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Economic and Social Commission for
Asia and the Pacific

# MACROECONOMIC REFORMS IN THE ECONOMIES IN TRANSITION

UNITED NATIONS

DEVELOPMENT PAPERS
NO. 18

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# PREFACE

The process of transition from a centrally planned economic system to a market-oriented one is both complex and painful. It involves the adoption of fundamentally different policies, the creation of an entirely new set of institutions and a complete reorientation of approach to economic management, which in turn demands extensive training and retraining of public officials. A successful transition requires, *inter alia,* redefinition of the role of the market and the State; revamping of monetary and fiscal systems; reform or privatization of State enterprises; and redirection of external economic relations. The wide range of policy and institutional reforms often entails significant transitional costs. Typically these are contraction of output, high rates of inflation and an increase in unemployment. While pursuing reforms and restructuring as instruments for accelerating long-run growth with an acceptable measure of equity, Governments have to find ways to cope with these hardships during the early stages of transition.

A sizeable number of countries in the Asian and Pacific region embarked on transition at different points in time and are currently at different stages of implementation of reforms. The ESCAP secretariat organized a regional seminar to provide a forum for exchange of experiences among these countries. The present volume consists of selected papers presented at the seminar. The papers analyse the experiences of countries of Indo-China and the Central Asian republics, focusing on the nature of reform measures adopted, the impact of reforms and priorities for future action. It is hoped that the volume will assist the countries concerned in making informed choices in their pursuit of economic reforms and contribute to a better understanding by others of the complexities that economies in transition face.

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# CHAPTER I. MANAGING ECONOMIC TRANSITION: AN OVERVIEW*

The principal element that distinguishes the economies in transition is that they have departed in a major way from the centrally-planned economic systems and chosen the path of strong market orientation. The countries included within the scope of the analysis in this paper are Azerbaijan, Cambodia, Kazakhstan, Kyrgyzstan, the Lao People's Democratic Republic, Mongolia, Turkmenistan, Uzbekistan and Viet Nam. The geographical and economic characteristics of this diverse group of countries differ widely. Some of the countries are land-locked. In terms of size Azerbaijan is a relatively small country with 86,000 square kilometres of surface area whereas Kazakhstan has a vast territory of 2.7 million square kilometres. The size of population ranges from only 2 million in Mongolia to nearly 70 million in Viet Nam (table 1).

**Table 1. Selected economies in transition in the ESCAP region, Area and population**

| | *Area (square kilometre)* | *Population* | |
|---|---|---|---|
| | | *Million* | *Year* |
| Cambodia | 181 000 | 8.3 | 1990 |
| Lao People's Democratic Republic | 236 800 | 4.2 | 1990 |
| Viet Nam | 331 690 | 66.7 | 1990 |
| Azerbaijan | 86 000 | 7.3 | 1992 |
| Kazakhstan | 2 700 000 | 16.7 | 1991 |
| Kyrgyzstan | 198 500 | 4.4 | 1991 |
| Turkmenistan | 500 000 | 3.7 | 1990 |
| Uzbekistan | 447 000 | 20.6 | 1991 |
| Mongolia | 1 600 000 | 2.2 | 1992 |

*Sources:* Economic and Social Commission for Asia and the Pacific *Economic and Social Survey of Asia and the Pacific*. Various issues.

The World Bank. World Bank country studies. *Azerbaijan: From Crisis to Sustained Growth (*1993); *Kazakhstan: The Transition to a Market Economy* (1993); *Kyrgyzstan: The Transition to a Market Economy* (1993); *Turkmenistan* (1994); *Uzbekistan: An Agenda for Economic Reform* (1993).

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* Prepared by Azizul Islam, Director and E.I. Gherman, Economic Affairs Officer, Development Research and Policy Analysis Division, ESCAP Secretariat.

From the point of view of resource endowment, there are considerable differences. Natural resource endowments of Cambodia and the Lao People's Democratic Republic are modest compared to several of the Central Asian republics. Azerbaijan has a fairly diversified agricultural and industrial base, but cotton dominates the agricultural sector of Uzbekistan which accounts for nearly two fifths of the country's net material product. These diversities clearly point to the need for country-specific approaches to economic reforms for successful transition to market-oriented systems. Nevertheless, there is a range of common macroeconomic issues that arise in such transition. The objective of this paper is to highlight those issues in light of reform experience in the economies mentioned above.

