Real Exchange rate (RER) and real effective exchange rate (REER)²¹
(index 1990=100)



Source: Exchange rate management in Vietnam: Information Content and Policy Options, (Thanh et al., 2000)

The trends indicate that REER was higher than RER over the period of 1990-1997, implying that the VND was overvalued. An overvalued VND made Vietnam's products more expensive for foreigners in USD terms, thus reducing the export volume and leading to a sharp fall in the trade account over this period (refer to Graph 3). The current account deficit rose to an alarming 9% of GDP in 1995; this fact combined with a trade deficit of -11.3% placed great pressure for devaluation of the VND.

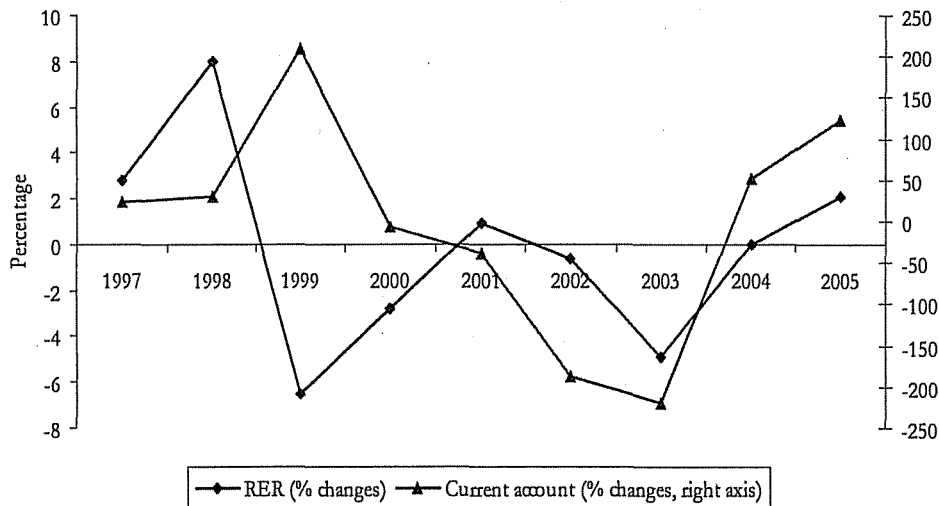
Additionally, currency depreciation in regional economies after the Asian financial crisis and subsequent decrease in FDI (the primary source of deficit financing) lent further support for devaluation of the Dong. As a result of such pressures, Vietnam embarked on gradual and cautious currency devaluation. In 1998, the official exchange rate was devalued by 16% relative to the USD, and the fluctuating band was widened from 1% in 1996 to 7% in 1998 (Idem,2000). These efforts succeeded in slowing down the deficits and gradually improved the trade balance.

In an attempt to further enhance the positive impact of devaluation on the overall trade balance, Vietnam also applied "strict controls over foreign exchange", with the exception of FDI flows, capital was not allowed to freely flow in and out of the country

²¹ Thanh et al (2000) calculated RER based on $RER = ER * P_{US} / P_{VN}$ (ER-nominal exchange rate VND/USD, P_{US} and P_{VN} – price indexes of US and VN respectively), while $REER = \sum RER_i * W_i$ (i is price index of partner i , W_i is trade-based weight)

(Idem, 2000). Over the long-run, however, the impact of devaluation on the current account was not as positive as had been expected.

Graph 13: Moves of RER vs. Changes in current account



Source: ADB, WDI (RER based on twelve months average)

As the VND is now pegged to the USD, devaluation of the VND implies that in terms of currency value, one VND can buy fewer USD than before. Furthermore, since Vietnam's exchange rate is the ratio of VND to USD, devaluation of Vietnam's currency equals depreciation in the exchange rate which is represented by an upward trend in Graph 13. Theoretically, devaluation will help to improve exports while possibly reducing imports. If the exchange rate can perfectly explain movement in the current account, then depreciation will lead to both a rise in the current account balance and movement tightly aligned with changes in the real exchange rate.

As evidenced in the above graph over the years 1998-2001, the trends do not support this conclusion. The main contribution to a rise in the current account in 1999 are the increasing demand of Vietnam's exports to the EU market and particularly the recovery of regional economic activities after the Asian financial crisis. Vietnam's trade structure is such that exports are dependent on USD denominated foreign imported inputs such as capital, intermediate goods, and fuel (Ohno, 2003). When the VND depreciates, imports will clearly become more expensive. Since most of Vietnam's imports are for domestic production, both

the contraction in imported inputs and increases in the cost of imported goods will logically increase production costs of many domestic goods. By extension, the producer's price will increase and competitiveness as reflected in the current account will suffer.

