



Vietnam's Lesson for China: An Examination of the Sachs–Woo Hypothesis

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This paper examines the Sachs and Woo hypothesis that the experience of Vietnam's 1989 reforms shows that China would have grown faster had she followed the 'big bang' approach to reform instead of the gradual approach. The paper scrutinises this hypothesis from the viewpoint of accuracy of facts, appropriateness of characterisation, and acceptability of the hypothesis. The paper finds that Sachs and Woo fall short of meeting these criteria. The paper next examines the possible source of Sachs' and Woo's pitfalls and shows that the source lies in the authors' subjective preference for the big bang approach to reform.

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'Nature does not jump! "Quantum theory does not require the existence of discontinuities: neither in time (quantum jumps), nor in space (particles), nor in spacetime (quantum events)"' (Physical Letters A172, 189 (1993))

INTRODUCTION

In several recent papers, Sachs and Woo (1994, 1997, 2000)¹ put forward the hypothesis that Vietnam's experience with her 1989 reforms shows that

¹The journal version of the paper, Sachs and Woo (2000), is almost identical to the NBER Working Paper version, Sachs and Woo (1997), except at a few places. Most of the references in this paper are to Sachs and Woo (2000), other than a few cases where we refer to Sachs and Woo (1997). See also Sachs *et al* (1994).



China would have grown faster had she followed what most economists call the big bang approach to reform instead of the so-called gradual approach. This paper scrutinises this hypothesis from the viewpoint of (a) accuracy of facts, (b) appropriateness of the characterisation, and (c) acceptability of the hypothesis.

So far as facts are concerned, Sachs and Woo (2000) appear to either misunderstand or misrepresent the history of Vietnamese reforms in several important respects. According to them, Vietnamese reforms started to succeed only after 1989. In actual fact, the reforms started much earlier and produced significant positive results during the pre-1989 years. It is the success of these pre-1989 reforms that made it possible for Vietnam to implement the 1989 reforms and withstand the industrial contraction that the 1989 reforms caused.

With regard to the characterisation, this paper shows that Vietnam's 1989 measures do not satisfy either of the big bang's two key characteristics, namely that reform has to be the sudden beginning of a process and that it has to be big, meaning both extensive in terms of economic activities and institutions that are reformed and deep in terms of the changes wrought in the economic mechanism. This paper demonstrates that, first, the 1989 measures were a continuation of efforts made earlier along the same direction. Second, the 1989 changes appear bigger when viewed from the outside than they actually were when seen from the inside. Third, the 1989 measures did not involve any privatisation, regarded generally as a hallmark of big bang reforms.

With regard to the hypothesis itself, this paper shows that it is not acceptable in its either prospective or retrospective interpretations. In 1989, when Vietnam undertook its so-called big bang reform, China was already ahead of Vietnam in terms of reform. Hence, in a prospective sense, there was not much scope for China to raise its growth rate by emulating Vietnam's 1989 measures. On the other hand, China's growth rates during 1978–1989 were already very high by historical and international standards, and were higher than Vietnam's post-1989 growth rates, making it difficult to see how China could have grown any faster during the pre-1989 years by imitating Vietnam's 1989 measures earlier in the period.

This paper finally raises the question why Sachs and Woo fall into the pitfalls mentioned above. It shows that the reason for the pitfalls lies in the authors' subjective preference for the big bang approach. This subjectivity leads them to see big bang reforms and success where these do not exist, and to see failure and departure from gradualism where these are not the case. Sachs' and Woo's subjectivity may have several sources. The epistemological source seems to lie in their lack of appreciation of the dialectics of the reform



process. This lack is reflected in their reluctance to see (i) the time-specificity of various reform measures; (ii) the organic connection between economics and politics in the reform process; and (iii) their often very linear, mechanistic reasoning.

The paper is organised as follows. The next section provides the background and splits the overall research question into four constituent parts. The subsequent section considers the issue of factual accuracy of Sachs' and Woo's assertions. The fourth section examines the appropriateness of their characterisation of the 1989 measures as a big bang reform. The fifth section discusses the acceptability of their hypothesis. The penultimate section examines the reasons behind Sachs' and Woo's pitfalls. The final section concludes the paper.

BACKGROUND

Jeffrey Sachs is one of the architects of the big bang approach to economic transition, and he has played an active role in its implementation in several countries, including Russia. The disappointing results in Russia, on the one hand, and the success achieved by China by following the gradual approach, on the other, have led many to question the merits of the big bang approach. Sachs, however, remains defiant and argues that even China's experience supports the big bang approach. In particular, alluding to Vietnam's 1989 reforms, Sachs and Woo (1997, 2000) put forward the hypothesis that China would have grown faster had she followed the big bang approach to reform. The following passage presents their hypothesis in full:

'Suppose that China had in fact pursued more rapid liberalization of the economy, including a harder constraint on state enterprises and a faster unification of product markets and the market for foreign exchange. How much larger would have been the dislocations in the economy? While we cannot answer this crucial question with any precision, it is instructive to look next door at the case of Vietnam. During 1985–88, Vietnam implemented a gradual reform strategy that did not address serious macroeconomic imbalances. The program failed: inflation and import of rice accelerated while growth performance remained unchanged. In 1989, Vietnam enacted an Eastern-Europe style "big bang," including across-the-board price liberalization, 450 percent devaluation to unify the exchange market and a tight credit policy. The collective farms were returned to family farms with long-term leases. Growth accelerated, inflation ended, agricultural productivity soared (turning Vietnam into a rice exporter in 1989), and small, non-state enterprises proliferated. The "big bang" did not



cause an output decline in Vietnam as in Eastern Europe (Sachs and Woo, 2000, pp. 16–17).

The goal of this paper is to examine the validity of this hypothesis. To facilitate the task, we split the research question into the following three constituent questions. First, how accurate are Sachs and Woo with regard to facts? Second, how appropriate is their characterisation of the Vietnamese 1989 reform measures as a big bang? Third, how acceptable is the Sachs and Woo hypothesis?

HOW ACCURATE ARE THE FACTS?

We begin with the issue of facts. For that purpose, we first list the main factual points that Sachs and Woo try to make in the passage above. The passage claims that:

- (a) The gradualist reforms of Vietnam began in 1985.
- (b) The return from collectivist farming to family farming took place in 1989 and was part of the 1989 big bang.
- (c) The pre-1989 reforms were of no positive effect. As Sachs and Woo put it, ‘inflation and import of rice accelerated’ while ‘growth performance remained unchanged’.
- (d) Pre-1989 reforms did not address ‘serious macro-economic balances’.

In order to examine the accuracy of these claims, it is necessary to take a brief look at the history of Vietnamese reforms.²

Pre-1989 reforms in agriculture

Disappointed by the economic performance during the immediate post-unification years of 1976–1980, Vietnam started major reforms in agriculture beginning in 1981. Vietnam started off in 1976 with considerable euphoria resulting from her stunning victory in 1975 over the United States and reunification of the country under the banner of the Communist Party of Vietnam (CPV). The main goal during 1976–1980 was therefore construction of socialism, which in terms of economic policies for agriculture meant collectivisation and cooperativisation, particularly in the South. At the beginning, both campaigns were conducted with some gusto. However, the perils of imposing collectivisation on a pre-industrial agriculture began to

² Detailed accounts of early years of Vietnamese reforms can be found in, among others, Arkadie and Mallon (2003), De Vylder and Fforde (1988), Fforde and Vylder (1996), Riedel (1995), Riedel and Comer (1997), and Tran (1994).



surface soon. Inefficiency of production was the pervasive passive form of these perils. However, in the South, particularly in the Mekong delta, they took the active form of leaving large tracts of land uncultivated and slaughtering large numbers of cattle.

Alarmed by these developments and in the midst of the gloom that had set in, the Sixth Plenum of the CPV CC, held in August–September of 1979, decided to reduce the pace of transformation and change its direction. In particular, it decided to introduce what came to be known as the ‘Contract System’, directed towards household/family farming and away from collective farming. The switch was formalised in the form of Resolution 100 adopted by the Central Secretariat of CPV on 13 January 1981. The move was backed by decisions of the 5th Congress of CPV held in 1982.

The *Doi Moi* programme adopted by the CPV Sixth Congress in 1986 helped agricultural reforms to progress further. Following the Congress, the National Assembly passed a ‘Law on Land’ in its December 1987 session. This Law, enacted in 1988, conferred long-term private land use rights for agricultural purposes to rural families.³ Also, Party Resolution No. 10, passed on 5 April 1988 by the Politburo of the CC CPV, greatly enhanced the rights of rural families and reduced the legal authority of village cooperatives. This resolution allowed farmers to hold about 40% of the contracted output and thus encouraged them to supply more labour as well as to invest capital. In many areas, farmers raised funds for building irrigation works and purchasing draught power, buffaloes and oxen, and even small agricultural machinery. They also took the initiative to apply new technology and introduced new varieties to increase yield.

Were these reforms of no effect, as Sachs and Woo suggest? Contrary to their suggestion, the pre-1989 reforms actually brought about a marked positive change in Vietnamese agriculture (see Table 1 and Figure 1). While the average annual growth rate of gross agricultural production for the 1976–1978 period was a negative 3.8%, it jumped to 5.1% during 1979–1988. If 1979 and 1980 are left out as years of recovery from natural disasters and wars with China and Cambodia,⁴ the average annual growth rate for 1981–1988 turns out to be 4.4%, a significant increase over the previous period’s growth rate. Going across the columns of Table 1, we see

³ The ‘land use rights’ are not the same as ‘private property rights’, which include the right to sell the land.

⁴ In addition, there was considerable decline towards the end of 1970s in the amount of aid that Vietnam was receiving, primarily from the East European socialist countries belonging to the COMECON (Council of Mutual Economic Assistance) bloc.

**Table 1:** Impact of pre-1989 reforms on Vietnamese agricultural production (Growth rates in percentage)

Year	Gross agricultural production: Annual growth rate (%) (Tran, 1994, pp. 114–116)	Gross agricultural production from cultivation: Annual growth rate (%) (Tran, 1994, pp. 114–116)	Gross agricultural production from livestock: Annual growth rate (%) (Tran, 1994, pp. 114–116)	Production of food crops in rice equivalent: Annual growth rate (%) (Tran, 1994, pp. 114–116)	Yield of food crops in rice equivalent: Annual growth rate (%) (Tran, 1994, pp. 114–116)	Paddy production growth rate (%) (Minot and Goletti, 2000, p. 44)	Population growth rate (%) (Minot and Goletti, 2000, p. 44)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1976						11.7	3.3
1977	−5.6	−8.9	8.7	−6.3	−12.4	−10.7	2.4
1978	−1.8	−0.7	−6.0	−2.8	−4.7	−7.9	2.0
1979	8.7	9.5	5.4	14.0	11.6	15.1	2.1
1980	7.5	6.6	11.1	3.0	1.0	1.7	2.3
1981	4.4	1.5	15.3	4.2	5.4	6.7	2.2
1982	11.3	12.3	8.1	12.2	12.6	15.0	2.3
1983	3.3	1.3	10.3	0.9	3.7	2.1	2.1
1984	5.3	5.5	4.4	4.8	4.0	5.3	2.2
1985	2.5	2.8	1.5	2.3	1.9	2.6	2.0
1986	4.8	3.0	10.6	1.0	1.5	0.6	2.0
1987	0.4	−2.4	9.1	−4.4	−3.0	−5.8	2.3
1988	4.3	7.5	−4.8	11.5	7.3	11.9	1.9
1989	7.4	7.8	6.3	9.9	7.8	11.1	1.7
1990	1.6	1.0	3.2	−0.1	−0.3	1.0	2.1
1991	1.1	0.6	3.0	2.3	−2.3	2.0	2.4
1976–1980	2.0	1.4	4.5	1.7	−1.5	−0.4	3.0
1981–1985	5.4	5.3	5.8	4.8	5.3	6.0	2.1
1981–1988	4.4	4.1	5.3	3.8	3.8	4.5	2.1

Source: Columns (2) through (6) are also based on GSO (2000b, pp. 77–78, p. 178, p. 190, and p. 201). The growth rates for 1976–1980, 1981–1985, and 1981–1988 are compound annual averages of respective periods.