## A. MACROECONOMIC PERFORMANCE

Table 2 provides data on recent economic growth in these countries. It is worth mentioning that the Indochinese countries, in particular, the Lao People's Democratic Republic and Viet Nam, with comparatively longer period of sustained reforms, have largely overcome the severe pangs of transition. Both of these economies have been able to maintain highly respectable rates of growth during the 1990s. For these economies, therefore, the thrust of future

**Table 2. Selected economies in transition in the ESCAP region, GDP/GNP growth rate**

| | *1990* | *1991* | *1992* | *1993* |
|---|---|---|---|---|
| Cambodia | 1.2 | 7.6 | 7.0 | 5.7 |
| Lao People's Democratic Republic | 6.7 | 4.0 | 7.0 | 4.0 |
| Viet Nam | 5.3 | 6.0 | 8.3 | 7.5 |
| Azerbaijan | –11.7 | –0.7 | –35.1 | –10.0 |
| Kazakhstan | –0.8 | –7.0 | –14.0 | –12.9 |
| Kyrgyzstan | 3.2 | –3.9 | –24.0 | –13.0 |
| Turkmenistan | 2.0 | –4.7 | –5.3 | 8.0 |
| Uzbekistan | 11.3 | –0.5 | –10.0 | –4.5 |
| Mongolia | –2.1 | –16.2 | –5.0 | –1.3 |

*Sources:* Economic and Social Commission for Asia and the Pacific. *Economic and Social Survey of Asia and the Pacific 1993*. (United Nations publication, Sales No. E.94.II. F.8).

The Economist Intelligent Unit. *Georgia, Armenia, Azerbaijan, Kazakhstan, Central Asia Republics*, First quarter 1994, (London, Business International Limited, 1994).

The Economist Intelligent Unit. *China, Mongolia*, Second quarter 1994, (London, Business International Limited, 1994).

economic reforms will concentrate on bringing about structural change and enhancement of international competitiveness. This will require progressive improvement in human resources, change in the composition of output in favour of higher value-added products and technological upgradation. The Central Asian republics as well as Mongolia, where economic reforms were introduced only during the 1990s, following major political upheavals and the breakdown of the former Soviet Union, are still grappling with the problem of arresting continued decline in their output. However, as data in table 2 show, the downward slide may have moderated.

To some extent the fall in output was almost inescapable for most of the economies in transition. This resulted from a combination of factors. Among those were drastic decline in inflow of external resources, a complete breakdown of the previous trade and payments systems resulting in severe limitations on access to raw materials and other imported inputs required for domestic production, loss of traditional market opportunities for exports and dislocation of the production system itself in situations where privatization has been taking place in the absence of a dynamic private sector to fill the vacuum.

Perhaps the most important requirement for both bringing about structural changes and arresting decline in output in these economies in transition is to ensure macroeconomic stability. All these countries have had periods of extremely high rates of inflation (table 3). The initial spurt was provided by dislocations in supply and liberalization of previously controlled prices.

Hyper-inflation has many harmful consequences for economic development. It causes a loss of confidence in the value of money and acts as a disincentive for saving. In so far as people happen to save, they are most likely to hold it non-monetary form making it difficult to mobilize for investment. It generates tremendous problems for cost, revenue and profit calculations by enterprises, be they in the private or the public sector. This acts as a severe disincentive to investment which in turn constrains the growth of output. The scarcity of supply thus generated further exacerbates inflation. Apart from the negative impact on the volume of investment, high rates of inflation also distort the pattern or structure of investment. In general, it encourages short-term, quick yielding and speculative types of investment. Long-term investment in infrastructure or manufacturing output which involves a period of gestation is severely discouraged. It also erodes the real income of large sections of the population resulting in social stress and instability to the detriment of popular support for reform measures. Thus restoration of macroeconomic stability holds the key to revitalization of economic growth. This requires action on many fronts. The rest of the paper is devoted to some key areas.

**Table 3. Selected economies in transition in the ESCAP region, Inflation**

| | *Inflation rate (per cent)* | | | |
|---|---|---|---|---|
| | *1990* | *1991* | *1992* | *1993* |
| Cambodia | 142 | 197 | 75 | 45 |
| Lao People's Democratic Republic | 35 | 13 | 10 | 7 |
| Viet Nam | 67 | 67 | 38 | 15 |
| Azerbaijan | 8 | 87 | 1 350 | 2 000 |
| Kazakhstan | 4 | 91 | 1 513 | 2 265 |
| Kyrgyzstan | 3 | 88 | 906 | 1 300 |
| Turkmenistan | 5 | 88 | 831 | 1 500 |
| Uzbekistan | 7 | 106 | 598 | 2 600 |
| Mongolia | | 130 | 126 | 145 |

*Sources:* Economic and Social Commission for Asia and the Pacific. *Economic and Social Survey of Asia and the Pacific 1993*. (United Nations publication, Sales No. E.94.II. F.8)

The Economist Intelligent Unit. *Georgia, Armenia, Azerbaijan, Kazakhstan, Central Asia Republics*, First quarter 1994, (London, Business International Limited, 1994).

