

Vietnam's Economy in Transition: Successes and Challenges

By

Thomas R. Gottschang

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Department of Economics and Accounting
College of the Holy Cross
Box 45A
Worcester, Massachusetts 01610
(508) 793-3362 (phone)
(508) 793-3708 (fax)

<https://www.holycross.edu/academics/programs/economics-and-accounting>

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Abstract

Vietnam's twentieth century economic development was interrupted by long years of destructive warfare and stunted by the distortions of central planning. During the last two decades, however, under the reform policy known as doi moi (renovation), Vietnam's economy has made tremendous strides, establishing the institutions of a market system and dramatically improving living standards. Success has been accompanied, however, by serious challenges, some of which are legacies of the old central planning structure, while others have been largely caused by the growth of the market economy and are likely to prove very difficult to resolve.

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[†]Department of Economics, Box 152A, College of the Holy Cross, Worcester, MA
01610-2395, 508-793-2678 (phone), 508-793-3710 (fax), tgottsch@holycross.edu

INTRODUCTION

Vietnam's twentieth century economic development was interrupted by long years of destructive warfare and stunted by the distortions of central planning. During the last two decades, however, under the reform policy known as *doi moi* (renovation), Vietnam's economy has made tremendous strides, establishing the institutions of a market system and dramatically improving living standards. A land of rich natural resources that nonetheless struggled to feed its own population under previous economic regimes, Vietnamese agriculture now meets the country's own needs and has become a major supplier in world markets, most notably of rice, coffee, and seafood. Industrial growth has been stimulated not only by rapid increases in foreign trade and by foreign investors drawn by the country's young and literate work force, but also by thriving domestic markets, epitomized by a nationwide boom in private housing construction. The international population of overseas Vietnamese – the *Viet Kieu* – have contributed growing amounts of funds, business contacts, and advanced skills to the increasingly sophisticated modern segments of the economy. In a reflection of Vietnam's new economic status, near the end of 2009, a year of world-wide recession, the government reported that it expected the gross domestic product (GDP) for the year to grow at a rate of around five percent.¹

Success has been accompanied, however, by serious challenges. Some problems, like deficiencies in education and health care, are legacies of the old central planning structure and have experienced rapid improvement with rising national prosperity. Other issues, particularly rising income inequality, corruption, and threats to the environment, have been largely caused by the growth of the market economy and are likely to prove very difficult to resolve. Finally, the problem of an unstable currency and insufficiently responsive banking system reflects both state

rigidities and the problems of establishing an efficient financial system in an economy that has little experience with formal banking.

A SOCIALIST MARKET ECONOMY

Vietnam is rare among transitional states in that it has retained a communist government and socialist elements in its economy, while moving to a predominantly market-based economic system. The states that emerged from the breakup of the former Soviet Union and the old Soviet Bloc quickly instituted capitalist market systems, privatized state firms and assets and endured several years of economic chaos and recession. Vietnam, like its giant neighbor, China, followed a gradual path of market reform, beginning with a return to family-based farming in the early 1980s, then introducing the broader *doi moi* policies liberalizing commerce and ownership in the mid- to late 1980s, and only moving to a predominantly market system in the early 1990s, after losing its main socialist foreign trade partners with the collapse of the Soviet Bloc countries. Like China, it has not experienced negative economic growth since the reforms began.

Today the Vietnamese economy operates in most respects as a true market economy, its firms interacting with each other and with global markets on the principles of profit and loss. Several major elements, however, remain under state control. State-owned enterprises have adapted surprisingly well to the market environment.² The share of total industrial output value produced by state-owned enterprises (SOEs) has fallen from 50 percent in the mid-1990s to just over 25 percent in 2008, but the absolute value of SOE output has continued to grow, while the state sector still employs around 9 percent of the labor force.³ The banking system is still dominated by state-owned banks, and the energy sector – electricity generation and oil and

natural gas production – is mainly state-owned. The state also retains the major responsibility for education and health care, although public funding for both was drastically cut under *doi moi*.

What it means to be a socialist state and how a Vietnamese socialist economy should be structured has been debated within the party and the government throughout the reform period, including disputes over the extent of privatization and the role of foreign trade. There is general agreement that the main objective of economic policy should be to improve living standards, but there is also a widespread belief that the socialist goals of sharing the benefits of development and providing basic services for all cannot be abandoned.