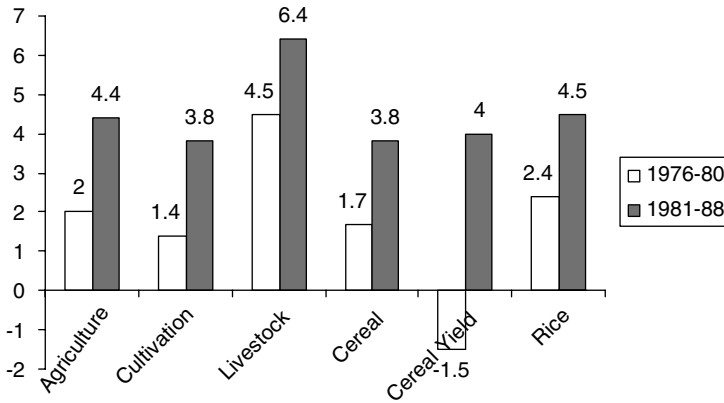


Figure 1: Impact of the pre-1989 reforms on the performance of Vietnamese agriculture: Comparison of average annual growth rates (%) during 1976–1980 and 1981–1988.

that the turnaround was wide-ranging, covering both cultivation and livestock.⁵

Table 1 also shows that, contrary to Sachs’ and Woo’s claim, the 1989 measures did not have much, if any, positive impact on Vietnamese agriculture. It is true that the overall growth rate of agriculture in 1989 proved to be higher than in 1988. However, this was largely a result of a rebound from a downturn in livestock in 1988. Looking at cultivation, we find that growth rates in 1989 and 1988 were similar, 7.5 and 7.8%, respectively. In fact, the growth rate of paddy production was actually lower in 1989 than in 1988, 11.1% compared to 11.9%. Furthermore, the performance of Vietnamese agriculture deteriorated sharply in the immediate post-1989 years (Table 1).⁶

Sachs and Woo make much of Vietnam’s export of rice in 1989. According to them, while rice imports were ‘soaring’ in the previous years,

⁵ Cereal production underwent a dramatic improvement, with the average annual growth rate increasing from –4.7 to 4.7 between the periods of 1976–1978 and 1979–1988, respectively. Much of this increase resulted from increase in yield, which is not surprising given that arable land in Vietnam is very limited. While the yield of food crops had decreased at an annual rate of 9.1 during 1976–1978, it increased at a rate of 4.4% during the whole period of 1979–1988. Even Riedel and Comer, who are sympathetic to Sachs’ and Woo’s view, concede that ‘the response to this reform was ... a remarkable acceleration in agricultural output’ (Riedel and Comer, 1997, p. 6).

⁶ The annual growth rate of agriculture in 1990 and 1991 proved to be only 1.6 and 1.1%, respectively. The production of cereals actually fell in 1990 compared to that of the previous year, and the yield of food crops fell in both 1990 and 1991.



the 1989 measures created a miracle for Vietnamese agriculture, so that all of a sudden there was a huge increase in production and exporting of rice began. In fact, Vietnam's annual rate of growth of paddy production increased from 2.4%, less than the population growth rate of 3.0%, during 1976–1980 to 4.5%, more than twice the population growth rate of 2.1%, during 1981–1988 (Tables 1 and 2). Over time, therefore, the Vietnamese had more rice to consume and eventually to export. Per capita consumption of rice rose from 126 to 150kg between 1981 and 1988 (Table 2). Instead of 'soaring', Vietnam's imports of rice during the years immediately preceding 1989 actually *decreased* from 0.4 million tons in 1986 to 0.1 million tons in 1988. Furthermore, Vietnam's exports of rice increased from 9 thousand tons in 1981 to 132 thousand tons in 1986 (GSO, 2000b, p. 11).⁷ What happened in 1989 was mainly a price effect arising from devaluation, which made export more lucrative than domestic sales. That is why Vietnam's rice export in 1989 was associated with a significant decline in per capita consumption, which fell from 150 in 1988 to 142kg in 1989, and remained less than the level reached in 1988 until 1993.⁸

Pre-1989 reforms in industry

Vietnamese industrial reforms also started with the August–September 1979 CPV CC Sixth Plenum. The industrialisation strategy pursued during the 1970s was influenced by the Soviet model, with emphasis on capital-intensive heavy industry, and was executed through a command system. This led to inefficiencies. For example, the output–capital ratio decreased from 1.48 in 1976 to 0.87 in 1980 (Tran, 1994, pp. 27–28).

The CPV CC Sixth Plenum of 1979 therefore decided to reform the state-owned enterprises (SOE) in the direction of self-accounting and self-financing. Following the Plenum's decision, the Vietnamese government promulgated its Decision 25 on 21 January 1981. Under the new system, SOEs were subject to three plans and hence the name 'Three Plan' system. Under

⁷ The rising agricultural capability was not limited to rice. Table 2 shows a steady increase in Vietnam's exports of agricultural commodities throughout the 1980s. Between 1981 and 1988, Vietnam's export of tea, coffee, rubber, and peanuts increased by 82.7, 1140.7, 63.8, and 6381.8%, respectively.

⁸ There is a similarity in this regard to what happened in Vietnam's oil and gas sector. Vietnam has been conducting, with Soviet help, exploration for a long time during the 1970s and 1980s. However, coincidentally, oil output for export became available around 1989. It is therefore inaccurate to imply that Vietnam suddenly became capable of exporting oil in 1989 as a result of measures taken in that year, just as it is inaccurate to suggest that the production capability to export rice was created overnight in 1989 due to the measures taken in that year. In fact, the rice output increase in 1989 was in part the outcome of coming on stream of some works in the Mekong delta area (*Dong Thap Muoi*). I would like to thank a referee for pointing this out.

Table 2: Impact of pre-1989 reforms on Vietnamese agricultural exports

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
1975		10.5	144	-0.3	130			
1976	49.2	11.8	156	-0.1	137	8.5	1.5	
1977	50.4	10.6	137	-0.2	121	2.1	1.0	
1978	51.4	9.8	124	-0.1	107	3.5	0.1	
1979	52.5	11.4	141	-0.1	122	2.8	0.7	
1980	53.7	11.6	141	-0.2	124	4.0	0.5	
1981	54.9	12.4	147	0	126	2.7	1.1	
1982	56.2	14.4	167	-0.2	146	4.2	4.3	
1983	57.4	14.7	167	0	143	4.6	16.2	
1984	58.7	15.5	172	-0.2	151	3.9	17.9	
1985	59.9	15.9	172	-0.3	152	9.2	24.8	
1986	61.1	16.0	170	-0.4	151	24.0	43.2	
1987	62.5	15.1	157	-0.2	138	25.6	56.3	0.3
1988	63.7	17.0	173	-0.1	150	33.5	71.3	0.7
1989	64.8	19.0	191	1.4	142	57.4	38.5	1.5
1990	66.2	19.2	189	1.6	137	89.6	70.7	2.7
1991	67.8	19.6	188	1.0	146	93.5	78.9	4.0





Plan One, the enterprises were provided with inputs at subsidised prices and in turn were required to supply set quantities of goods to the state at set prices; under Plan Two, enterprises could produce beyond the amount specified in Plan One and use revenues to purchase additional inputs; Plan Three gave enterprises the right to engage in sideline activities more or less on a free market basis, what became known as the ‘fence-breaking’ (*xe rao*) movement (Riedel and Comer, 1997, p. 6). Another decision issued around this time allowed enterprises to link managerial salary to output. Enterprises were allowed to retain up to 85% of the profits made from outside-plan production and to use these retained profits for paying bonuses to workers.

These reforms were initiated during 1979–1981 and were strengthened further by the *Doi Moi* programme adopted at the CPV Sixth Congress. In general, renovation of the management mechanism, rather than investment promotion, was given priority as the way to enhance industrial production. Following the Congress, the Vietnamese government in late 1987 promulgated Decree 217 that set forth a broad reform programme aimed at putting SOEs on a commercial footing, with increased autonomy and financial responsibility (Arkadie and Mallon, 2003, p. 125).

These changes implied altogether different types of relationships among SOEs and business entities in general, which were now based on economic contracts instead of directives from above. The government established economic arbitration offices to facilitate enforcement of contracts. By creating a fundamentally different environment for SOEs operations, these changes led to a significant improvement in their performance (Brabant, 1990, p. 216).

The pre-1989 industrial reforms were not limited to SOEs. Another direction in which these reforms proceeded was the development of non-state-owned enterprises (NSE). First, there was a basic change in the understanding of the role of the government in the industrialisation process, which was now recognised more in creating conditions and ‘building the necessary premises’ for industrialisation rather than actually carrying out. Second, in line with this changed attitude, the government took measures to facilitate the creation of enterprises under cooperative and individual ownership. As a result, the number of NSEs jumped from 3,799 in 1981 to 350,909 in 1988 (GSO, 2000a, p. 249). Thus, contrary to Sachs’ and Woo’s claim, the explosion in the number of NSEs in Vietnam started as a consequence of the pre-1989 reforms and did not wait for the 1989 measures.⁹

⁹ As a result of their rapid growth, the share of NSEs in the total industrial output rose from 39.8% in 1981 to 43.5% in 1988 (Table 3). Another reflection of the growth of NSEs, which were more often under local than central jurisdiction, can be seen in the changes in the relative weights of central and local enterprises. As Table 3 shows, between 1981 and 1988, the share of local

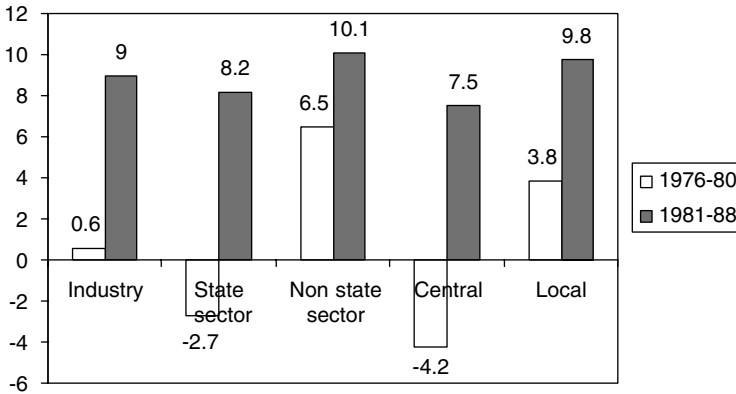


Figure 2: Impact of the pre-1989 reforms on the performance of Vietnamese industry: Comparison of average annual growth rates during 1976–1980 and 1981–1988.

The increase in efficiency of the SOEs and the rise of the non-state sector combined to bring about a turnaround in Vietnam’s industry. While the average rate of industrial growth during 1976–1980 was only 0.6%, it accelerated to 9.0% during 1981–1988 (Table 3 and Figure 2).¹⁰ Even Riedel and Comer (1997, p. 6) concede that ‘in industry, also, the introduction of even a limited amount of economic freedom had a tremendous effect, with industrial growth rising from an average of 0.6 percent in the Second Five-Year Plan to about 7 percent in the Third’.

Table 3 also shows that, contrary to Sachs’ and Woo’s claim, the 1989 measures did cause a contraction in the industrial sector. The growth rate of industrial output decreased from a high 14.3% in 1988 to a negative 3.3% in 1989. The contraction applied to both the state and non-state sectors whose output declined by 2.5 and 4.3% in 1989 after increasing at 15.5 and 12.9%, respectively, in 1988.¹¹

enterprises rose from 63 to 67.8% while the share of central enterprises in total industrial output decreased from 37 to 32.2%. The percentage change in the weight of NSEs in the total output appears small compared to the dramatic increase in their number. This is because most of the NSEs set up at that time were very tiny in size.

¹⁰The turnaround was more dramatic in the state sector than in the non-state sector. The average growth rate of industrial output in the state sector rose from –2.7% during 1976–1980 to 8.2% during 1981–1988, while the analogous growth rates for the non-state sector were 6.5 and 10.1%, respectively. The fact that during these years only state enterprises were allowed to enter into joint venture projects with foreign enterprises is one reason for faster growth in the state sector. A similar situation can be seen in the relative changes in the growth rates of the central and local enterprises.

¹¹The industrial sector remained depressed in 1990, growing at only 3.1%, with the non-state sector undergoing a further contraction by –0.7%.