The Economist Intelligent Unit. *China, Mongolia,* Second quarter 1994, (London, Business International Limited, 1994).

## B. KEY POLICY IMPERATIVES

### 1. Fiscal balance

An important area which would require continued attention of Governments is the restoration of fiscal balance. It should be noted that there is no necessary cause-effect type of relationship between budgetary deficit and inflation. It all depends on how the deficit is financed. However, large budgetary deficits generally tend to fuel inflation, particularly so in the economies in transition where the scope for non-inflationary financing through, for example, sale of government bonds, is rather limited. Monetization of fiscal deficits through borrowings from the banking system, specially the Central Bank, is a direct cause of inflation.

Many of the economies in transition recorded high fiscal deficits (table 4). Among the causes of fiscal deficits were the cessation of grants from the former Soviet Union, poor financial performance of state-owned

**Table 4. Selected economies in transition in the ESCAP region, Budget balance**

| | *Budget balance (percentage of GDP/GNP)* | | |
|---|---|---|---|
| | *1990* | *1991* | *1992* |
| Lao People's Democratic Republic | -13.5 | -9.5 | -8.9 |
| Viet Nam | -3.1 | -2.9 | -1.6 |
| Azerbaijan | -0.2 | 8.7 | -5.6 |
| Kazakhstan | 2.8 | -8.3 | ... |
| Kyrgyzstan | -0.9 | 4.5 | -1.2 |
| Turkmenistan | 1.6 | 4.0 | ... |
| Uzbekistan | -0.9 | -4.9 | -11.0 |
| Mongolia | -13.5 | -9.7 | -10.0 |

*Sources:* Economic and Social Commission for Asia and the Pacific. *Economic and Social Survey of Asia and the Pacific 1993*. (United Nations publication, Sales No. E.94.II. F. 8).

The Economist Intelligent Unit. *Georgia, Armenia, Azerbaijan, Kazakhstan, Central Asia Republics*, First quarter 1994, (London, Business International Limited, 1994).

The Economist Intelligent Unit. *China, Mongolia*, Second quarter 1994, (London, Business International Limited, 1994).

enterprises, inability of the tax systems to mobilize adequate revenues and downward rigidity of some government expenditures.

In order to bring about an improvement in the situation, the economies in transition have introduced a variety of measures. For instance, Azerbaijan instituted sales tax. In Kazakhstan, tax measures included introduction of value-added tax and progressive income tax to increase government revenue. Value-added taxes and excise duties replaced the turnover and sales taxes in Kyrgyzstan. Viet Nam also has overhauled its tax system.

Governments have also made efforts to reduce government expenditure through reduction in subsidies and cuts in public sector wage bill. In Mongolia, for instance in 1993, the Government reduced considerably the subsidies that formerly made up as much as 25 per cent of government expenditure. In Lao People's Democratic Republic, there have been major retrenchments of public sector employees.

At the same time, some Governments have been trying to finance budgetary deficits in a relatively non-inflationary manner. For instance, Viet Nam has started selling treasury bonds, Uzbekistan also plans to do so.

The above are but a few examples of measures to improve fiscal balance. In order to restore fiscal stability, Governments will have to continue to pay attention to both the revenue and the expenditure sides of the fiscal equation. On the revenue side, efforts will have to be made to develop appropriate tax structure which can bring into the tax net as much of the national income or expenditure as possible with a realistic and enforceable rate. Tax collection machinery will have to be strengthened. In addition, the question of introduction of user fees for publicly provided services merits attention. On the expenditure side, Governments will have to deal with issues relating to the type of services to be provided by the public sector, the size of employment in the public sector, subsidies to public enterprises, and expenditure on social welfare.

## 2. Exchange rate

Stabilization of national currency is also crucial for macroeconomic stability. The Central Asian republics introduced their national currencies only in 1993. During the short period after introduction the local currencies devalued considerably. The value of the local currency of Kazakhstan fell from Tenge 4.75 in November 1993 to Tenge 11.21 per $US 1 in February 1994, equivalent to devaluation by 136 per cent. In terms of the rouble the tenge devalued by 242 per cent from Tenge 1 to 3.42 per 1,000 roubles during the same period. The value of the manat, national currency of Turkmenistan, dropped since its introduction in November 1993 from 1.99 Manat to 10 per $US 1 at the official rate and from Manat 6 to 65-70 per $US 1 at the market rate by April 1994. The Uzbekistan Som collapsed in value from par with rouble in November 1993 to Som 5-6 per 1 rouble in mid-January 1994.