SUCCESES

Overall Growth

Since the early 1990s Vietnam's GDP has grown at one of the fastest rates in the world, averaging over 7 percent a year.⁴ Although the pace of growth has differed greatly by region, most income groups have seen major improvements in their standard of living. The largest share of new economic activity has occurred in industry and commerce. Real industrial output value (adjusted for inflation) has grown at an average rate of over 15 percent per year since 1995 and by 2008 accounted for about 40 percent of GDP. Foreign trade and investment has been spurred by new international agreements. In 2001 a bilateral trade agreement with the United States came into effect, and in 2007 Vietnam joined the World Trade Organization. Foreign trade, in U.S. dollar terms, has increased by over 10 times between 1995 and 2008, with average annual growth near 20 percent. Foreign investment has played a significant role, introducing advanced technology and international standards. A good recent example is a one billion dollar

semiconductor factory built by Intel near Ho Chi Minh City. By 2007 firms funded entirely or partially by foreign investment accounted for 18 percent of GDP.⁵

Agriculture

With its subtropical location and plentiful rainfall, much of Vietnam can grow three crops of rice per year. The rich alluvial soil and natural waterways of the Mekong Delta make it one of the world's most productive rice growing regions, followed by the Red River Delta around Hanoi in the north. Hilly areas and the broad plateau of the Central Highlands support tree crops, including rubber, bananas, and most importantly, coffee. The long coastline and numerous rivers and ponds have long generated plentiful supplies of fish, shrimp, and other aquatic products.

Agriculture struggled through much of the twentieth century, however, and there were even occasional periods of famine, most recently in 1980 following the 1979 border war with China and the termination of Chinese food aid.⁶ The first effective reform measure, begun in the early 1980s, was to allow farmers to make their own production decisions.⁷ Farmers were subsequently allowed to bring produce into the cities and sell it on the streets or in markets, rather than requiring food sales to be handled by state agencies. By the early 1990s, street markets had appeared throughout the country's cities and towns, increasing the amount and variety of food available, reducing the time required for shopping, and raising the incomes of farmers. In the following years, produce marketing was gradually moved off the streets and into market structures, while food transportation and retailing flourished.

By the mid-1990s Vietnam's natural advantage in rice production, complemented by market incentives for farmers, made it one of the three leading world exporters of rice, along with the United States and Thailand.⁸ A more surprising agricultural success is coffee, which was

introduced to Vietnam by French colonialists in the nineteenth century and is popular among urban Vietnamese. The strong *Robusta* variety, tolerant of lower temperatures than the milder *Arabica*, was grown in plantations in the Central Highlands, but Vietnamese coffee was little known internationally before it was introduced to the world market in the 1990s. Coffee production in Vietnam tripled in the second half of the 1990s, and by 2006 it was the world's second largest producer after Brazil.⁹ In 2009, after increasingly sophisticated international marketing efforts and tremendous growth in cultivation, the coffee growing industry employed 2 million workers and generated 3 percent of GDP.¹⁰

Housing

An important characteristic of Vietnam's development under *doi moi* is that it has been driven largely by the growth of dynamic domestic markets, especially housing. From the time incomes began to rise in the early 1990s, there has been a continuous boom in private housing construction. Many parts of Hanoi, Ho Chi Minh City, and other urban centers have changed beyond recognition as dilapidated buildings have been replaced by new construction, and then replaced again with larger and more modern structures. Large areas of former farmland have become bustling, modern residential and commercial districts. A lively market in land rights has emerged and in Ho Chi Minh City much of the new construction is carried out by vigorous private real estate development firms.¹¹ The housing boom has generated jobs for thousands of construction workers and for additional thousands who work in the factories and small workshops producing the cement, reinforcing bars, bricks, metal work, doors, windows, plumbing supplies, electric fixtures, and all the other construction materials and products that go into the construction and maintenance of a home. Real estate analysts believe that the supply of

housing is still insufficient for the increasingly affluent segments of the population and prices have increased sharply, particularly in Hanoi and Ho Chi Minh City, raising concerns about a possible bubble in the market.¹²

Paralleling the rise in housing construction has been rapid growth in construction of new buildings for businesses and hotels. Here too the increased jobs for construction workers have been accompanied by expansion in the numerous industries linked to construction, followed by additional jobs in maintenance, landscaping, and the positions created by the new businesses. Between 2000 and 2007, investment in both residential and commercial real estate more than quadrupled in constant price terms and grew as a share of total national investment from 2.7 percent to 4.6 percent.¹³

Population and the Labor Force

Vietnam's population is young, relatively well-educated, often ingenious, and imbued with a strong work ethic. Totalling over 87 million as of mid-2009,¹⁴ it is one of the largest in Southeast Asia. Prior to the 1990s the population grew at around 2 percent per year and had the high birth and death rates of a poor country, with few older people and many children. The 1999 census found that 53 percent of the population was below the age of 25.¹⁵ The implication for the economy is that the majority of the population will be of working age for several decades to come, unlike most industrialized countries which have large and rapidly increasing numbers of retirees.