**Table 3:** Impact of pre-1989 reforms on the performance of Vietnamese industry (Growth rates in percentages)

(1)	Growth rate of Industrial production (Total) (%) (2)	Growth rate of Industrial production (Central) (%) (3)	Growth rate of Industrial production (Local) (%) (4)	Growth rate of Industrial production (State) (%) (5)	Growth rate of Industrial production (Non-state) (%) (6)	Share of local enterprises in total Industry Output (%) (7)	Share of non-state enterprises in total industry output (%) (8)
1976						55.9	31.4
1977	10.8	16.4	6.4	11.8	8.7	53.6	30.8
1978	8.2	2.8	12.7	5.8	13.4	55.9	32.3
1979	-4.7	-14.5	2.9	-10.4	7.0	60.4	36.3
1980	-10.3	-17.2	-5.7	-15.2	-1.6	63.5	39.8
1981	1.0	2.4	0.2	-1.0	4.0	63.0	41.0
1982	8.7	4.7	11.0	4.0	15.5	64.4	43.6
1983	13.0	11.2	14.1	11.6	14.9	64.9	44.3
1984	13.2	12.0	13.8	14.3	11.8	65.3	43.8
1985	9.9	7.6	11.1	10.0	9.7	66.0	43.7
1986	6.2	5.6	6.5	6.2	6.2	66.2	43.7
1987	10.0	6.8	11.6	9.3	10.9	67.2	44.1
1988	14.3	12.3	15.3	15.5	12.9	67.8	43.5
1989	-3.3	5.9	-7.6	-2.5	-4.3	64.7	43.0
1990	3.1	15.3	-3.5	6.1	-0.7	60.6	41.4
1991	10.4	15.5	6.1	11.8	7.4		
1976–1980	0.6	-4.2	3.8	-2.7	6.5		
1981–1985	10.6	8.5	11.8	9.6	12.2		
1981–1988	10.2	8.2	11.2	9.4	11.0		

Source: Tran (1994, p. 149).

Notes: Non-state includes enterprises under cooperative and private ownership. The growth rates for 1976–1980, 1981–1985, and 1981–1988 are compound annual averages of respective periods.



Pre-1989 reforms in trade, service, and crafts

The pre-1989 reforms also extended to the tertiary sector. By allowing free disposal of above-quota output, the Contract System led to the development of a free market in rural areas. This in turn stimulated the handicrafts and small scale service sector enterprises. The process benefited further from many complementary measures taken by the government. For example, in early 1987 many checkpoints restricting domestic trade were removed. Many administrative restrictions on private trade were also lifted (Arkadie and Mallon, 2003, p. 69).

The introduction of the Three Plan system in industry similarly led to the development of a free market in industrial products, thereby stimulating further increases in trade and services. There was a huge increase in the number of privately owned businesses, shops, restaurants, etc, as reflected in the dramatic rise in the number of NSEs reported earlier.¹² The reforms in the area of trade and crafts had a significant positive impact too. The average growth rate of the service sector, including trade, rebounded from a negative 0.1% during 1976–1980 to 4.7% during 1981–1985 and increased further to 8.7% during 1986–1990.

Reforms in the external sector

The pre-1989 reforms spread to the external sector too. First of all, there was a significant relaxation of restrictions on participation in external trade. SOEs were now allowed to engage in international trade on their own. Initially, only large-scale enterprises were allowed to do so, and they were permitted to retain only a portion of foreign exchange earnings. However, soon further reforms ensued, extending to a wider set of SOEs the right to engage in external trade and to retain a larger portion of their earnings.¹³ Second, following the Law on Export and Import Duties on Commercial Goods promulgated in December 1987, most quotas were eliminated and replaced by import duties. Third, in 1988 a Foreign Investment Law was passed by the National Assembly. This law provided guarantees against expropriation, allowed full repatriation of profits, and provided tax holidays in order to

¹² As Riedel and Comer (1997, pp. 9–10) observe, ‘Private economic activity did, however, blossom in the informal commercial sector immediately after *Doi Moi* as doors of restaurants and shops opened almost as fast as they had closed during the purge of the private sector in 1978.’ See also Tran (1994, p. 33). Private economic activity obviously flourished further after the reforms of 1989. See Wood (1989) for more details.

¹³ As UNDP–World Bank (1994, p. 48) notes, ‘another early important step in the *Doi Moi* program was the *elimination of the state monopoly of foreign trade in 1988*, allowing the establishment of foreign trade organisations (FTOs) and permitting some firms to engage directly in international trade outside the FTOs’.



encourage foreign direct investment. Altogether, these measures made it easier for foreign capital to flow into Vietnam, and SOEs, which were initially the only ones allowed to set up joint ventures with foreign firms, made active use of these opportunities.¹⁴

Overall positive effects of pre-1989 reforms

The combined outcome of pre-1989 reforms was a significant turnaround in the overall performance of the Vietnamese economy. The average GDP growth rate rose to 5.4% during 1981–1988 from only 0.5% during 1976–1980 (Table 4 and Figure 3). The turnaround spread across both state and non-state sectors, with their average annual GDP growth rate increasing from –2.8 and 2.0 during 1976–1980 to 6.8 and 5.2 in 1981–1988, respectively. It is this wide-ranging positive turnaround of the economy resulting from pre-1989 reforms that made it possible for the Vietnamese economy to withstand the industrial contraction caused later by the 1989 measures.

Conclusions regarding facts

Thus, we see that, contrary to the claims of Sachs and Woo, what we have is the following:

- (a) Gradual reforms in Vietnam began in 1981, and in some sense in 1979, and not in 1985.
- (b) The return from collectivist to family farming started in 1981 and was by and large complete before 1989. It was not a part of the 1989 package.
- (c) The gradual reforms of the pre-1989 years did produce significant positive results, which in turn allowed Vietnam to withstand the industrial contraction caused by the 1989 measures.
- (d) Some of the pre-1989 reforms were also directed at reducing macroeconomic imbalances. We take up this last point for discussion in the next section.

HOW APPROPRIATE IS THE CHARACTERISATION?

Sachs and Woo give the impression that no pre-1989 reform efforts were directed at Vietnam's macroeconomic imbalances. A closer look shows that this is not true. According to Sachs and Woo, Vietnam's big bang of 1989 consisted of the following measures: (a) across-the-board price liberalisation;

¹⁴ 'In addition to freeing up international trade, another early step was a new law permitting and even encouraging foreign direct investment, by providing tax holidays guaranteeing against expropriation, and allowing full repatriation of profits' (Riedel and Comer, 1997, p. 10).

Table 4: Overall impact of pre-1989 reforms on Vietnam's GDP

(1)	GDP in 1994 prices Total (Nguyen <i>et al.</i> , 2002, pp. 267–268; GSO, 2000a, p. 29) Billion dong	GDP growth rate (Nguyen <i>et al.</i> , 2002, pp. 267–268; GSO, 2000a, pp. 27–29)	GDP in 1994 prices Service (Nguyen <i>et al.</i> , 2002, pp. 267–268; GSO, 2000a, p. 29) Billion dong	Service sector GDP growth rate (Nguyen <i>et al.</i> , 2002, pp. 267–268; GSO, 2000a, p. 29)	Economic Growth Rate in State sector (GSO, 2000a, p. 27)	Economic Growth rate Non-state Previous Year=100 (GSO, 2000a, p. 27)
	(2)	(3)	(4)	(5)	(6)	(7)
1976	76,376					
1977	79,202	5.3			6.4	4.6
1978	79,757	1.1			2.1	3.0
1979	80,235	–1.8			1.6	–3.6
1980	77,908	–3.6			–16.9	4.0
1981	80,635	2.3			1.6	2.6
1982	87,166	8.8			2.3	10.8
1983	92,832	7.2			2.0	8.6
1984	100,166	8.3			18.8	5.6
1985	106,176	5.7	42,948		14.8	3.0
1986	109,189	2.8	41,973	–2.3	1.7	3.7
1987	113,154	3.6	43,893	4.6	5.7	2.1
1988	119,960	6.0	47,744	8.8	7.6	4.8
1989	125,571	4.7	51,497	7.9	–1.8	9.8
1990	131,968	5.1	56,744	10.2	–3.5	11.2
1991	139,634	5.8	60,934	7.4	6.6	5.3
1976–1980		0.5			–2.8	2.0
1981–1985		6.9			7.9	6.1
1981–1988		5.7			6.8	5.2

Note: The growth rates for 1976–1980, 1981–1985, and 1981–1988 presented in column (3) are compound annual average for respective periods. However, analogous growth rates presented in columns (6) and (7) and simple arithmetic averages of annual growth rates for respective periods.



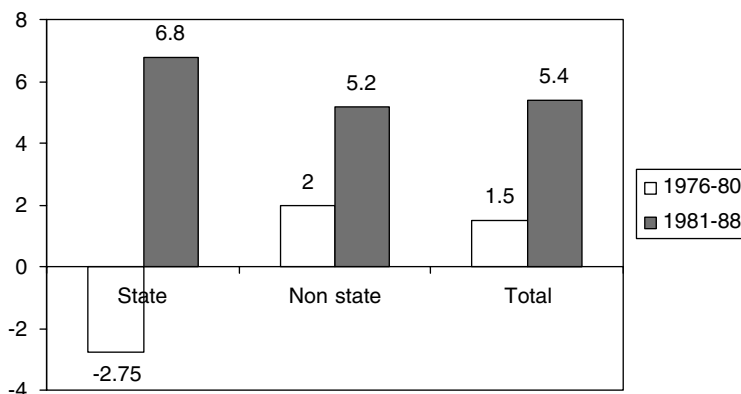


Figure 3: Overall impact of the pre-1989 reforms on Vietnam's GDP: Comparison of average annual growth rate between 1976–1980 and 1981–1988.

(b) devaluation and unification of the foreign exchange market; (c) tight credit policy; (d) return of the collective farms to family farms through long-term leases. We have already seen that the inclusion of item (d) is incorrect. This leaves us with items (a)–(c). Going by the conventional terminology of the transition literature, (a) and (b) can be grouped together as liberalisation measures, while (c) may be classified as a stabilisation measure. In considering whether it is appropriate to characterise Vietnam's 1989 measures as a big bang, we notice that the notion of big bang usually has two connotations: first, it has to be the sudden beginning of a fundamentally new process, and, second, it has to be something big. Let us examine whether Vietnam's 1989 reform measures satisfy these requirements.

Vietnam's 1989 measures: were they the beginning?

The reforms introduced in Vietnam in 1981, alongside their general positive impact, had some negative consequences. The most prominent among these was inflation. In the pre-reform years, when prices in Vietnam, as in other centrally planned economies, were controlled administratively, inflationary pressures remained generally suppressed, finding an outlet only in illegal black markets. The reforms since 1981, however, led to the development of a thriving market in both rural and urban areas setting the stage for visible inflation.

Friedman argued that inflation is always and everywhere a monetary phenomenon. Excess money supply was the main cause of inflation in Vietnam too. There were two main sources of excess money supply, the first of which was subsidies given to SOEs in the form of budgetary grants and concessionary credits. Introduction of enterprise autonomy under the Three



Plan system, while SOEs were still very much under soft budget constraints, led to some unintended consequences. In particular, the SOEs found it convenient to divert more resources to Plan Three, catering for the free market, and run deficits on Plan One catering for the Plan Sector. They could then turn to the state budget and/or banking system for subsidies to cover their deficits on Plan One.¹⁵ The second source of inflation was the subsidies to products for consumption, particularly by urban dwellers. Together, these led to a situation of rising output associated with rising inflation (Brabant, 1990, p. 213; Riedel and Comer, 1997, p. 8).

Table 5 helps to understand the process. We see that the budget deficit as a percentage of revenue jumped from an average of 2.5 during 1976–1980 to 18.1 in 1981. At the same time, credit on working capital jumped 4.3-fold from 8.3 billion Dongs in 1980 to 36.0 billion in 1981. It is not surprising that inflation; measured by the General Price Index, after averaging 20% growth annually during 1976–1980, jumped to 70% in 1981. During the subsequent 1982–1984 period, the government succeeded in restraining the budget deficit. However, this was offset by the expansion of credit, which grew at an average annual rate of 32.8% between 1981 and 1984. Accordingly, inflation during the 1982–1984 period was high, averaging about 70% per annum. Such high rates of inflation undermined the gains of reforms, hurting in particular government officials and other state sector employees on fixed salaries. It therefore became imperative, on both economic and political grounds, to control inflation.