The dramatic devaluation of national currencies in the Central Asian republics reflected the high levels of inflation, the lack of confidence in the currency as well as highly overestimated exchange rates when the currencies were first introduced. As a measure to firm up the national currencies, the Governments of the Central Asian republics established hard-currency auctions to produce more hidden hard currency and to build up the countries' reserves. However, currency auctions in Turkmenistan were cancelled in less than six months because of the lack of hard currency to meet demand. Along with replacement of the old Currency Exchange with an inter-bank currency auction, the Government of Kazakhstan lifted export restrictions on all goods purchased in tenge in the country.

One of the features of stabilization programme of Viet Nam was that Government parted with multiple and overvalued exchange rate system and unified all exchange rates of dong in terms of convertible currencies to a single official exchange rate. It pursued a policy of managed float which, in effect, involved upward adjustments of the official exchange rate to match free market rates. A large measure of stability in exchange rate has been restored since 1992. Efforts are underway to establish an inter-bank market for foreign exchange.

In common with many other economies in transition, Mongolia also had a complex system of multiple exchange rates. Different rates existed for convertible and non-convertible currencies and within each category there were commercial and non-commercial rates. These were unified under a floating rate regime in May 1993. The national currency, the tugrik devalued from 7.1 to 40 per $US 1 in 1991, then further to 390 in 1993.

The exchange rate is a result of both demand for and supply of foreign exchange. The supply of foreign exchange is determined to a large extent, by a country's capacity to export whereas the demand for foreign exchange originates in imports. There are also interactions between the two in the sense many of the imports have to be used as inputs into the production of exports. Here lies an important rationale for a relatively free import regime in addition to the incentive effect it generates for the production of inefficient import competing products. Furthermore, import tariffs or other restrictions on imports also act as a disincentive to exports by supporting an artificially high exchange rate.

Thus, compression of imports is not much of a viable policy tool to stabilize exchange rate. The formulation of a policy regime that promotes exports is the key requirement. In addition, inflow of external resources, both official and private, is vitally needed for exchange rate stabilization. External resources could help stabilize exchange rate by directly increasing the supply of foreign exchange. This in turn would reduce inflationary pressure in so far as such pressure is generated by the price of imports in local currency. Furthermore, external resource inflows help increase the domestic availability of goods and services and thus dampen inflationary pressure.

## 3. Monetary policy

Monetary policy was hardly used as a tool for macroeconomic management in the former centrally-planned economies. The banking system was designed largely to accommodate the financing needs for physical output targets laid down in plan documents or the budget. The prices of outputs were controlled or administered by the State. In consequence, monetary policy played practically no role in determining price level or interest rate.

As the economies in transition embarked on market-oriented economic systems, there has been a considerable liberalization of output prices and most of the countries have instituted a two-tier banking structure under which the Central Bank is an apex body of the monetary and financial system, whereas commercial banks and other financial institutions cater to the demand for credit. Money and credit supply have thus emerged as important determinants of the price level.

An appropriate monetary and credit policy needs to be followed in order to restore and sustain price stability. In this context, an important issue in the economies in transition relates to reform of state-owned enterprises. A significant part of money and credit in these economies can be ultimately related to a state enterprise operations. An improvement in the operational efficiency of these enterprises in a manner that reduces their dependence on budgetary subsidies or guaranteed access to bank credit is an urgent priority. Most countries have undertaken reform measures involving privatization, corporatization and application of commercial principles in state-owned enterprises. So far, the performance has been mixed. Continued reforms of state-owned enterprises will thus remain a policy priority in the context of monetary policy.

Another important issue in the conduct of monetary policy relates to the interest rate. Most empirical studies suggest that a positive real interest rate is important to promote savings, though there is no unanimity as to how high that rate should be. A positive real interest rate could increase the availability of investible resources in an economy and promote greater availability of domestically produced goods and services. The improved supply situation should, thus, help contain inflationary pressures. Moreover, in circumstances of high inflation a positive real interest rate would call for a nominal interest rate higher than the inflation rate and that in turn should help contain credit demand and reduce inflationary pressure.

## C. CONCLUDING OBSERVATIONS

This paper has argued that the economies in transition markedly differ in respect of their physical and economic characteristics and, therefore, policy reforms geared to restoration of stability and revival of growth have to take into account unique features of each country. Nevertheless, there are a number of common macroeconomic issues which merit attention. These relate to reduction in fiscal deficits, stabilization of exchange rate and implementation of monetary policies geared to reduce inflation. The paper has given a glimpse of some of the measures introduced along these lines in several economies in transition. A beginning has thus been made by the countries concerned with varying degrees of success in their efforts to restore stability and promote growth. There remains a long road to be traversed. A host of institutional requirements will have to be met to achieve success in this arduous journey. At the same time, some minimum social protection needs to be provided to those segments of populations that are severely affected by reform measures. The subsequent papers will throw greater light on various measures adopted by individual countries in these areas and their impact. That should provide the basis for sharing experiences with the ultimate objective of assisting improved design and implementation of policy reforms.