A rather surprising change occurred in the late 1990s, when declines in both birth and death rates reduced annual population growth to around 1 percent. If the newly emerging demographic structure continues, it will resemble those of wealthy countries, with the average

citizen living longer, spending more time in retirement, and being replaced more slowly by new workers.¹⁶ Although the slower growth rate foreshadows rising dependency ratios in the future, that future is at least ten years further out than for China, and it has already arrived for mature, industrial countries like Japan.

Viet Kieu Contributions

In 1975, when Vietnam was reunited at the end of the civil war, tens of thousands of families fled the south, most to the United States. Additional tens of thousands left in the following years, enduring harrowing ocean voyages in small boats and Southeast Asian relocation camps before reaching new homes in the United States, Australia, and other countries. Once established, the *Viet Kieu* found jobs, enrolled their children in school and sent growing streams of remittance payments to family members in Vietnam, especially at *Tet*, the Vietnamese lunar New Year holiday. With the growing success of *doi moi*, increasing numbers of *Viet Kieu* have returned, not only to visit family, but in many cases to pursue business or professional opportunities, and even to purchase homes.¹⁷ Official figures estimated a global Viet Kieu population of some 4 million in 2009, and remittances of around \$7.4 billion (US) in 2008.¹⁸

SOCIAL SERVICES: A GLASS HALF FULL

A strength of the centrally planned system was that it provided basic health care and education to most of the population. Substantial aid was given by the Soviet Bloc countries in the form of equipment, supplies, and most importantly, training of professionals. When *doi moi* began, Vietnam had more trained doctors, nurses, teachers, and professors than most countries at its very low income level. Access to health services and education, however, varied widely.

Much of the rural population was served only by minimal medical services and rudimentary primary schools.¹⁹ Nonetheless, in the late 1980s Vietnamese people had much higher rates of literacy – around 85 percent – and life expectancy - around 60 years – than the populations of most poor countries. The elimination of the collective system and central planning at the end of the 1980s removed the organizational basis and funding for both education and health care, particularly at the local level.

Education

At the end of the 1980s, private educational institutions were legalized and much of the funding for public schools was shifted to tuition fees. Enrollments initially fell sharply, especially in upper secondary schools, which saw a decline of over 40 percent from 1988 to 1992.²⁰ By the mid-1990s, however, the government doubled public funding for education, while still relying on families to cover nearly half of all educational expenses. Following traditions that emerged under early centuries of Chinese imperial domination, Vietnamese families typically will make great sacrifices to educate their children. In the pre-modern era, literacy in Chinese was the route to enter the government bureaucracy through an exam system. Today, education is again the route to success in a high-income, modern career, bringing affluence to the family as well as the individual. Despite rising private costs, enrollments at all levels have risen remarkably since the mid-1990s. Between 1994 and 2007 lower secondary school enrollment nearly doubled, rising from 3.7 million to 6.8 million, while upper secondary numbers more than quadrupled, rising from 727 thousand to over 3 million.²¹ By 2008 the primary school

completion rate was nearly 94 percent and 16 percent of young adults attended higher education, up from only 2 percent in 1991.

Access to education is still distinctly uneven between regions, with the lowest enrollment rates and years of schooling in the hill areas among minority peoples. Higher education suffers from insufficient capacity. In 2005, 1.5 million students took university entrance exams, but total admissions came to only 230,500. Numbers of trained teachers have lagged significantly behind the growth of universities and colleges, with only around 18 percent of faculty members holding doctorates in 2006, while nearly 41 percent held only bachelor's degrees. On the other hand, the country benefits from a healthy mix of public and private institutions, with the majority of students in the 2005-2006 academic year served by the 85 public universities, 2 publicly funded open universities and 99 public junior colleges, while almost 140,000 students studied at private universities and junior colleges.²²