In 1985, Vietnam took some drastic measures to curb inflation. On 17 June 1985, the 8th Plenum of CPV CC adopted the Resolution on ‘Price-Salary-Money’ to eradicate subsidies through equivalent increase in prices and salaries. The goals were as follows: (i) to raise salaries and wages to compensate for the erosion these underwent during 1981–1984; (ii) to monetise the in-kind components of salary and wages; (iii) to bring market and plan prices closer by withdrawing subsidies; and (iv) to increase salaries and wages to adjust for rise in prices of commodities resulting from subsidy withdrawal (Brabant, 1990, pp. 213–214; Tran, 1994, p. 33).

In addition to the above, Vietnam in 1985 also undertook currency reforms by introducing the new Dong, equivalent to 10 old Dong. To restrict private consumption and improve the money balance in the economy, each person was allowed to convert only a limited amount of deposits, with the remaining kept at the State Bank as long-term deposits.

¹⁵ While emphasising subsidised financing of SOEs as a source of inflation, it should be noted that there is a distinction between ‘passive’ and ‘active’ money and that SOE credits were not necessarily monetised.

**Table 5:** Inflation in Vietnam and its sources

(1)	General price index Previous year=100 (Tran, 1994, p. 179; GSO, 2000a, p. 378)	Other consumer price index, previous year=100, (Tran, 1994, p. 179; GSO, 2000a, p. 378)	Deficit as % of revenue (Tran, 1994, p. 101)	Revenue from foreign countries as % of state budget revenue (Tran, 1994, p. 102)	Credit on working capital Total (end of year) Million Dong (Tran, 1994, p. 108)	Credit on working capital State (end of year) Million Dong (Tran, 1994, p. 108)	Credit on working capital Cooperative (end of year) Million Dong (Tran, 1994, p. 108)	Credit on working Capital (private and other (end of year) Million Dong (Tran, 1994, p. 108)
(1)	(2)	(4)	(6)	(7)	(8)	(9)	(10)	(11)
1976	121.9	109.6	-2.6	44.8	4,649	4,146	408	94
1977	118.6	108.6	-1.5	34.5	5,664	5,034	532	97
1978	120.9	104.4	-2.8	32.0	6,030	5,339	596	94
1979	119.4	116.0	-4.6	40.7	6,193	5,460	637	95
1980	125.2	117.8	-1.0	38.9	8,302	7,590	609	103
1981	169.6	195.1	-18.1	22.5	36,013	35,737	101	174
1982	195.4	205.4	-8.1	28.8	45,322	43,126	1,950	246
1983	149.5	138.8	-3.9	21.6	62,970	59,721	2,924	325
1984	164.9	179.9	-3.6	13.7	96,286	90,504	5,436	346
1985	191.6	190.8	-36.6	25.1	36,166	34,404	1,727	35
1986	487.3	492.7	-23.4	14.6	111,622	102,162	8,641	819
1987	301.3	289.3	-20.9	10.2	400,252	360,173	30,098	9,981
1988	308.2	265.0	-33.6	17.3	1,718,697	1,480,114	255,545	43,650
1989	134.7	118.8	-34.2	21.6	3,229,083	2,787,012	268,158	173,913
1990	167.5	155.8	14.5	22.9	4,210,000	3,736,000	474,000	
1991	167.6	170.6	13.8	5.0	7,993,000	7,226,000	767,000	



Additional price reforms were implemented in mid-1987, raising the official price of most consumer goods closer to market prices and reducing even more the scope of rationing. At about the same time, 1985–1986, Vietnam implemented a substantial devaluation, bringing the value of the Dong down from 15 per dollar to 80. The government also took steps to streamline administration by reducing the number of line ministries, state committees, and other central government agencies, and by rationalising their structure.

Unfortunately the reforms of 1985 and 1987 failed to control inflation for the following reasons: first, the additional fiscal burden from increases in salaries, monetisation of in-kind payments, etc. outweighed the reduction in the fiscal burden from the withdrawal of subsidies. As a result, the budget deficit soared from 3.6% of revenue in 1984 to 36.6% in 1985, and it remained high, averaging at 28% of revenue during 1986–1989 (Table 5). Second, the volume of credit, after undergoing a marked contraction in 1985, expanded 15-fold between 1986 and 1988. Not surprisingly, inflation soared and averaged 222% per annum during 1985–1988.

The government's failure to mobilise private savings to cover the government budgetary deficit and expansion of credit was an important cause of inflation. There were two reasons for this failure. The first was the government's failure to realise the importance of and/or inability to ensure positive real interest rates to entice private savings into the formal financial system. The second was the availability, particularly in the south of the country, of dollars as an alternative medium of exchange and savings, in addition to gold. As a result of these two factors, the substantial surplus generated by the successful initial, in particular agricultural, reforms remained outside the reach of the formal financial system. The currency swap of 1985 and associated restrictions on withdrawals of deposits aggravated the situation by making people more reluctant to place their savings in the formal system. In the absence of domestic savings and in the face of dwindling external savings, especially loans and grants from the former COMECON countries and the western world, the government resorted to inflationary financing.

What is important to note is that Vietnam did take important steps during the pre-1989 years to address macroeconomic imbalances, even though these steps did not prove successful. The measures of 1989 were therefore a continuation of these ongoing efforts. Also, these reforms did not end with the 1989 measures, and follow-up steps were taken during 1989–1992 to keep prices in alignment. The 1989 measures were therefore neither the beginning nor the end of Vietnam's efforts at macroeconomic stabilisation.



Vietnam's 1989 measures: were they big?

Some of the changes introduced in 1989 were indeed apparently big. However, a close scrutiny shows that these changes were bigger when viewed from the outside than they were in essence. With regard to unification of product prices, it may be noted that much of the rural sector, representing about 70% of the economy and 80% of the population, was already tuned to market prices and operated outside plan prices. Hence, the unification of agricultural product prices did not have much effect in rural areas. Similarly, implementation of the Three Plan system made a significant part of the urban sector accustomed to free market prices of industrial goods.¹⁶ The effect of unification of prices was therefore mostly limited to the relatively narrow sphere of SOE interaction among themselves.

With regard to unification of foreign exchange markets, again, the actual impact was less than what the apparent size of devaluation would suggest. One of the reasons was the previously noted wide prevalence of dollars for accounting, exchange, and as a store of value. Much of the private sector's savings was also hedged against the devaluation of the Dong by switching to dollars and gold. The devaluation therefore did not have much effect on dollar-denominated transactions and on savers' net worth.

The main sting of the 1989 measures was therefore not in liberalisation but in stabilisation, which took several forms. The first was the reduction of government expenditure on public administration by, for example, restraining civil servants' wage increases to a rate below that of inflation and by demobilising half a million soldiers. The second was a reduction in public investment programmes. As a result of these two steps, the government's budgetary balance changed from a 34.2% (of revenues) deficit in 1989 to a 14.5% surplus in 1990, and it then remained on the surplus side for the subsequent year (Table 5). The third was a hardening of the SOE budget constraint. Fourth, the positive real interest rates and the 'No Questions Asked'-policy regarding deposits enticed savings that could be used to match expanding credit. As a result of these measures, inflation started to decrease, falling from about 200% in 1988 to 35% in 1989. However, inflation rebounded and reached pre-1989 levels of about 70% in both 1990 and 1991, making further measures necessary (Brabant, 1990, p. 214).

These stabilisation measures, however, led to an industrial contraction, which Vietnam was able to withstand because of the continued buoyancy of the agriculture and service sectors owing to the pre-1989 reforms, a buoyancy

¹⁶ Fforde and de Vylder (1996) provide more detail. In particular, their Table 4.1 shows how close to 'free market prices' the 'state staple buying prices' had already become by 1988.



that also enabled these sectors to absorb the half-million demobilised soldiers. In view of the dependence of the 1989 measures on the outcomes of the pre-1989 reforms, many internal and perceptive external observers did not attach separate importance to the 1989 measures. For example, Tran, one of the acclaimed internal Vietnam commentators, hardly mentions the 1989 measures in his account of the reform process. Instead, he emphasises that the achievements of Vietnam ‘are the results of a long research and test process, not simply a “leap” in 1989’ (Tran, 1994, p. 23). Similarly, Arkadie and Mallon (2003, p. 69), two perceptive external observers, note that ‘while some commentators focus on the reforms implemented from 1989 onwards, important micro-level reforms were introduced from 1986 that resulted in a strong supply response that greatly improved the environment for the successful implementation of the subsequent macro-level reforms’.

What about privatisation?

Sachs (1994) recognises that, in the early years of transition, many proponents of the big bang thought of privatisation as the first task, in particular due to their apprehension that stabilisation and liberalisation measures would not succeed without privatisation being carried out first.¹⁷ This conception of the big bang, according to which the whole process should start with privatisation, may be called the original definition. Subsequently, Sachs presented a modified definition, according to which privatisation was ranked as the third task, a task that was nevertheless to be undertaken alongside stabilisation and market liberalisation, the other two tasks. For example, in discussing the Polish big bang, Sachs clearly mentions that ‘the third step of the reform process should be privatization’ (Lipton and Sachs, 1990, p. 101). Similarly, in discussing the Russian big bang, Sachs repeats the same view, declaring that ‘the third task is privatization’ (Lipton and Sachs, 1992, p. 229). Thus, privatisation remains an integral part of the big bang package. As Sachs (1994, p. 31) explains, ‘Shock therapy presupposes that rapid privatisation will be initiated *at the time* of stabilisation and liberalisation, so that after a few years, the economy will be not only market-oriented, but predominantly privately owned’.

Against this backdrop, it is worthy of note that Sachs and Woo’s list of big bang measures taken by Vietnam in 1989 does not mention privatisation at all.

¹⁷ ‘Before 1989, a common view among reformers in the East was that market stabilisation and liberalisation in advance of privatisation would prove futile: the state-owned enterprises would not adjust to market forces, and would find ways to reassert “soft budget constraints,” thereby undermining stabilization’ (Sachs, 1994, p. 31).



At a different place in the paper, however, Sachs and Woo provide the following more general definition of big bang:

‘In our usage, Big Bang reforms include: rapid and comprehensive price and trade liberalization, macroeconomic stabilization, alignment of the official exchange rate to the market rate, ending legal discrimination against all types of non-state enterprises, and an early commitment to mass privatization of SOEs, recognizing that actual privatization will take several years in practice’ (Sachs and Woo, 1997, p. 5, emphasis added).

This new definition includes only ‘early commitment to mass privatisation of SOEs’ and leaves out actual privatisation and may be called the re-modified definition of big bang. Needless to say, the treatment of privatisation in the re-modified definition differs quite starkly from its treatment in the previous two definitions, either the original or the modified.¹⁸

Regardless of the definition used, it is important to note that Vietnam’s 1989 measures entailed neither an announcement of privatisation nor its actual implementation. In fact, among transition countries, Vietnam has proved to be the most reluctant to privatise SOEs, with no commitment to whole-scale privatisation even to date. The total absence of privatisation from the 1989 measures is therefore another reason why their characterisation by Sachs and Woo as a big bang is inappropriate.

Doi Moi of 1986: the real turning point

Vietnam basically followed the gradual approach to reform. However, if a decisive point in the reform process needs to be identified, the CPV Sixth Congress in 1986 that adopted the *Doi Moi* programme is the best candidate.¹⁹ Even though reforms got under way in the early 1980s, they had a hesitant character. It was still not clear whether the CPV and the government as a whole had committed themselves to a switch to the market system and how far they were ready to go in this new direction. In fact, Vietnam witnessed contradictory processes during the initial years of reform.

As the interim period, 1976–1980, following the 1975 victory and political unification came to an end, Vietnam drew up its post-unification Second Five

¹⁸ These repeated modifications of the definition of the big bang are instructive, and they seem to be *ex-post* responses to the negative experience of Russian privatisation. In fact, it is noteworthy that Sachs now does not want to consider Russia as an example of big bang reform (Sachs and Woo, 1997, pp. 5–6). Such *ex-post* tailoring of the definition of big bang, however, undermines the very integrity of the concept.

¹⁹ Most of the accessible works on Vietnam are written by outsiders. Even Tran, who worked and wrote in Vietnam, did not belong to the inner policy circle. There is little to be found written by insiders, the people who were or are engaged in policy formulation. In that sense, the inner history of policy development in Vietnam still remains unknown.