# CHAPTER II. ECONOMIC REFORMS IN COUNTRIES OF INDO-CHINA*

## A. VIET NAM

In Viet Nam, 1981, 1986, 1989 and 1993 are the years which demarcate the new beginnings in national reform. As result of the Sixth Congress of the Central Committee of Viet Nam's Communist Party held in August 1979, a number of economic reform measures were launched in January 1981. These reform measures include formalization of a product-based contract system in the agricultural sector, which had been experimentally implemented in some areas since 1979, and the institutionalization of autonomy for state-owned enterprises (SOEs) whereby they were allowed to produce and sell in the free market after fulfilling their government quotas.

However, the most comprehensive reform policy was set out in December 1986 by the Sixth National Congress of the Communist Party of Viet Nam (CPV). This policy, known as *doi moi* (renovation), showed a shift from a socialist model of development and ownership system to a regime which emphasizes the international division of labor in the formation of development policy and the recognition of private ownership in economic activities. In the context of doi moi policy, the Foreign Investment Law was promulgated in 1987.

Another demarcating year reforms was 1989 when a set of drastic reform measures was adopted, mainly in the pricing system, with the principal purpose of fighting hyper-inflation. Abolition of the dualistic price system, including the unification of exchange rates, and the realization of positive interest rates were major items for reform.

Finally, since 1993, Viet Nam's reforms have centred on the improvement of a legal environment in which the market economy can effectively work. A set of related laws were passed by the National Assembly in June 1993, December 1993 and June 1994.

This section will review the economic reforms taken so far in Viet Nam and provide an assessment of those reforms in light of macroeconomic stability

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* Prepared by Tran Van Tho, consultant to the ESCAP secretariat and Motoyoshi Suzuki, Associate Professor, Mie National University, Mie, Japan.

and long-term economic development. The paper begins with a short review of the economic situation and structure in the latter half of the 1970s and the first half of the 1980s, a period prior to the comprehensive reform policies. Then it will analyze the reform measures in a number of areas such as monetary and fiscal policies, export promotion, and foreign direct investment. Finally, an overall assessment which refers to both stability and development will be given along with proposals for further reforms in the future.[1/]

## 1. Economic situation prior to the comprehensive reforms

Prior to the start of economic reforms, the Vietnamese economy exhibited all of the basic characteristics of a socialist planned economy as well as those of an underdeveloped one. Industrial production had been carried out mainly by state-owned enterprises (SOEs) and agricultural production by cooperatives. The majority of the labour force had worked in the agricultural sector for which productivity had been low (table 1). As will be seen later, domestic savings were almost zero and investment had been financed by assistance from the former USSR and other Eastern European countries. Regarding external economic relations, Vietnamese exports had been dominantly accounted for by primary products and trade was generally limited to the former Council for Mutual Economic Assistance (CMEA) countries.[2/]

In December 1976, the year which demarcated the reunification of Viet Nam, the Fourth National Congress of the Viet Nam Communist Party set forth long term economic development and socialist construction strategies which were characterized by development of heavy industries and the socialization of economic activities on a nation-wide scale. The socialization of economic activities is the collectivization of activities in agriculture, industry and commerce, and is characterized by the rise in the number of SOEs and farming cooperatives.

Since the latter half of the 1970s, however, the Vietnamese economy was faced with stagnation and high inflation. In real terms and on an annual

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[1/] The literature on Viet Nam's economic reforms is increasing. Among the works written in English are Tran (1990), Ljunggren (1993) and Turley and Selden (1993). Chinh Phu (The Government of Viet Nam) (1993), World Bank (1994) and Perkins, Depice and Haughton (1994), available in both Vietnamese and English, are among the best systematic accounts of the latest developments.

[2/] For more details, see, for example, Tran Van Tho, The Economic Development of Viet Nam in an Asian Pacific Perspective, Research Report No. 1. The Japan Center for Economic Research, (1990), Tokyo.

**Table 1. Industrial structure of Viet Nam in 1976 and the 1980s**

| | *1976* | *1980* | *1986* | *1989* |
|---|---|---|---|---|
| Share of agriculture (per cent) | 34.5 | 41.1 | 34.4 | 38.2 |
| Share of industry (per cent) | 38.4 | 33.0 | 42.0 | 40.6 |
| A Group | (11.5) | (12.5) | (13.5) | (11.7) |
| B Group | (26.9) | (20.5) | (28.5) | (28.9) |
| Other | 9.6 | 13.0 | 14.3 | 10.5 |
| Labour force (million) | – | 2 164 | 2 740 | 2 875 |
| Share of physical production (per cent) | – | 92.9 | 93.2 | 93.6 |
| Agriculture | – | 70.0 | 72.3 | 70.9 |
| Industry | – | 10.4 | 10.7 | 11.7 |
| Other | – | 5.0 | 4.6 | 6.5 |
| Share of service | – | 7.0 | 6.4 | 6.4 |

*Source:* So Lieu Ke, Chong hoa xa hoi chu nghia Viet Nam (Statistical Date of the Socialist Republic of Viet Nam), 1976-1989.