In summary, it is understandable why both currency devaluation and the contribution of the exchange rate regime are not sufficient to explain in toto current account trends, as factors such as terms of trade or production costs have a much greater impact.

Summary

By testing the relationship between Vietnam's excess money supply and the current account movements, the author was unable to ascertain a correlation between increases in excess M1 and deterioration of the current account. Furthermore, there was only a slight change when M2 was substituted for M1 in the analysis. In terms of applying the Monetary theory to the case of Vietnam, it does not appear to provide a plausible explanation for the persistent current account deficit. Application of the Structuralist approach, together with empirical evidence from China, South Korea, Malaysia, however, does provide some insight into this problem. Owing primarily to its economic structure, the types of imports and exports of Vietnam are subject to problems with terms of trade. The impact of this serves to deteriorate and induce fluctuations in the trade account, worsen current account accordingly. The inelasticity in price and demand for imported goods coupled with an insignificant share of manufactured goods in total exports are the main reasons for the enduring deficit in the current account. The problems are exacerbated by high costs of production and an uncompetitive exchange rate. Furthermore, disaggregating Vietnam's income account brings to light the additional problem of an increase in foreign capital borrowing without proper utilization. On the other hand, while the exchange rate does have some impact on the trade balance, the implications are not great over the long-term.

Chapter 5: Conclusions and policy implications

Warning! Trade liberalization can not be shown on theoretical grounds to enhance technical efficiency; nor has it been empirically demonstrated to do so.

Robert Wade, 1990

The benefits of trade liberalization and international economic integration have been increasingly questioned, yet the trend towards greater trade and international integration is so strong that no country can stand to resist these forces without being discriminated against and left behind. The approval of Vietnam's entrance into the WTO on the 7th November 2006 was the green light for Vietnam to become a full player in this economic liberalization game. While acknowledging many achievements that openness has brought to the country over the last twenty years, it is nevertheless evident that "the next steps in this area are arduous" (Masina, 2006:103).

One challenge of WTO accession and increasing economic liberalization pertains to the current account balance. Within the limited scope of this paper, the author outlines the general implications for Vietnam's current account with respect to the agriculture and manufacturing sectors while deferring a detailed discussion on specific requirements pertaining to WTO membership

5.1. General implications for improving current account

Previous chapters in this paper served to explain recent current account trends of Vietnam and concluded that the primary causes of Vietnam's current account weakness lie in the trade and income accounts when viewed in light of the Structuralist approach to the BoP. One contention was that these current account problems stem largely from an agricultural export driven and resource based economy. Although the share of light manufacturing is increasing, the rate of increase is modest, and the high-tech and competitive business services sectors continue to lag far behind those of other regional economies.

Hence, the basic policy implication that can be drawn from this analysis is the need for a shift in the production structure from a heavy dependence on export agriculture and resource-based industries to a greater emphasis on manufacturing and competitive services.

It was also argued that a second major factor contributing to the poor current account performance is the relatively high deficit in the income sub-account resulting from increasing FDI and loans combined with inefficient capital utilization.

Future economic policy should thus take a more cautious approach to foreign borrowing and FDI inflows by limiting the former and directing the latter more towards export-oriented manufacturing in a way which results in a transfer of technology and skills development. Other factors considered were the competitiveness of the exchange rate and excess money stock growth. Although there was some indication that the uncompetitiveness of the exchange rate might have had some bearing on the current account balance, there was no evidence for the money stock having any bearing. It may be argued that policy on exchange rate regime needs to be adopted only in the context of a shift of the production structure since there are grounds for believing that a competitive exchange rate is great important to manufacturing exporters.

5.2. Policy implications with respect to accession in the WTO

Vietnam potentially stands to derive positive current account gains from a number of areas related to WTO accession: decreased import and export tariffs; reduction in protections by gaining access to the markets of 150 member countries; and expansion of investment under Trade Related Investment Measures (TRIMs) with opportunities for technological change ensured by Trade Related Investment Properties (TRIPs).