Health Care

Health care under the centrally planned system was based in health centers at the level of the commune, the rural local administrative unit. The system emphasized preventative public health measures, which were inexpensive and effective at reducing the incidence of diseases such as malaria, tuberculosis, and leprosy. Under *doi moi*, health care was largely privatized and the emphasis shifted from preventative activities to curative care. Commune health centers lost much of their funding and the focus of the system moved to hospitals and prescription drugs.²³ Many doctors, nurses, and midwives left the public system, leaving less than one health care professional per commune health center. By 2006, private expenditures accounted for 64 percent of the total cost of health care and some estimates placed the true figure as high as 80 percent.²⁴

The result of relying so heavily on family payments is that access to health care and the quality of the care provided vary widely. According to figures from 2005, higher income families made three times as many visits to hospitals as poor families, and overall government expenditure on health care focused twice as much spending on the wealthy as on the poor.²⁵

Despite these problems, health conditions have improved greatly since the mid-1990s. Between 1995 and 2005 life expectancy has risen from 65 years to 71 years, and infant mortality has fallen from 45 per thousand to 17 per thousand.²⁶ Much of the progress is simply the result of better food supplies; the rate of malnutrition among children under the age of 5 fell from 45 percent in 1995 to 25 percent – still tragically high – in 2005. Other causes of improvement include successful vaccination campaigns, effective measures to control malaria, and a sharp decline in deaths from communicable diseases.

Some old diseases have proven difficult to eradicate. Vietnam ranks thirteenth in the world in incidence of tuberculosis, and acute respiratory infections, diarrhea, and parasitic infections are the most common diseases among children. New diseases have risen in importance in recent years, led by HIV/AIDS, avian flu, and severe acute respiratory syndrome (SARS). The Vietnamese medical system dealt with SARS promptly and effectively when it emerged in 2003, suffering only 63 cases and 5 deaths.²⁷ It became the first to be removed from the World Health Organization's list of countries with local transmission of the dangerous disease.²⁸

LONG-TERM CHALLENGES

Regional Poverty

The poverty rate for Vietnam as a whole has fallen from 37 percent in 1998 to 16 percent in 2006, but rural poverty at 20 percent is five times as high as the urban rate of just under 4

percent. The most affluent regions of the country are the two great river deltas, each with its bustling metropolis – the Mekong Delta and Ho Chi Minh City, and the Red River Delta and Hanoi. The two cities have been the focus of most investment and the majority of new business. In 2006 poverty was lowest in the region of Ho Chi Minh City, at 3.8 percent, followed by the Red River Delta at 8.9 percent and the Mekong River Delta at 10.3 percent. The most impoverished areas are in the rugged limestone mountains that rim the Red River Delta and border on China and Laos. Here the poverty rate was nearly 65 percent in 1998 and still stood at 32 percent in 2006. Similarly the broad plateau of the Central Highlands, isolated by poor transportation from the coast and from major urban centers, registered nearly 29 percent of the population below the official poverty line in 2006, while the North Central mountains and the Central coastal area reported a poverty rate of 22 percent.²⁹

Transportation difficulties severely limit the development of industry and commerce in these regions. For the most part they are poorly suited to agriculture, except for coffee production in the Central Highlands. The highlands and mountains have historically been inhabited primarily by minority peoples, whose education and health care levels lag behind the rest of the population. For many of these groups income improvement requires cultural adaptation, as well as education and access to modern job opportunities, all of which are difficult to provide outside the orbits of the major cities.

Corruption

The transition from central planning to the market led to waves of corruption in all the transitional economies due to undefined property rights and undeveloped legal codes. Vietnam is no exception and the incentives to use official positions to elicit bribes – often referred to as

“rent-seeking” – expanded further with the economy’s rapid growth under *doi moi*. In many cases, bribery can be seen as a fee for expedited service and has little negative economic impact. In other situations, however, corruption prevents productive projects from going forward or diverts investment funds to inefficient uses. In all cases it undermines the authority of the government and weakens Vietnam’s attractiveness to foreign business. The government has been praised by the international community for undertaking serious anti-corruption measures, but in a speech on January 14, 2010, Prime Minister Nguyen Tan Dung acknowledged the issue’s persistence, saying, “corruption is a growingly serious and complicated problem arising from land management, taxation, customs, urban housing development, and economic projects.”³⁰ In 2009, Transparency International ranked Vietnam at 120 out of a total of 180 countries for perceived corruption.³¹