*Notes:* A Group: Production of capital goods (heavy industries).
B Group: Production of consumer goods (light industries).

average, agricultural and industrial products rose only about 1 to 2 per cent in the latter half of the 1970s (table 2). The main reasons for this stagnation were an overambitious promotion of heavy industrialization and defects in collectivist economic management. Another reason was a shortage of capital and other resources as a consequence of the worsening international political climate surrounding Viet Nam since the late 1970s.

Due to the economic revisions made by the Fifth National Congress of the Communist Party in 1982, as shown in table 2, industrial and agricultural production in the first half of the 1980s showed a recovery. However, industrial production had been based on a planned system, carried out by inefficient SOEs which had always received large subsidies from the government. The more the Government stimulated industrial production the higher the inflation rate rose.

Since the late 1970s until 1988, prices in Viet Nam had increased steadily by rates measured in triple digits. Rates of inflation were in the range of 101 and 104 per cent during the period of 1977 and 1980, and jumped to

**Table 2. Growth rates of Viet Nam's economy in the 1970s and 1980s**
**(Per cent)**

| | *1976-1980* | *1981-1985* | *1986-1989* |
|---|---|---|---|
| Agriculture | 1.9 | 5.1 | 3.8 |
| Industry | 0.6 | 9.5 | 5.9 |
| A Group | 7.1 | 6.5 | 2.7 |
| B Group | -3.3 | 11.3 | 7.3 |
| Foodstuff production | 1.7 | 4.8 | 4.2 |
| Labour force | 2.8 | 3.8 | 3.3 |

*Source:* So Lieu Thong Ke, Cong hoa xa hoi chu nghia Viet Nam (Statistical Data of the Socialist Republic of Viet Nam), 1976-1989.

*Notes:* A Group: Production of capital goods (heavy industries).
B Group: Production of consumer goods (light industries).

a much higher level in most of the 1980s, with the highest level recorded during 1986 (557 per cent). These rates measure only the inflation experienced in the government sector. If the free market sector were taken into consideration these rates would certainly be higher.[3]

The reasons for hyper inflation in Viet Nam had been the shortage of supply and the expansion of money circulation which stems from the management system of a planned economy. As noted above, due to the increasing subsidies provided to the generally inefficient SOEs, the government expenditure had expanded rapidly and most of the fiscal deficit was financed by printing more money. For example, in 1988, the combination of wage, subsidies and investment, the three largest government expenditure items, increased by 578 per cent over the previous year. Because so much new money was printed to finance these expenditures, money circulation increased to 12.3 billion dong at the end of 1985, 55.4 billion dong at the end of 1986 and 83.3 billion dong at the end of 1988.[4]

[3] See, for example, Vo Dai Luoc, Current Micro-economic Issues in Viet Nam: With Special Reference to the Problem of Inflation (1990) p. 94.

[4] For a more detailed analysis of the factors accounting for hyper inflation, see Vo Dai Luoc (1994), pp. 123-137. See also Dang Duc Dam (1993) for an excellent account of the inflation problems in Viet Nam.

## 2. Reforms for stability and development

### *(a) Monetary reforms*

Since the early 1980s, the Vietnamese Government already recognized the phenomenon of inflation and tried to overcome this problem. The fight against inflation had been the first priority of macroeconomic policy in Viet Nam until very recently.

Before 1989, inflation was considered as structural, with the familiar explanation that economic underdevelopment and imbalances in the supply-demand of goods were its main causes. That was why the solution for inflation was to increase production in order to re-establish the balances of goods. However, to encourage production, the Government had to provide more capital for SOEs, thus causing credit to expand and money supply to increase. The money supply therefore increased much faster than output, and inflation rose to a higher level. In addition, this measure deteriorated the balance of the government budget and the increasing deficit was financed by printing new money.

Since 1989, the direct cause of inflation has been recognized as the excess of money flow so that the solution has been sought in the monetary and fiscal policy.

Until early 1990, the Vietnamese banking system had been a one-level system and in fact it was a part of the state budget. The main activities of the state bank at that time had been to receive funds from SOEs and the state budget and to provide loans to the SOEs. The state budget had always run large deficits and the most popular and easy remedy was to print more money to finance that deficit and to provide credit loans to SOEs. This structure caused inflation to become worse and worse.