Despite all the alleged benefits from WTO membership, successful results from other countries do not necessarily imply an equally positive outcome in the case of Vietnam. For one, the types of exports produced by Vietnam do not confer great bargaining power and are burdened with a highly inelastic demand. More importantly, lessons learned from the experience of other countries after joining the WTO points to the fact that only countries that aggressively promote manufacturing exports such as China will be met with great economic success (Nicholas, 2006). As a latecomer, the road for Vietnam as a WTO member will be more difficult than for more established economies.

As a consequence of membership, Vietnam has to commit itself to trade liberalization and the removal of protections on domestic products.

These agreements not only diminish government income from import taxation but place great pressure on export sectors of the country. On average, Vietnam must reduce its

maximum rate of tariffs from their current levels to 23% over the next 5-7 years. With agricultural and non-agricultural imports, Vietnam is lowering duties to between zero and 35%²².

5.2.1. For agricultural and primary products

The removal of import tariffs for foreign agricultural products as well as the elimination of subsidies for Vietnam's agricultural export commodities represents a threat to the existence of domestic agricultural production sectors and raises concern regarding food security and economic independence.

In countering cheap agricultural foreign products, the long term strategy should be focused on building a sound basic food production scheme for domestic consumption for reasons of food security and independence, rather than expanding production and exportation of commodities like coffee, tea or nuts.

In parallel, a short term strategy can help ease the transition by continuing to export higher value agricultural products while simultaneously advocating use of the abundant pool of inexpensive labor in rural areas for the production of marine products, fruits, and vegetables.

Protecting agricultural domestic producers in the local market through research and development, promotion for domestic agricultural products, training for farmers in basic market economics, and improving the agricultural infrastructure will further enhance the country's food security as well as ensure social security by protecting the employment of the 80% of Vietnamese who are farmers.

The utilization and exportation of minerals must take into consideration the country's environment and long-term sustainability. In this regard, Vietnam needs to strictly limit the foreign sector invested in these industries to ensure proper use and limit exploitation.

5.2.2. For manufacturing and industry

Some attendant WTO membership benefits might include the lifting of the US and EU quotas on textiles and garments (which accounted for about 14% of total exports), a

²² Report of Working Party on the accession of Vietnam, documents available at www.wto.org

bolstering of foreign investor confidence of which further increases the investment flows²³ into the country, and cheaper imported production inputs.

Nonetheless, Vietnam's light industry and manufacturing sectors are in the initial development stages. All the underdeveloped industries - electrical equipment manufacturing, electronics and informatics, mineral exploitation and processing - are weak and not competitive²⁴. These industries will face the greatest peril when attempting to compete with products from more developed countries. In this regard, proper utilization of foreign investment to bridge the gap in technology and skills as well as to bolster infant industries represents the best possible solution to this disparity. Learning from China, Vietnam needs to encourage export-oriented and high-tech foreign investment while limiting foreign involvement in protected and exploitive industries.

Additionally, subsidizing domestic manufacturing must be given priority by engaging in projects such as upgrading domestic service industries and adjusting competitive exchange rate in favor of exports.

Regardless, maximizing capital from domestic private sectors is a way to retain the profits within the country and to reduce the income payment burden. Moreover, merging private entrepreneurs into national corporations will also strengthen their competitiveness against foreign competitors. These approaches will help guide Vietnam down the largely desirable path of modernization and industrialization. /

²³ Right after Vietnam officially became WTO's member, Intel raised its investment in Vietnam plant tripled to \$US 1 billion (Vietnam news).

²⁴ Ministry of Trade, 2006, report at the forum "Vietnam: Readiness for WTO's accession"