Year Plan for 1981–1985, which was to lay the foundation for ‘a more complete socialist transformation’ and to construct ‘a strict central planning system with allocations of capital and inputs and labor being made centrally’ (Arkadie and Mallon, 2003). Yet, at the same time, the disappointing performance during 1976–1980 prompted the CPV to initiate a critical reevaluation, as reflected by the discussion of the August–September 1979 Sixth Plenum of CC. However, the professed goals of the Second Five Year Plan clearly showed that the CPV as a whole was still not sure about the direction to take. Meanwhile, at the field level, instead of further collectivisation, as envisaged in the Plan, a process of de-collectivisation started; instead of stricter central planning, the dynamics pointed away from the Plan. There was therefore a clear contradiction between the official line, as expressed in Plan documents, and actual practice (Tran, 1994; Fforde and de Vylder, 1996; Arkadie and Mallon, 2003).

Describing the factors leading to this contradiction and understanding why practice moved away from theoretical, official thinking is beyond the scope of this paper. However, the following few brief observations can be made. First, Vietnam could not avoid the inefficiencies resulting from collectivisation imposed on a pre-industrial agriculture. Second, Vietnam could not avoid the inefficiencies arising from an industrial policy that emphasised heavy industry at the expense of light industries, in which Vietnam’s comparative advantage lay. Third, efficient management of the SOEs continued to pose problems despite the attempt to overcome them through formation of Unions of enterprises. Fourth, the exodus of the Chinese population following the unification in 1975 and the aggressive pursuit of anti-capitalist policies of the post-1975 years added to the economic problems. Fifth, military conflicts with Kampuchea and China in 1978 made things worse. Sixth, Vietnam had to confront the actual and potential decrease in assistance from the COMECON countries. Seventh, Vietnam could not avoid the impact of the reforms already underway in China since 1978. Eighth, Vietnam could not avoid the influence of successful market economies of the neighbouring East Asian countries.

It was as a result of these influences that the CPV adopted Resolution 100 in January 1981 initiating de-collectivisation of agriculture and the Three Plan system for industry, even though these went against the professed goals of the SFYP. The hesitant nature of the reform process is reflected further in some policy reversals that took place in 1983 in order to contain ‘anarchy’ in the market. Even the Third Five Year Plan (TFYP), drawn up for 1986–1990, emphasised the need to ‘broaden the collective economy’, to ‘restrict the negative aspects of the private economic sectors’, and to uphold the leading role of the state sector (Arkadie and Mallon, 2003).



By 1986, however, the CPV was ready for a strategic switch from central planning to the market system. Two sets of circumstances led to this development. The first was the encouraging results from reforms introduced in 1981. The second was the emergence of new problems, in particular the problem of inflation. Faced with inflation, the government had two options. One was to halt the reform process and return to central planning and administered prices. Time and experience had, however, made that route unacceptable. The other option was to accept the market outcome and make the best use of market mechanisms to solve the problem. The Sixth CPV Congress opted for market reforms by adopting *Doi Moi*. The Sixth CPV Congress was therefore the decisive event in Vietnam's gradual transition from central planning to market economy. See Fforde and Vylder (1996, pp. 12–16, 144–146) for further details.

Conclusions regarding characterisation

The characterisation of Vietnam's 1989 measures as a big bang is a mischaracterisation that is based on a rather superficial understanding of the Vietnamese reform process. The 1989 measures did not start anything fundamentally new and were rather a continuation and part of an ongoing and wide-ranging reform process. It is erroneous to view them as an absolute change in direction and to counterpose them against pre-1989 measures. Even the failure of pre-1989 stabilisation measures provided a valuable learning mechanism for Vietnam to enable it to better enact and implement the 1989 reforms. If any pivotal point for the Vietnamese reform process needs to be identified, it should be sought in the 1986 CPV Sixth Congress that adopted the *Doi Moi* programme.

HOW ACCEPTABLE IS THE HYPOTHESIS?

Sachs and Woo's hypothesis may have two interpretations, prospective and retrospective. The prospective interpretation would suggest that China could have had higher growth rates in the post-1989 years if she had adopted similar measures as Vietnam did in 1989. The retrospective interpretation, on the other hand, would suggest that China would have grown faster in pre-1989 years had she adopted measures similar to Vietnam's 1989 measures at some point in the past, say, in 1978 or 1984. It is not clear which of the two interpretations Sachs and Woo have in mind. However, to judge the hypothesis in either case, we need to examine the concrete big bang steps that Sachs and Woo would have liked China to take. Their list in this regard includes: (a) faster unification of product markets, (b) faster unification of



foreign exchange markets, and (c) imposition of harder budget constraint on state enterprises. Let us consider these suggestions in turn.

Unification of product markets

What could China emulate from Vietnam's 1989 measures with regard to unification of product markets? To answer this question, we may take a brief look at the Chinese price reform process, described earlier by Byrd (1987), followed by discussions by Lau *et al.* (1997, 2000), Wu and Zhao (1987), Xu (1998), Lin and Cai (1996), and Bramall (2000).²⁰ The picture that emerges from these accounts is as follows. Price reform in the recent period in China started in September 1979, when industries and localities were allowed to vary prices of their products by 20% from centrally determined prices. Further, the prices of many non-strategic commodities were left completely to 'market forces'. In January 1985, the pace of price reform was accelerated through the introduction of the Dual Track system, under which enterprises were allowed to charge 'market floating prices', prices that were marginally below market prices, for output that was above the Plan.

The Dual Track system triggered dynamics that propelled the economy toward more market determined outcomes along several channels.²¹ According to Byrd (1987), introduction of the Dual Track system was enough, so far as the incentive role of prices is concerned, as it made only market prices matter at the margin, thereby full unification of the two markets unnecessary.²² In Byrd's view, with the introduction of the Dual Track system, the price reform issue for China became *passé*.²³

In their discussion of unification of product prices in China, Lau *et al.* (1997, 2000) distinguish between two types of market liberalisation. The first is 'Limited Market Liberalisation (LML)', which they define as the situation when 'market resale of plan-allocated goods and market purchases by planned suppliers for fulfilling plan-mandated delivery quotas are not permitted'. The second is the 'Full Market Liberalisation (FML)', which refers

²⁰ Byrd (1987) begins his analysis with a theoretical treatment of the dual track system and distinguishes between sellers' and buyers' markets. Given that transition economies are generally characterised by shortages and that we are generally dealing with sellers market, the conclusions regarding the former are more pertinent. Byrd (1987, pp. 296–298) also notes a more complex origin of the Two-Tier system going back to even the Maoist period.

²¹ See Byrd (1987, pp. 299–305) for the details.

²² Byrd (1987, p. 306) observes that 'where the two-tier system remains, planning plays a re-distributional rather than allocative role'.

²³ As Byrd (1987, p. 307) puts it, 'At a fundamental level, the issues of market allocation and to a lesser extent price reform are become *passé*, and they no longer need to be the prime concern for reformers' (Byrd, 1987, p. 307).

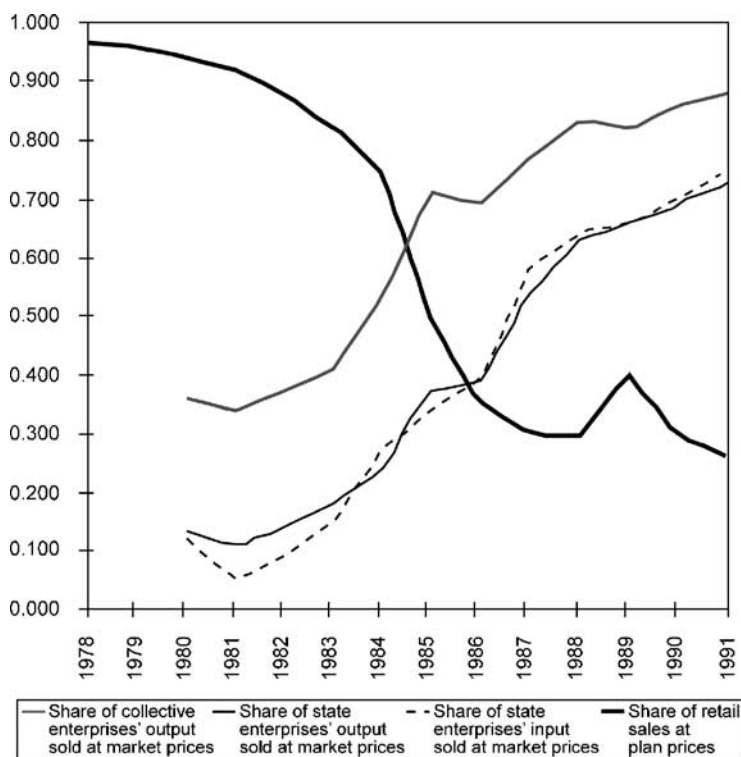


Figure 4: Continuous process of unification of prices in China. Source: Gelb et al. (1993).

to the situation when 'market resale and market purchases for redelivery are all allowed by a planned supplier or a rationed user, as long as its obligations under the plan are all fulfilled'. Lau, Qian, and Roland consider the Chinese product market liberalisation as being close to FML, as resale, sub-contracting, and purchases for redelivery are not prohibited.

The process of steady unification of product prices in China can be seen from the graph presented in Figure 4. It shows that between 1978 and 1988 the share of sales at market prices in total sales of state enterprises increased from about 12% in 1980 to about 70% in 1988. Similarly, the share of output sold at market prices in total sales of collective enterprises increased from about 37% in 1980 to about 82% in 1988. As the mirror opposite, the share of retail sales at state fixed prices over the same period decreased from 97% (of total sales) to about 30%. This shows that China was quite ahead of Vietnam in the unification of product prices and was not in need of a large correction as was the case with Vietnam in 1989.



Inflation

We saw that it was runaway inflation that triggered Vietnam's 1989 measures. Was there anything for China to emulate from Vietnam's 1989 measures with regard to inflation? Ironically, keeping inflation under control was one of the remarkable successes of China, where the general retail price index increased at only 3.94% per annum on average during the entire 1978–1987 period (Figure 5 and Table 6). The corresponding rate for CPI was only 4.24%.²⁴ This is radically different from what we witnessed in Vietnam.²⁵

Thus, in so far as controlling inflation is concerned, Vietnam had much to learn from China, rather than the other way round. Why China proved so successful in controlling inflation is a crucial question that we will soon discuss.

Unification of foreign exchange markets

The foreign exchange markets in China were also integrated rapidly, as Lin and Cai (1996) document. They note that a dual exchange rate system was introduced in 1981, whereby exporting enterprises could retain a larger proportion of foreign exchange and swap their exchange entitlements with other enterprises through the Bank of China at rates higher than the official rate. In 1985, a 'foreign exchange adjustment centre' was established in Shenzhen in which enterprises could trade foreign exchanges at negotiated rates. By the late 1980s, most provinces of China had such centres through which more than 80% of foreign exchange earnings were swapped. Thus, *de facto*, a market exchange rate emerged and prevailed for the larger part of foreign exchange transactions.

The Chinese government was also keen to keep the official exchange rate of the Yuan closely aligned with its market value. In order to do so, the authorities continually adjusted the official exchange rate so that the official value of the Yuan decreased steadily from 59 cents in 1978 to 27 cents by 1988 (Table 7 and Figure 6). As a result, China was not in need of a one-time major change in foreign exchange rate of her currency as was the case with Vietnam in 1989.

Hardening of SOE budget constraints

China was also ahead of Vietnam in hardening the budget constraints of the SOEs, as was shown by McKinnon (1994, p. 454), who pointed out that, even though China granted more autonomy to SOEs under the Dual Track system,

²⁴ The averages refer to simple arithmetic averages of annual rates.

²⁵ McKinnon (1994) noticed that China's success at controlling inflation was all the more remarkable in view of China's deteriorating public finances during the period.