Since 1988, preparation for a two-level or two-tier banking system had been underway and in 1990, indications of a turning point were seen for monetary policy with the passing of two ordinances on banking, one on the central bank and another on commercial banks and credit organizations. Under the new system, the State Bank acts as the central bank responsible for monetary policy to stabilize the currency and manage macroeconomic activity and the commercial banks and financial companies deal with financial businesses such as loans and fund mobilizations.

However, the turning point for monetary policy in Viet Nam was the decision of the Government to change the interest policy. According to

Directive No. 39/HDBT in April 1989, (a) interest rates must be applied uniformly to various economic sectors and adjusted according to the changes of prices in the market, (b) banks have to pay interest for all capital resources mobilized for loans and receive interest for all credits, (c) the difference between the lending interest rate and deposit interest rate will be 0.5 per cent monthly, and (d) the interest rate must consist of both basic interest and inflation rate.

Thus the deposit interest rates were increased to a level higher than inflation. The time deposit interest rate applied to the household sector, for example, increased from 8 per cent in 1988 to 12 per cent per month in 1989. Subsequently, the interest rates were continuously adjusted by the State Bank in pursuing the real positive interest rate. This policy resulted in controlling inflation in 1989. However, the high interest rates also discouraged investors and thus had an adverse effect on production. In addition, inflation rates went up again in 1990 and 1991 (4.4 per cent per month in both years, compared with 2.5 per cent in 1989)[5/] due to a large deficit in the government budget. This point suggests the necessity of fiscal reforms which will be discussed below.

Regarding the reforms in the banking system, in 1988, three national (state-owned) commercial banks (Agriculture Bank, The Bank of Trade and Industry, and the Foreign Trade Bank of Viet Nam or Vietcombank) were set up. Foreign banks have also been allowed to open representative offices since 1990 and set up branches or joint ventures since 1991. By mid-1994, three joint venture banks had been established with investment from Indonesia, Republic of Korea and Malaysia.

From April 1994, commercial banks have been allowed to offer individual accounts. By mid-1995, automatic teller machines (ATM) will also be set up in Hanoi and Ho Chi Minh City.

These developments show great efforts by the Government in building up a competitive financial system in Viet Nam.

### *(b) Exchange rate policy*

Since 1989, the Government has adopted a policy for a controlled floating exchange rate. Attempts have been made to unify the exchange rates

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[5/] Vo Dai Luoc, Industrial Development Policy of Viet Nam in the Doi Moi Process (1994), p. 138.

by frequent upward revision of official rates to match free market rates. By mid-1991 such unification had been realized and the dong had been largely depreciated. Since the beginning of 1992, the exchange rate was established at the stable rate of 11,000 dong per US dollar. This was due to various governmental intervention measures. In September 1992, the Government prohibited the imports of 17 commodities as a means to narrow the trade deficit and reduce the demand for foreign currency. This measure was abolished in early 1993, and the Government instead intervened into the exchange market by selling dollars from foreign reserves.

However, while inflation has progressed, a stable nominal exchange rate means that the real exchange rate of the Vietnamese dong has been appreciated. For example, the exchange rate of 1 US dollar increased from 5,200 dong in early 1989 to 10,500 dong in early 1993, i.e, the value of the US dollar increased by two times. On the other hand, during the same period, the general price level has increased by approximately 3.7 times. In other words, the real exchange rate (value of dong) was appreciated, and this discouraged exports and encouraged imports. This trend was particularly pronounced in 1993 when both nominal and real interest rates were appreciated.

Since the early 1990s, the Government has made efforts to establish a foreign exchange market. In 1992, exchange centres were open in Hanoi and Ho Chi Minh City. At present, attempts are being made to establish an inter-bank market for foreign exchange.

### *(c) Fiscal reforms*

#### *(i) Tax system*

Before 1990, the only national tax applied to agriculture. Taxation in trade, industry and in state businesses was based on government regulations which were ineffective and tax exemption was very common in many businesses. Since 1990, the National Assembly has concentrated its efforts regarding tax reform laws. By early 1994, turnover tax, excise tax, profit tax, personal income tax, agricultural land tax, royalty, tariff, and profit remittance tax have been passed. In order to collect tax in line with the tax law, the Ministry of Finance has implemented a decree on accountancy and statistics, required SOEs to submit documentation, audited financial reports and tax declarations, and organized tax collection teams.