Environmental Degradation

Between 1979 and 2009 Vietnam’s population grew from 52 million to 87 million, making it one of the most densely populated countries in the world.³² Thousands of acres of forest have been cleared for farmland and thousands of acres of farmland have been turned into housing and commercial districts. In the late 1960s, as much as 55 percent of Vietnam’s land area may have been forested; by 1990 that figure had fallen to between a third and a tenth of the total area. Throughout the country large areas have been rendered barren by deforestation, inappropriate cultivation practices, and loss of soil nutrients.³³ The expansion of industry has been accompanied by the emission of polluted smoke, waste water, and chemical waste. Small scale industry, which has provided many of the new jobs that raise income levels, is particularly

polluting, due to its characteristically low level of technology and lack of information about pollutants.³⁴

Banking

Under the centrally planned economy the state-owned banking system served only to hold deposits and to disburse funds according to plan. In the 1980s it was converted into a commercial banking system, the core of which now consists of a central bank – the State Bank of Vietnam – five large state-owned commercial banks, each with dozens of branches, and the state-owned Bank for Social Policies.³⁵ In addition to the state banks there are 38 joint stock banks, each with only a few branches, 33 branches of foreign banks, and 5 joint-venture banks. In 2007, the state banks accounted for 57 percent of all formal sector loans and deposits; joint stock banks, non-bank credit institutions and credit funds made 34 percent of loans, and foreign and joint-venture banks provided the remaining 9 percent of loans.³⁶

Banking in Vietnam has a troubled history. In 1990, a broad network of private credit cooperatives went bankrupt due to unwise practices and pyramid schemes, wiping out the life savings of depositors and ruining thousands of small private businesses. The scandal destroyed the public reputation of the banking system,³⁷ which was further tarnished by several years of high inflation, which reached an annual rate of 500 percent in 1986. By the early 1990s inflation declined to around 8 percent, and at the turn of the century it briefly went negative, due to the Asian Financial Crisis. By 2005, however, it returned to 8 percent and during the international commodities boom of 2008 it reached 23 percent.³⁸ Although the system has achieved some success in restraining inflation, the banks are still widely distrusted and the great majority of the population is “unbanked.” A Ministry of Finance article in 2007 commented that fewer than 6

percent of Vietnamese held bank accounts and that some \$8 billion U.S. worth of gold and currency were believed to be held by families in their homes.³⁹ The banks have shown little interest in providing loans to individuals and small business, and reportedly lend out far less than the funds available to them. Small scale credit is available, usually from friends or family members, or at high nominal interest rates from informal private lenders. Even developers of large projects report that they rarely seek bank loans, turning instead to private investors.⁴⁰

The banking system is expected to improve markedly as the terms of Vietnam's 2007 accession to the WTO come into effect and foreign banks gain greater access to Vietnam's financial markets.⁴¹

THE ROAD AHEAD

Vietnam's economy will undoubtedly continue to grow rapidly for the foreseeable future. It is located in one of the most vibrant regions of the global marketplace, bordering on China, with good sea links to Taiwan, Japan, South Korea, Singapore, Thailand, Indonesia, Australia, and the United States. It will be attractive to investors while its average income levels remain low and its labor inexpensive. This will be the case as long as a major portion of the labor force is engaged in low productivity jobs in agriculture, which currently provides half of all employment, a huge reservoir to supply the urban job market.

Less clear is how the country will deal with the side effects of development. The incomes of farmers will rise as family members move to the cities and send home money and as new farm technology is adopted. But the experiences of other countries indicate that income disparities will continue to widen; urban incomes almost always rise more rapidly than rural incomes. Environmental degradation is also bound to increase as the country's natural resources are

pressured to provide for the growing needs of a rising and more affluent population. Higher incomes and new technology will eventually allow for cleaner air and water, but these conditions are probably decades in the future.

Solutions to the country's problems require resources and Vietnam is still a very poor country. Growth has been impressive, but when *doi moi* began in the late 1980s, Vietnam was among the poorest countries in the world. Away from the modern hotels and the computer chip factories, 70 percent of the population still lives in the countryside, where the average income is less than \$400 U.S. per year. Officials will continue to be faced with the difficult task of deciding how to divide the government's very limited funds between providing roads, electricity, better schools, and improved health care to the chronically disadvantaged, while also creating the improved urban infrastructure and institutions of higher education that support modern industry and lead to greater prosperity for the country as a whole.

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