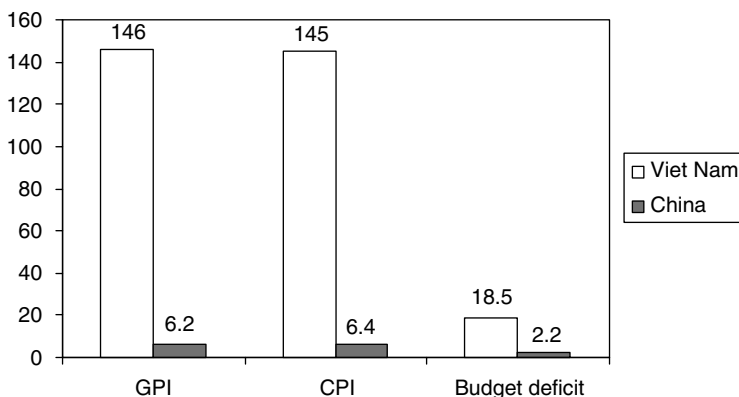


Figure 5: Comparative financial performance of Vietnam and China during pre-1989 years: Annual average rate of inflation (in percent) and budget deficit as percentage of revenue during 1981–1988.

‘state enterprises remained *on a tight financial leash*’. McKinnon shows that China’s success in hardening the budget constraints of the SOEs early on is a major reason why China avoided inflation. During reforms, SOEs play an important role in the formation of market prices, as they operate in both the planned and market sectors (Groves et al., 1994 and Naughton, 1994). Although this was the case under both systems, China’s Two Track system could control inflation while Vietnam’s Three Plan system could not do so. The reason for this very different outcome lay in the broader policy environment, in particular the type of budget constraint under which the systems operated. McKinnon (1994, p. 455) points out that in the case of China the state maintained ‘infra-marginal price control’ on, and constrained financial support for, traditional soft budget enterprises. To illustrate, he notes that from the beginning of enterprise reforms, the Chinese SOEs were not allowed to bid freely with each other for scarce domestic resources (inputs) or foreign exchange. By contrast, Vietnam’s Three Plan system failed to harden the budget constraints, which thus led to inflation, even though the system provided the right incentives for supply response.

Positive real interest rates

Unlike Vietnam, China established and maintained positive real interest rates from the very beginning of the reform process. McKinnon (1994), in fact, points to China’s positive real interest rates as the most important reason why China could control inflation. He notes that its agricultural reforms beginning in 1978 yielded quick results and generated considerable surplus in the hands of millions of rural households. Unlike Vietnam, where the private surplus

Table 6: GDP growth rate, inflation, and exchange rate in China under Reform

Year	Growth rate (%) of GDP (cf. NBS, 1999, p. 3)	Growth rate (%) of general retail price index (NBS, 1999, p. 21)	Growth rate (%) of consumer price index (CPI) (NBS, 1999, p. 21)	Government budget balance as % of government revenue	Government budget balance as % of GDP	USD per Yuan (Bramall, 2000, p. 381)
(1)	(2)	(3)	(4)	(5)	(6)	(7)
1976	-1.6	0.3	0.3	-3.8	-1.0	
1977	7.6	2.0	2.7	3.5	1.0	
1978	11.7	0.7	0.7	0.9	0.3	0.59
1979	7.6	2.0	1.9	-11.8	-3.4	0.63
1980	7.8	6.0	7.5	-5.9	-1.5	0.67
1981	5.2	2.4	2.5	3.2	0.8	0.59
1982	9.1	1.9	2.0	-1.5	-0.3	0.53
1983	10.9	1.5	2.0	-3.1	-0.7	0.50
1984	15.2	2.8	2.7	-3.5	-0.8	0.44
1985	13.5	8.8	9.3	0.03	0.0	0.34
1986	8.8	6.0	6.5	-3.91	-0.8	0.29
1987	11.6	7.3	7.3	-2.9	-0.5	0.27
1988	11.3	18.5	18.8	-5.7	-0.9	0.27
1989	4.1	17.8	18.0	-6.0	-0.9	0.26
1990	3.8	2.1	3.1	-5.0	-0.8	0.21
1991	9.2	2.9	3.4	-7.5	-1.1	0.19
1992	14.2	5.4	6.4	-7.4	-1.0	0.18
1993	13.5	13.2	14.7	-6.8	-0.9	0.17
1994	12.6	21.7	24.1	-11.0	-1.2	0.12
1995	10.5	14.8	17.1	-9.3	-1.0	0.12
1996	9.6	06.1	8.3	-7.2	-0.8	0.12
1997	8.8	0.8	2.8	-6.7	-0.8	
1998	7.8	-2.6	-0.8	-9.3	-1.2	



**Table 7:** Deposits and loans in the Chinese banking system (Growth rates and shares)

Year	Growth rate (%) in total household deposit with state banks (McKinnon, 1994, p. 448)	Growth rate (%) in urban household deposit with state banks (McKinnon, 1994, p. 448)	Growth rate (%) in rural household deposit with state banks (McKinnon, 1994, p. 448)	Growth rate of M0 (%) (Bramall, 2000, p. 305)	Growth rate of M2 (%) (Bramall, 2000, p. 305)	Growth rate (%) in total deposit with state banks (cf. NBS, 1999, p. 64)	Growth rate of loans provided by state banking system in billion USD (cf. NBS, 1999, p. 66)	Household savings as percentage of GNP (McKinnon, 1994, p. 449)
1976								
1977						8.7	7.9	
1978						6.7	11.2	5.9
1979	33.4	30.8	40.8	26	27	18.0	10.3	7.1
1980	42.2	39.4	49.2	29	27	24.1	18.4	8.9
1981	31.1	25.4	45.0	15	23	22.0	18.5	11.0
1982	29.0	26.3	34.5	11	19	16.9	11.2	13.0
1983	32.1	28.0	40.3	21	20	17.7	12.9	15.4
1984	36.1	35.6	37.0	49	31	28.5	32.8	17.5
1985	33.6	36.2	28.9	25	17	19.0	23.9	19.0
1986	37.9	39.1	35.6	23	29	25.6	28.5	23.1
1987	37.4	40.5	31.3	19	24	21.7	19.0	27.2
1988	23.7	28.6	13.6	47	22	14.0	16.8	27.1
1989	35.4	40.5	23.6	10	18	45.3	36.1	32.3
1990	36.7	39.0	30.4	13	28	29.9	23.1	39.8
1991	29.5	30.8	26.0	20	27	29.0	20.7	45.9

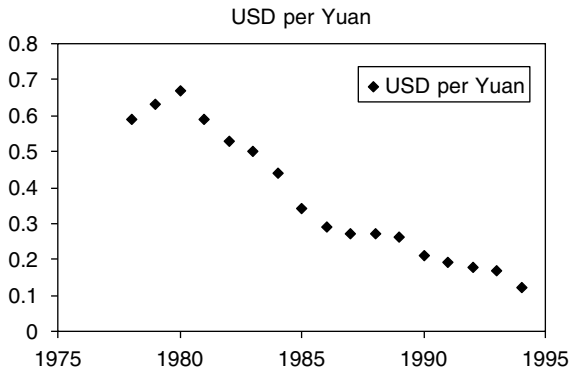


Figure 6: Continuous adjustment of the official exchange rate of Yuan.

went underground, China succeeded in drawing this surplus into the formal financial sector by offering positive real interest rates. According to some estimates, China could mobilise almost 80% of rural savings through the banking system.

Table 7 shows a marked and steady increase in household savings in China, rising from 5.9% of GNP in 1978 to 27.1% in 1987. It also shows that much of this saving was actually deposited in the banking system.²⁶ Table 8 shows why bank deposits increased in China during the reform years: the real interest rate for most of the years during 1980–1987 was positive, averaging 1.69% on households’ one-year time deposits. In the initial years of reform, the rate was much higher, averaging 2.70% during 1980–1984. The keen appreciation by Chinese authorities of the role of positive real interest rates was further displayed by their behaviour during the crisis years of 1988–1989, when some rates were fully indexed to ensure positive real interest rate despite high inflation. When inflation came down to very low levels in 1990–1991, indexing was discontinued (McKinnon, 1994, pp. 452–453).

The Chinese authorities also displayed considerable prudence in the use of deposits mobilised through positive real interest rates. The non-state sector as a whole, including rural and urban households, TVEs, and agriculture, accounted for only about 20% of overall bank lending, with TVEs accounting

²⁶ Total household deposits with the banking system grew by an average (simple arithmetic) rate of 33.65% per year during 1979–1988. This rate was faster for rural households (35.62%) than for urban households (32.99%). The corresponding rates were 41.96 and 29.98% during 1979–1984, showing that rural households were building up bank balances at a much faster rate than their urban counterparts during the initial years of reform.

Table 8: Interest rates in the Chinese banking system

Year	National Retail price index (% change) (McKinnon, 1994, p. 452)	Nominal interest rate on household 1-year time deposit (McKinnon, 1994, p. 452)	Nominal interest rate on household 3-year time deposit (McKinnon, 1994, p. 452)	Nominal interest rate on loan to industry (McKinnon, 1994, p. 452)	Nominal interest rate on loans to TVEs (McKinnon, 1994, p. 452)	Real interest rate on household 1-year time deposit (McKinnon, 1994, p. 452)
1976						
1977						
1978						
1979						
1980	6	5.4	6.1	2.5	2.2	-0.6
1981	2.4	5.4	6.1	2.5	2.2	3.0
1982	1.9	5.8	6.8	3.6	4.3	3.9
1983	1.5	5.8	6.8	7.2	4.3	4.3
1984	2.8	5.8	6.8	7.2	7.9	3.0
1985	8.8	7.2	8.3	7.9	10.1	-1.6
1986	6	7.7	8.3	7.9	10.1	1.7
1987	7.3	7.2	8.3	7.9	10.1	-0.1
1988	18.5	8.6	9.7	9.0	10.1	-9.9
1989	17.8	11.3	13.1	11.3	11.3	-6.5
1990	2.1	8.6	10.1	9.4	9.4	6.5
1991	2.9	7.6	8.3	8.6	8.5	4.7





for only 6–7% (Table 9).²⁷ This shows that TVEs were financed mainly out of local governments' budgets. To the extent that local governments were not allowed to run deficits, TVE financing was therefore by and large non-inflationary.

The upshot is that, by mobilising household savings through offering positive real interest rates and by not using them for TVEs, the government of China could use the bulk of household savings for non-inflationary financing of its budget deficit, investment programme, and for meeting the credit needs of SOEs.²⁸ In contrast, Vietnam realised the importance of positive real interest rates belatedly and tried to attain such rates through its 1989 measures.

Any room for faster growth?

The above discussion shows that there was not much for China to emulate from Vietnam's 1989 measures to bolster her future growth rate, negating thereby the prospective interpretation of the Sachs and Woo hypothesis. What about the retrospective interpretation? To answer this question, we first note that even the pre-1989 growth rates in China were higher than the post-1989 growth rates in Vietnam. While the average annual GDP growth rate for Vietnam during 1989–1999 was 7.1%, the same for China during the 1978–1988 and 1984–1988 periods was 9.6 and 10.7%, respectively. China's post-1989 growth rate, 9.5% per annum for 1989–1998, is also higher than Vietnam's post-1989 growth rate (NBS, 1999, p. 4, Tables 10, 11). As a result of higher growth rates, China's per capita income (\$1,225) in 2004 was more than double of Vietnam's (\$514), and according to MekongCapital's computation, at Vietnam's current growth rate of 7.1%, on average between 2000 and 2004, it will take more than 12 years just to catch up with China's 2004 per capita income level (see http://www.mekongcapital.com/mr_gdp.htm).

Second, China's record of nearly 10% annual average GDP growth for three decades is unparalleled from both historical and international perspectives. As Kojima (2008) points out, Japan's high post-war economic growth lasted 18 years with an average annual growth rate of 9.3%. For

²⁷ The table further shows that a considerable part of the savings deposited with Rural Credit Cooperatives (RCCs) was mobilised for purposes other than those in the rural sector. The RCC loans-to-deposit ratio rose from 22.0% in 1979 to 64.9% in 1988. Also, the share of TVEs in total RCC lending increased from 29.89% in 1979 to 50.20% in 1988. Thus, in most years TVEs got less than half of the limited amount of credit that RCC provided for rural purposes.

²⁸ Another benefit of positive real interest rates and consequent high lending rates was that they forced the borrowing to be directed to more productive investments. See McKinnon (1994, pp. 461–462).