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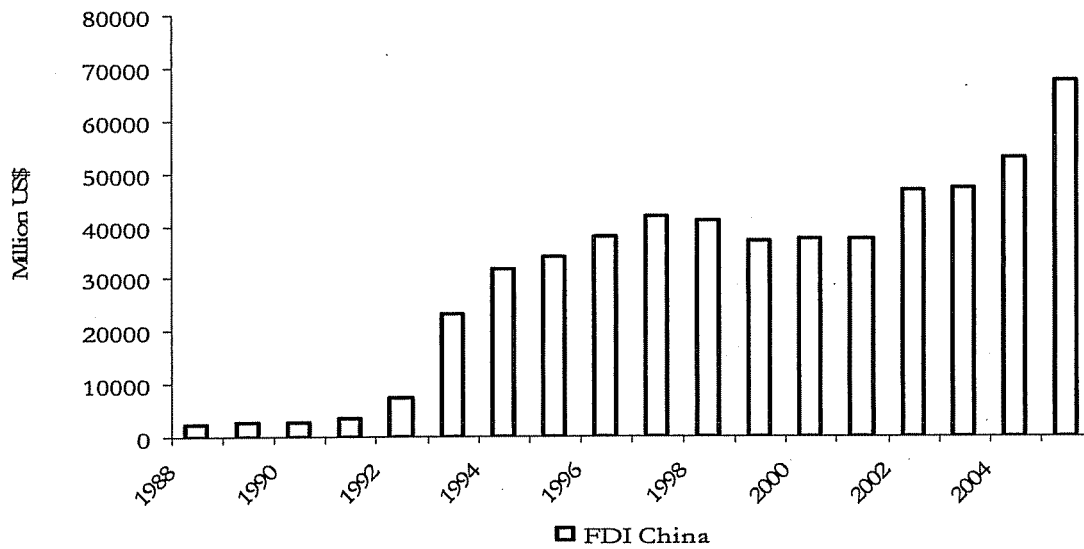
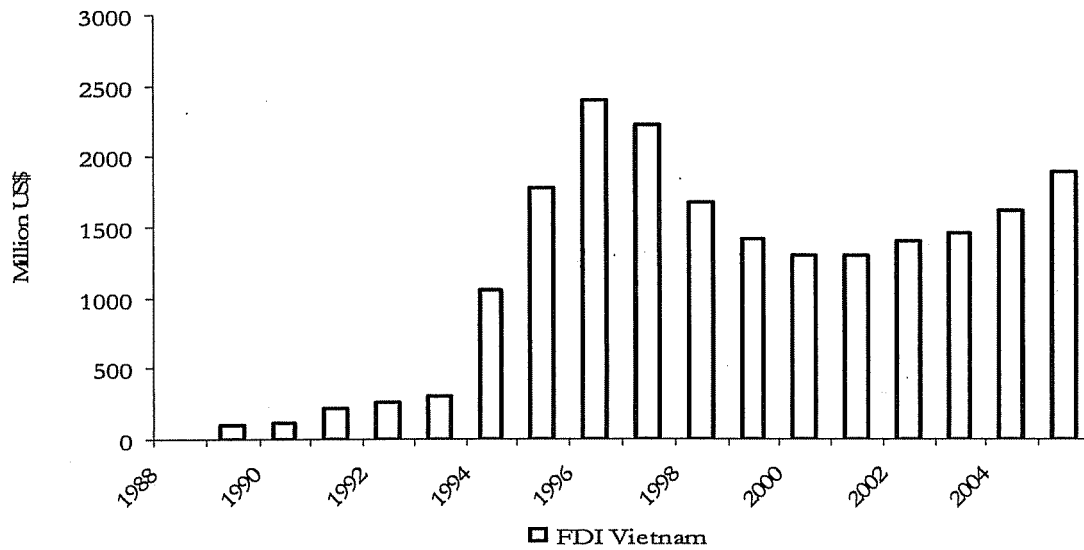
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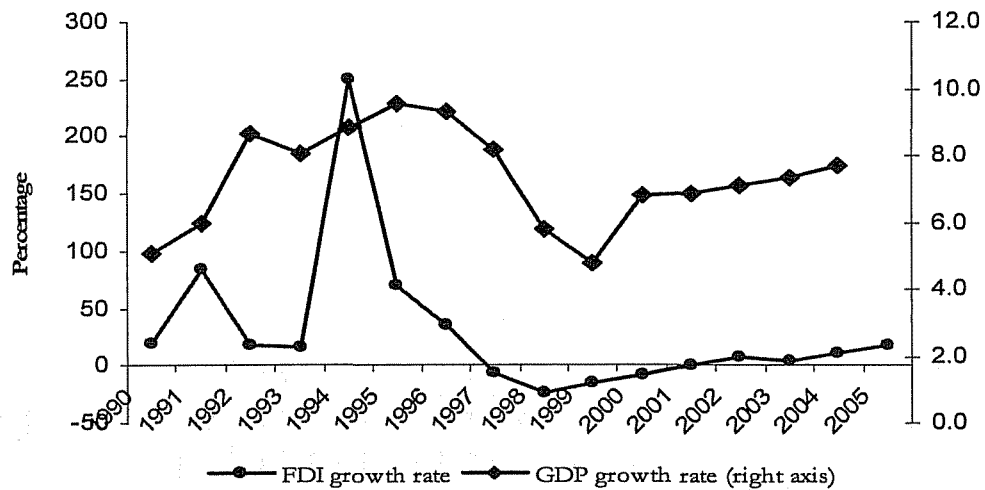
APPENDICES