**Table 9:** Bank lending to non-state sectors and lending and deposits of Rural Credit Cooperatives (RCC)

Year	Bank lending to urban collectives as % of total outstanding bank loans	Bank lending to urban individuals as % of total outstanding bank loans	Bank lending to TVEs as % of total outstanding bank loans	Bank lending to agriculture as % of total outstanding bank loans	Total non-state loans as % of total outstanding bank loans	Total deposits in RCC in billion Yuan (McKinnon, 1994, p. 450)	RCC loans to TVEs as % of total RCC loans (based on McKinnon, 1994, p. 450)	RCC total loans/ total deposits (%) (McKinnon, 1994, p. 450)
1976								
1977								
1978								
1979						21.59	29.9	22.0
1980						27.23	38.1	30.0
1981						31.96	36.8	30.2
1982						38.99	34.9	31.1
1983						48.74	36.7	33.6
1984						62.49	38.1	56.7
1985	4.95	0.17	5.63	6.85	17.60	72.49	41.1	55.2
1986	5.11	0.13	6.82	6.68	18.94	96.23	46.8	59.1
1987	5.47	0.16	7.25	7.28	20.16	122.52	46.6	63.0
1988	5.58	0.17	7.59	7.19	20.53	139.98	50.2	64.9
1989	5.15	0.11	7.39	7.12	19.97	166.95	52.2	65.6
1990	4.93	0.09	7.42	7.17	19.61	214.49	53.8	65.9
1991	4.74	0.08	7.63	7.39	19.84	270.93	55.7	66.8

Table 10: Comparison of economic performance of China and Vietnam

Item	Vietnam	China
Population growth rate during 1981–1988 (annual average in %) (<i>Source: UNSD</i>)	2.2	1.5
Population growth rate during 1991–2004 (annual average in %) (<i>Source: UNSD</i>)	1.5	0.9
Population growth rate during 1981–2004 (annual average in %) (<i>Source: UNSD</i>)	1.8	1.1
GDP (at constant prices) growth rate during 1981–1988 (annual average in %) (<i>Source: UNSD</i>)	5.9	11.2
GDP (at constant prices) growth rate during 1991–2004 (annual average in %) (<i>Source: UNSD</i>)	7.6	9.8
GDP (at constant prices) growth rate during 1981–2001 (annual average in %) (<i>Source: UNSD</i>)	6.8	9.7
Per capita GDP (at constant prices) growth rate during 1981–1988 (average per year in %) (<i>Source: UNSD</i>)	3.6	9.6
Per capita GDP (at constant prices) growth rate during 1991–2004 (average per year in %) (<i>Source: UNSD</i>)	5.9	8.8
Per capita GDP (at constant prices) growth rate during 1981–2004 (average per year in %) (<i>Source: UNSD</i>)	4.8	8.5
Inflation during 1981–1988, as measured by increase in GPI (arithmetic annual average in %) (<i>Source: Tran, 1994 for Vietnam, McKinnon 1994 for China</i>)	146.0	6.2
Inflation during 1981–1988, as measured by increase in CPI (arithmetic annual average in %) (<i>Source: Tran, 1994 for Vietnam, MacKinnon 1994 for China</i>)	145.0	6.4
Inflation during 1991–2003, as measured by increase in GDP deflator (arithmetic annual average in %) (<i>Source: ICSEAD</i>)	15.4	5.8
Inflation during 1995–2003, as measured by increase in CPI (arithmetic annual average in %) (<i>Source: ICSEAD</i>)	3.9	3.1
Budget deficit during 1981–1988 (arithmetic annual average in %) (<i>Source: Tran, 1994 for Vietnam; McKinnon (1994) for China</i>)	18.5	2.2
Budget deficit during 1991–2002 (arithmetic annual average in %) (<i>Source: ICSEAD</i>)	1.8	1.4

Note: Abbreviations are as follows: General Price Index (GPI); Consumer Price Index (CPI); United Nations Statistical Division (UNSD); International Centre for the Study of East Asian Development (ICSEAD)





Table 11: Timeline of economic reforms in China and Vietnam

Date	Reform in China	Reform in Vietnam
1978 [Dec] (Third Plenum of 11th CC, CPC)	Initiation of agricultural reforms: introduction of the Household Responsibility System, de-collectivisation	
1979 [Aug–Sep] (Sixth Plenum of 4th CC, VCP)		Initiation of reforms: introduction of the Contract System in agriculture and introduction of self-accounting and self-financing for SOEs
1979	Introduction of measures to facilitate export of manufactures and to allow for foreign investment	
1979	Beginning of gradual adjustment of the exchange value of Chinese Yuan	
1979	Creation of four coastal Special Economic Zones	
1981 [Jan] (CC, VCP meeting)		Adoption of Resolution 100 formalising adoption of the Contract System
1981 [Dec]		Adoption of Decision 25 by the Vietnamese government the process toward Three Plan system for SOEs
1984	Initiation of industrial reforms; introduction of the Dual Track system	
1984	Creation of Economic Development Zones in 14 largest coastal cities	
1985 [June] (8th Plenum of VCP CC)		Adoption of Resolution on Price-Salary-Money; introduction of stabilisation measures and new currency to curb inflation
1986 (Sixth Congress of VCP)		Adoption of Doi Moi (Restructuring) programme
1987		Promulgation of Decree 217 by Vietnamese government to put SOEs on a commercial footing



Table 11: (continued)

Date	Reform in China	Reform in Vietnam
1987		Further price reforms and attempts at stabilisation;
1987 [Dec.] (National Assembly Session; enacted in 1988)		Adoption of Law on Land giving households long term user rights to land
1987 [Dec.]		Adoption of the Law on Export and Import Duties on Commercial Goods
1988 [Apr] Politburo CC, VCP		Adoption of Resolution 10 enhancing rights of rural families <i>vis-à-vis</i> those of collectives/cooperatives
1988		Adoption of Foreign Investment Law
1988–1989	Student unrest and Tien An Mien Event	
1989		Radical reform measures aiming at stabilisation and liberalisation
1992	Deng Xiao Peng’s southern tour and reaffirmation of reform	
1993 [Nov.] (CPC CC meeting)	Moving SOEs even further toward complete autonomy from the central government	
2001	China’s accession to WTO	
2007		Vietnam’s accession to WTO

Note: The following abbreviations have been used: Central Committee (CC); CPC (Chinese Communist Party); VCP (Vietnamese Communist Party); WTO (World Trade Organization); and State-Owned Enterprises (SOE).

Taiwan and Korea, the high economic growth phase lasted longer, about 40 years, but the rate averaged 8.3 and 8.6% per year, respectively. Given this record, it is difficult to see how China could have grown any faster than she already did. Most observers rather worry about China’s too high growth rates and recommend that its growth rather be slowed down. In light of these facts, Sachs’ and Woo’s recommendation for China to boost her growth rate by emulating Vietnam’s 1989 reforms seems completely misplaced.

Conclusions regarding the hypothesis

The Sachs and Woo hypothesis that China would have grown faster had she followed Vietnam’s 1989 measures is not tenable either in a prospective or



retrospective sense. By 1989, China had already reached the stage of reform Vietnam had aimed at reaching through its 1989 measures, and hence there was not much scope for China to increase her post-1989 growth rates by emulating those measures. On the other hand, China's unprecedented high growth rates from the very beginning of her reform makes untenable the hypothesis that she could have enjoyed higher pre-1989 growth rates by adopting at some time earlier measures similar to the ones Vietnam took in 1989.

WHY THE PITFALLS?

The question that naturally arises is why Sachs and Woo run into pitfalls regarding facts and characterisation and offer an untenable hypothesis. We will see that the answer lies in their subjective preference for the big bang approach to reform. However, to show that, we first demonstrate very briefly that Sachs and Woo run into pitfalls regarding facts and characterisation regarding not only Vietnam but also China.

Pitfalls regarding China and contradictions in the broader conclusions

The Sachs and Woo papers are intended to reach some broader conclusions regarding reform processes in general. Sachs and Woo (2000, pp. 4–5) list these conclusions as follows:

'(H.1) China's rapid growth has come despite gradualism, in areas of the economy characterized by radical rather than gradual reforms. China's ability to grow rapidly despite gradual reforms reflects China's particular structure;

(H.2) China's gradualist strategy is not transferable to Eastern Europe and the former Soviet Union (hereafter EEFSU), because of fundamental differences in economic structure;

(H.3) China's experiments in non-capitalist institutions are proving to be unsuccessful in (a) agriculture; (b) rural industry; (c) state industry, and are therefore in need of further reform toward more typical capitalist institutions;

*(H.4) China is gradually harmonizing its economic institutions with those of East Asian market economies.'*²⁹

²⁹The allusion to Vietnam pertains directly to (H.1). However, it is not difficult to see that the conclusions listed above are interrelated. Thus, (H.1) helps to reach (H.2) and (H.3), and to some extent (H.4) too. Hence, the allusion to Vietnam serves as an important link in Sachs' and Woo's causality chain.



It may be noticed that there are several contradictions in the set of conclusions above. The first is the contradiction between the universalist and particularist positions. The position that even China would have done better had she followed the big bang approach instead of the gradual approach may be termed as the universalist position, because it suggests that the superiority of the big bang approach is universal, no matter where the country is located and what the structure of its economy is, for example, whether it is labour-surplus agrarian or full-employment industrial. It is this universalist position that is reflected in conclusion (H.1). However, this position contradicts the particularist position implied by conclusion (H.2), according to which a particular reform approach is suitable for a particular country, depending on its economic structure and other conditions.

Sachs and Woo do not see the contradiction because, according to their reconciliation of the two positions, China's success following the gradual approach was limited and would have been much greater had she followed the big bang approach. However, we have already observed that from both the historical and the international perspectives the proposition of a growth rate higher than what China already achieved is not realistic, and hence the above reconciliation is not tenable.

The second contradiction lies in the presentation of China by Sachs and Woo as an example of both gradualism and big bang. In (H.2), China is presented as a case of gradualism. Yet in (H.1), China's success is attributed to 'radical' rather than 'gradual' reforms, claiming that China's growth occurred despite gradualism.³⁰ The suggestion here is that even China had its big bangs, just as Vietnam had one in 1989, and that it is to those big bangs that China owes its growth. The question that arises is: What were China's big bangs?

Sachs and Woo (2000, p. 10) cite three examples. These are: (a) a switch from collectivist to household farming, (b) liberalisation of TVEs, and (c) opening to the external world (see Islam, 2008). A detailed perusal of these examples is beyond the scope of this paper. However, it may be noted briefly that the portrayal of these steps as examples of big bang type measures is erroneous. First, China's record of opening up, beginning with a few special economic zones and then gradually increasing the number and scope of such special zones, is rather a classic example of proceeding gradually than that of opening up the entire economy at one stroke, as the big bang approach would suggest. Second, it is unclear what Sachs and Woo mean by 'liberalisation of

³⁰ As Sachs and Woo make it clear elsewhere in the paper, 'Favorable outcomes have emerged (in China) *not because of gradualism, but despite gradualism*' (Sachs and Woo, 2000, p. 3, italics added).



TVEs'. Generally, TVEs have been regarded as another classic example of China's gradual approach, of experimentation with intermediate institutional forms, rather than jumping directly from state ownership to outright private ownership. TVEs are an epitome of the gradual approach from two other viewpoints, namely (i) the spatial character of industrialisation and (ii) the mobility of labour. TVEs allowed China not to jump directly into industrialisation concentrated in a few urban centres, as can be seen in many other developing countries, and not to jump directly from the restricted labour mobility situation, characterised by the Chinese household registration system, *Hukou*, to a situation of entirely unrestricted mobility. As is known, TVEs were associated with the slogan: 'Leave agriculture, not the village!' Characterisation of TVEs as a big bang type of measure therefore does not conform to Chinese reality. If, on the other hand, by 'liberalisation of TVEs', Sachs and Woo are referring to the subsequent privatisation of TVEs, then it should be mentioned that this privatisation has been a protracted process, a process that is yet to be fully completed. Third, even the switch from collectivist to household farming did not happen as fast as Sachs and Woo present. As Bramall (2000) documents, this switch also took a long time with leads and reversals. Thus, it is difficult to agree with the portrayal of any of these three reforms as big bang.

However, suppose we agreed with the Sachs and Woo's portrayal, we would then be faced with the following thorny conceptual problem. According to their conclusion (H.2), China overall is an example of the gradual approach. That being the case, we have a situation where big bangs themselves are part of the gradual approach. This makes the already controversial definition of big bang even more problematic.