1. FDI inflows 1988-2005: Viet Nam – China



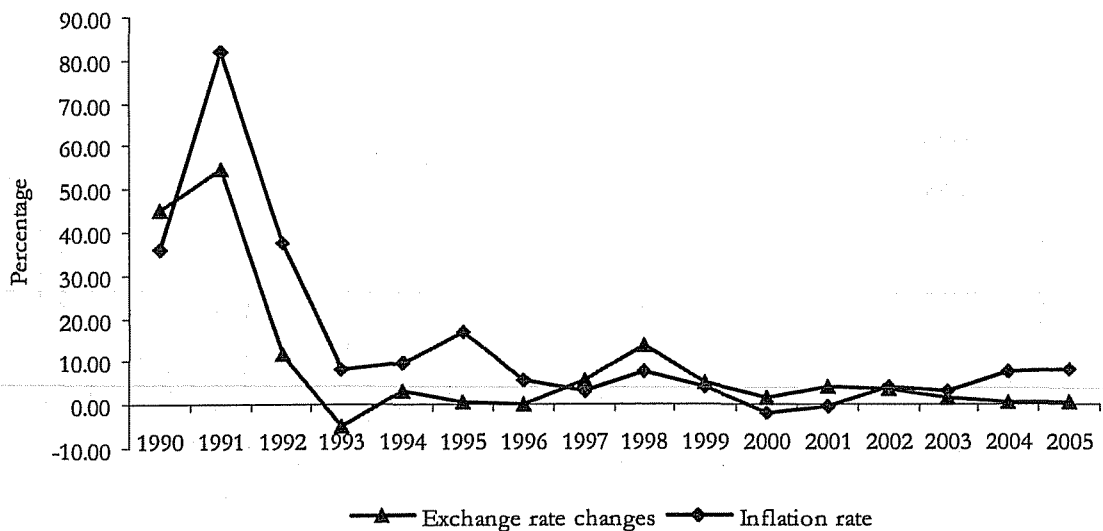
Source: ADB Key Economic Indicators, 2006

2. Vietnam's FDI and GDP growth rate



Source: ADB Key Economic Indicators, 2006

3. Trends of exchange rates and inflation rates



Source: ADB Key Economic Indicators, 2006

4. Average percentage changes in manufacture exports and trade balance

M= Manufacture share in total exports, T = Trade balance as percentage of GDP)

Average period	China		Malaysia		Thailand		Vietnam	
	M	T	M	T	M	T	M	T
1988-1993	74.2	0.2	57	7.2	63.6	-4.6	23.8	-2.4
1994-1999	85.4	3.3	77.4	10.5	74	2.5	40.1	-5.8
2000-2004	89.9	3.3	79.4	22.4	77.4	7.7	47.8	-2.4

Source: ADB Key Economic Indicators, author's calculation.

5. Changes in prices of Vietnam's leading exports

Year	Crude oil price (%)	Rice price (%)	Coffee price (%)
1998	-31.8	11.4	22.3
1999	39.6	-16.8	-21.9
2000	61.0	-15.4	-43.7
2001	-17.6	-12.5	-38.5
2002	3.7	33.3	6.9
2003	14.9	-15.6	50.1
2004	30.5	23.3	-2.4
Standard deviation	32.5	21.2	33.7

Source: Vietnam's Statistical Appendix, IMF, 2006

6. Business costs in selected capital cities (US\$)

	Hanoi	Ho Chi Minh	Shanghai	Singapore	Bangkok	Kuala Lumpur	Jakarta	Manila
Worker's salary/month	94	113	248	468	176	329	64	228
Engineer's salary/month	251	221	447	1,313	378	668	190	344
Middle-level manager's salary/month	511	488	453	2,163	727	1,407	723	620
Expenses for office lease/month/m2	23	16	24	42	13	17	19	28
Expenses for house rent for foreign representative	1,850	1,800	1,500	2,285	1,420	920	2,000	1,970
International telephone cost (A 3 minute call to Japan)	8.52	8.52	4.3	2.23	3.11	2.61	2.59	3.78
Electricity cost for business/KWh	0.07	0.07	0.035	0.05	0.03	0.06	0.0177	0.09
Container transportation (40/ft/container) (from factory to Yokohama port)	1825	1375	880	670	1466	895	1252	994
Petrol price (1 liter)	0.31	0.31	0.3	0.74	0.34	0.29	0.138	0.35
Personal income tax (Highest tax rate, %)	50	50	45	29	37	29	30	33