There is therefore a similarity between Sachs and Woo's ways of viewing the reform processes in Vietnam and China. Just as they ignore the role of the pre-1989 reforms and try to ascribe all success to the 1989 measures in Vietnam, so in the case of China they try to attribute all success to certain apparently 'radical' measures and try to disparage and discount gradual changes. In their penchant to find successful big bangs, they try to see success and a big bang where they do not exist, and, in their desire to discredit the gradual approach, they try to see failure and departure from gradualism where these do not occur. Sachs and Woo thus have a subjective preference for the big bang approach, and in order to promote this subjective view, they often abandon objectivity.

There may be several sources of Sachs and Woo's subjectivity. One of these is epistemological, which in this case lies in these authors' lack of appreciation of the dialectics of the reform process. This lack finds expression in several features of Sachs' and Woo's analysis, such as (i) a non-recognition of the time specificity of reform measures and their propensity toward



comparative statics when the essence lies in the dynamics; (ii) a limited view of the interaction of politics and economics in the reform process; and (iii) mechanistic, linear reasoning.

Non-recognition of time-specificity of reform measures

Sachs and Woo fail to recognise reform measures' time specificity, whereby a reform measure can become redundant tomorrow without losing its necessity today. In fact, its very success today may be the reason for its redundancy tomorrow. Sachs and Woo's conclusion (H.3) above displays their tendency to discount the role of intermediate institutions that arose in China in the process of reform just because these institutions are now in need of change and are undergoing change. TVEs are a good example to illustrate the point. It is well known that TVEs played and are playing a historic role in China's industrialisation. From a limited base TVEs exploded to account for about one-third of Chinese industrial production. The phenomenal growth of TVEs has been one of the major driving forces behind China's growth of GDP and exports. A confluence of factors led to the emergence of TVEs as a unique, non-capitalist institution, which hardly finds any matches elsewhere in the world. Among these factors are: (i) the introduction of successful agricultural reforms resulting in a significant surplus in the hands of rural households; (ii) the introduction of industrial reforms in the form of the Two-Track policy resulting in out-of-plan market for both industrial input and output; (iii) the Maoist legacy of decentralisation and delegation of economic decision making to the commune/township level; (iv) the Maoist legacy of rural industrialisation carried out by communes as part of the Great Leap Forward campaign; (v) the introduction of fiscal reform, pushing Chinese local governments to rely increasingly on local enterprises as sources of revenue; and (vi) the inflow of overseas Chinese and foreign capital as a result of the adoption of the open-door policy.

With time, however, circumstances changed, and the unique, non-capitalist ownership of TVEs proved no longer indispensable and/or suitable. There are many reasons for this outcome, some of which are as follows: (i) TVEs themselves promoted internal migration, which in turn created a divergence between the territorial community and the legal community of townships, causing an incongruity between the collective ownership by the legal community and the actuality of the territorial community. (ii) Industrial reforms in cities and the phenomenal growth of economic activities in the special economic zones led to the *de facto* and legal acceptance of private entrepreneurship and private ownership. (iii) Economic reforms led to the creation of wealth and to the emergence of people with requisite capital and management skills to take over TVEs under private ownership. (iv) Fiscal and



economic management reforms pushed local governments to generate funds through privatisation of TVEs in order to finance public recurrent expenditure and investment projects and to concentrate on the management of bigger enterprises under their control.

However, the subsequent privatisation of TVEs under the impact of the factors mentioned above does not mean that China was mistaken in attempting a ‘non-capitalist’ rural industrialisation during 1980s and early 1990s, or that the alternative of trying to foster private capitalist industrialisation right from 1984 would have produced better results. Yet by arguing for a big bang in China, this is precisely the type of suggestion that Sachs and Woo make. Their unwillingness to recognise the time-specificity of reform measures can also be illustrated by considering other examples such as the Household Responsibility System in agriculture, the Dual Track System in industry, Special Economic Zones in foreign trade and investment, and the more recent use of non-tradeable shares in the equitisation of SOEs, etc. All of these intermediate forms have their historic necessity and a positive role to play even though with time they may or might have become redundant. The same applies to Vietnam. The Contract System of agriculture, the Three Plan system of industry, the preferred stocks in equitisation, etc, may all in time lose their rationale. However, that does not mean that they were not appropriate and did not have a positive role at the time they were introduced.³¹

Limited view of the interaction between economics and politics

The epistemological weakness of the Sachs and Woo position finds another reflection in their somewhat limited view of the interaction between economics and politics in the reform process. For example, Sachs and Woo argue repeatedly that the gradual approach of China owes more to political considerations than to an economic rationale.³² This view is problematic on

³¹ Sachs and some other researchers (eg Murphy *et al.*, 1992) have pointed out that the gradual approach gives rise to new problems. This is perfectly natural and expected and is actually how things progress. Resolution of one contradiction leads to the generation of new contradictions and so forth. So emergence of new problems cannot be an argument against the gradual approach. The issue is whether the new contradictions are resolved at an appropriate time. Otherwise, they may create a crisis. So far, it seems that both China and Vietnam have been more or less successful at deciphering new contradictions and resolving them in time.

³² For example, Sachs and Woo (2000, p. 1) observe that ‘the convergence school also holds that China’s gradualism results primarily from a lack of consensus over the proper course, with power still divided between market reformers and old-style socialists; and that the “innovative” non-capitalist institutions are responses to China’s political circumstances and not to its economic circumstances’. They make the same point elsewhere stating that ‘Gradualism ... has not been a strategy so much as a result of continuing political conflict and other difficulties inherent in setting a policy course in a country of some 1.2 billion people’ (Sachs and Woo, 2000, p. 3).



two grounds. First, it is questionable *prima facie*. Consider the example of TVEs again: when the TVE movement began, there were hardly enough individuals in the Chinese countryside or, for that matter, even in most urban areas, with the kind of capital and capability necessary to set up TVEs. One can argue that government could direct bank credit to create such *nouveau* capitalists from scratch. This argument has its own problems. First, we saw earlier that bank credit was not the main source of financing TVEs, which were instead financed mainly by local governments' own revenues. It is difficult to suggest that local governments should have handed over its revenues to individuals to set up enterprises under private ownership. The second problem concerns how banks or local governments would choose such persons. Neoclassical economics discourages governments from making such choices and advocates that the choice be left to impersonal market forces. Thus, the creation of *nouveau* capitalists from zero was not a feasible option for China on *economic* grounds.

Second, the option of hatching TVEs under private ownership from the very beginning was also not feasible on political grounds. Society was still steeped in the ideology and practice of 'socialism', as manifested in the principle of 'Eating from the Same Iron Bowl'. In such a social context, any attempt to foster *nouveau* capitalists, even if successful in its immediate sense, would create social resentment, undercutting these capitalists' legitimacy and hampering their ability to function properly. Quite instructive in this regard is the experience of Russia, where a class of capitalists has emerged by 'grabbing' state assets. To this day, this class finds it difficult to gain social legitimacy and hence remains vulnerable to populist pressures as well as revivalist attempts to retake those assets. Consequently, Russia still has not been able to establish a well functioning market economy.

Thus, the contraposition of political grounds to economic grounds is a false contraposition. The economics and politics of a situation are usually intertwined as an organic whole, so that it is difficult to separate the two. Reforms never happen in a political vacuum; rather, political parameters are as much a part of the landscape as are economic ones, the two of which are related. It is unreasonable to claim that policy advice was correct but did not prove successful as the political situation was not right. The reform policy needs to be formulated, keeping in mind both the political and economic conditions and, in particular, their interrelationship.

Mechanistic, linear reasoning

Another reflection of the epistemological weakness of the Sachs and Woo position can be seen in their often very mechanistic, linear reasoning. An example is provided by their claim that 'since reforms unleashed growth,



even more reform would have unleashed faster growth' (Sachs and Woo, 2000, p. 13).³³ This is obviously a very mechanistic, linear projection.³⁴ The reality is usually far more complex, organic, non-linear, and full of breaks, feedbacks, turnarounds, and unintended consequences.

We have already noticed that China's historically and internationally unprecedented high growth rates makes redundant Sachs' and Woo's claim that more reforms are required to grow faster. What is important to note is that it is rather the lack of reform in Sachs' and Woo's sense that may sometimes generate faster growth than the other way round. An example may be seen in the Chinese experience with liberalisation of interest rates. According to Lin and Cai (1996), the main sluggishness in China's unification of markets concerns the interest rate. Referring to the situation in 1994, they explain that maintaining the interest rate at artificially low levels led to higher demand for credit. Previously, excessive demand used to be curtailed by administrative means. However, the delegation of credit approval authority to banks made such rationing difficult, leading to a 'rapid expansion of credit and an investment thrust', and very high growth rates.³⁵ We thus see an example where less reform, that is, less liberalisation of interest rates, ended up causing faster growth, illustrating the pitfalls of linear reasoning.

The simplistic reasoning of Sachs and Woo also finds reflection in their conclusion (H.4), whereby they suggest that China and, for that matter, Vietnam have no need to experiment with institutions, because the ultimate forms of capitalist institutions are known.³⁶ This is again quite simplistic. First of all, neither China nor Vietnam has yet declared capitalism as their end-goal, and both governments are characterising their reforms as rather ways to construct better variants of socialism. Hence, the entire argument that institutional forms of capitalism are known and that no experimentation is necessary may be unwarranted. Second, even if both China and Vietnam were in fact headed towards capitalism, the fact remains that institutional

³³ Similarly, they argue elsewhere that 'the faster the convergence, the better will be the outcome' (Sachs and Woo, 2000, p. 2).

³⁴ Some may say that this is like arguing for binge drinking because some studies have found that moderate drinking leads to fewer cardiac problems.

³⁵ 'Maintaining the interest rate at an artificially low level gave enterprises an incentive to obtain more credits than the supply permitted. Before the reforms, the excess demands for credit were suppressed by restrictive central rationing. The delegation of the credit approval authority to local banks in the autumn of 1984 resulted in a rapid expansion of credits and an investment thrust' (Lin and Cai, 1996, p. 208).

³⁶ As they put it, 'The key point is that little experimentation is needed or desired. The long-run goals of institutional change are clear, and are found in the economic models of existing market-based economies' (Sachs and Woo, 2000, p. 8).



forms of capitalism can be quite varied. Even after several centuries, institutions of developed capitalism vary, as can be seen in the differences in (i) the relative role of the public *versus* private sectors of the economy, (ii) the role of banks *versus* stock markets in financing companies, (iii) the role of labour institutions in the bargaining between labour and capital, (iv) social safety network, etc. Only through a gradual process of change, experimentation, trial and error, and evolution, can a country attain the configuration of institutions that are best suited for it, based on its economy, history, culture, physical characteristics, etc. Also, it may not be only an issue of adjusting institutional forms that are already available elsewhere. There is also the possibility of new institutional forms arising. As North (1990) emphasises, institutions cannot just be supplanted from the outside; they must be home-grown (even if the seeds and samplings are brought from outside); and growth is a gradual process.

CONCLUDING REMARKS

The analysis of this paper shows that the Sachs and Woo hypothesis that Vietnam's experience with her 1989 reforms shows that China would have grown faster had she adopted a big bang approach rather than the gradual approach to reform is flawed. The allusion to Vietnam suffers from inaccuracy of facts and inappropriate characterisation, and the hypothesis itself is untenable both in its prospective and retrospective interpretations.

The Sachs and Woo papers contain a wealth of information and help greatly in understanding China's reform process. However, their analysis suffers from weaknesses that emanate from their subjective preference for the big bang approach. It is this subjectivity that leads them to pitfalls regarding facts, interpretation, and the overall hypothesis. The epistemological source of the subjectivity lies in the authors' lack of appreciation of the dialectics of the reform process. This lack is reflected in their reluctance to see the time-specificity of various reform measures and the complex interaction between politics and economics in the reform process and in their mechanistic reasoning. The discussion of other possible sources of Sachs and Woo's subjectivity remains beyond the scope of this paper.

Recognition of the subjectivity of the Sachs and Woo position is important, because their views, particularly those of Sachs, carry considerable weight in academic and policy circles. Sachs had a profound impact on the course of the Russian reform, and he continues to exert considerable influence on issues concerning transition and development. The subjectivity



of his position, as revealed in this paper, suggests that Sachs' views on reform and transition may warrant more scrutiny than they have received so far.

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