Source: JETRO (2003)

6. **Producer Price Index percentage changes (Industry: year 1995=100; Agriculture: previous year =100)**

Year	2000	2001	2002	2003	2004	Year	2000	2001	2002	2003	2004
General index	111.2	113.6	115.6	118.1	127.3	General index	97.5	96.2	107.4	103.9	108.7
Products of mining	116.8	123.6	121.3	156.6	172.6	Agriculture products	93.1	93.7	110.2	101.7	107.8
Coal, lignite, peat	86.2	102.7	115.0	110.7	132.1	Cultivation products	91.0	93.8	108.7	100.6	108.5
Crude oil, natural gas	163.1	146.7	148.1	243.8	284.9	Paddy	90.3	89.8	112.8	99.1	114.3
Metal ores	100.0	0.0	100.0	103.4	119.7	Other food crop products	98.4	88.1	108.6	96.8	104.1
Stone, mining products	113.7	128.6	123.8	140.4	140.2	Industrial crops	90.4	105.4	98.5	105.4	99.3
Processed products	109.1	111.3	113.8	118.6	123.2	Medicinal plant	100.5	91.9	104.5	102.5	90.4
Food and beverage	116.7	116.3	119.3	104.9	125.9	Fruit crops	86.7	100.3	104.4	98.5	112.9
Tobaccos	108.4	108.6	108.0	107.5	108.2	Vegetable, bean, spice	97.2	93.6	114.9	107.0	94.2
Textile products	96.2	103.5	99.6	105.1	111.0	Livestock products	98.9	93.4	114.1	104.3	106.3
Garment	126.2	135.2	148.6	109.4	113.8	Domestic animals	99.8	94.1	114.8	106.2	111.8
Leather, articles of leather	109.4	107.3	114.5	96.4	117.9	Poultry	94.9	86.6	114.4	97.1	106.9
Wood, banjo, species of bamboo	118.4	121.7	127.6	155.9	155.0	Other livestock products	104.4	107.3	110.4	109.7	69.9
Paper and paper products	107.3	125.6	143.1	149.3	150.6	Forestry products	105.4	102.1	102.5	106.8	113.6
Printing, record tapes and disks	102.2	102.8	100.2	102.4	106.4	Exploitation	105.4	102.1	102.5	106.8	113.6
Chemical products	104.0	106.9	109.8	121.1	128.6	Afforestation	105.4	102.1	102.5	106.8	113.6
Rubber, plastic products	92.6	99.2	101.3	113.4	121.0	Fishing products	109.0	99.2	103.5	111.1	106.3
Non metal products	102.4	103.4	104.8	107.3	125.1						
Other metal	118.1	114.8	128.6	133.5	153.8						
Metal articles	115.4	108.2	108.9	103.1	108.8						
Mechinery and equipment	104.8	98.6	97.3	96.6	125.8						
Mechinery, other equipment	114.1	120.6	116.6	119.0	140.2						
Manufacture of radio and communication equipment	109.0	110.3	113.2	107.6	117.1						
Trailer and motor vehicles	105.4	103.4	101.5	103.7	103.2						
Other transport means	99.1	100.3	96.2	101.9	104.9						
Wardrobe, table, chair	117.0	124.6	126.7	137.5	143.4						
Electricity, water supply	138.0	140.1	135.6	146.8	153.7						
Electricity	136.3	136.8	139.7	140.6	145.8						
Water supply	150.0	163.6	153.4	183.8	209.1						

Source: Vietnam General Statistic Office's website

1. The first part of the document discusses the importance of maintaining accurate records of all transactions and activities. It emphasizes the need for transparency and accountability in financial reporting.

2. The second part of the document outlines the various methods and techniques used to collect and analyze data. It highlights the importance of using reliable sources and ensuring the accuracy of the information gathered.

3. The third part of the document discusses the challenges and limitations of data collection and analysis. It identifies common pitfalls and provides strategies to overcome them.