Thanks to the reforms in the tax system and in the administrative mechanism for tax collection, in the period of 1991-93, the total tax revenue increased on average by 63 per cent per annum. In terms of share in GDP, total government revenue has also showed an increase since 1992 (table 3). However, there are still too many different tax rates and tax revenue is still not enough to cover expanding expenditure. The Government is planning to simplify the tax rates, and to replace the turnover tax by the value added tax. Another problem is that taxes have not been collected as smoothly as expected simply because people tend to avoid paying tax. So far, the majority of tax revenue has come from a number of large or foreign-related organizations or corporations. In 1993, for example, tax paid only by the employees of Viet Nam Oil and Gas Corporation accounted for 35 per cent of total income tax revenue. Since April 1991, the Government has commissioned companies or organizations to withhold income tax before paying out salaries to their employees. This tax collection from the original sources became obligatory from June 1994 by an ordinance of the Government.

*(ii) Policies on SOEs*

For decades, SOEs were a major cause of deficits and difficulties for the government budget management. Until 1991, there were about 12,000 SOEs under central and local administrations. Since 1990 the Government has

**Table 3. Summary of budgetary operation, 1986-1993**
**(In billions of current dong and per cent)**

| | *1986* | *1987* | *1988* | *1989* | *1990* | *1991* | *1992* | *1993 (P)* |
|---|---|---|---|---|---|---|---|---|
| Total government revenue | 83.7 | 382.3 | 1 758 | 3 899 | 6.153 | 10 353 | 18 970 | 26 380 |
| | (16.4) | (14.4) | (13.3) | (16.0) | (16.1) | (14.8) | (18.6) | (21.0) |
| Current expenditure | 75.9 | 329.1 | 1 623 | 3.724 | 6.156 | 8.728 | 15 005 | 26 000 |
| | (14.8) | (12.4) | (12.2) | (15.3) | (16.1) | (12.5) | (14.7) | (20.7) |
| Therefore government saving | 7.8 | 53.2 | 135 | 175 | –3 | 1 625 | 3 965 | 380 |
| | (1.5) | (2.0) | (1.0) | (0.7) | (–0.0) | (2.3) | (3.9) | (0.3) |
| Capital expenditure | 43.1 | 181.5 | 1 181 | 2 208 | 2 124 | 2 135 | 5 710 | 7 000 |
| | (8.4) | (6.9) | (8.9) | (9.1) | (5.6) | (3.1) | (5.6) | (5.6) |
| Therefore primary deficit | 35.3 | 128.3 | 1 046 | 2 033 | 2 127 | 510 | 1 745 | 6 620 |
| | (6.9) | (4.8) | (7.9) | (8.4) | (5.6) | (0.7) | (1.7) | (5.3) |
| Interest and repayment | 1.1 | 2.1 | 26 | 48 | 906 | 1 218 | 2 100 | 2 300 |
| | (0.2) | (0.1) | (0.2) | (2.0) | (2.4) | (1.7) | (2.1) | (1.8) |
| Therefore financing requirement | 36.4 | 130.4 | 1 072 | 2 081 | 3 033 | 1 728 | 3 845 | 8 920 |
| | (7.1) | (4.9) | (8.1) | (8.6) | (8.0) | (2.5) | (3.8) | (7.1) |
| **Financed by:** | | | | | | | | |
| Gross foreign loans and grant | 14.2 | 43.5 | 368 | 1 072 | 1 860 | 1 335 | 2 845 | 4 500 |
| | (2.8) | (1.6) | (2.8) | (4.4) | (4.9) | (1.9) | (2.8) | (3.6) |
| Credit from state bank | 22.9 | 89.2 | 450 | 1 963 | 1 173 | 393 | – | – |
| | (4.5) | (3.4) | (3.4) | (8.1) | (3.1) | (0.6) | (0.0) | (0.0) |
| Other domestic borrowing | – | 3.0 | 17 | – | – | – | 1 000 | 1 500 |
| | (0.0) | (0.1) | (0.1) | (0.0) | (0.0) | (0.0) | (1.0) | (1.2) |

*Source:* Reproduced from Perkins, Dapice and Haughton (1994). Original data are from Statistical Yearbooks and the Ministry of Finance.

*Note:* Figures in parentheses are per cent of GDP.

intensively eliminated subsidies to SOEs by raising prices of a large number of raw materials to international levels, and by reducing the supply of circulating capital (bank credit) to them. Under this severe situation, the number of SOEs dropped sharply to 7000 in mid-1993.

*(iii) New measures for eliminating budget deficits*

Throughout the latter half of the 1980s, budget deficit rose to 5 to 8 per cent of GDP (table 3). This situation brought about a hyper-inflation since the Government tended to cover the deficits by printing more new money. Since 1989, the Government tried to balance the budget by curtailing subsidies to SOEs and reducing the current expenditure. Also in 1989, more than 500,000 soldiers were demobilized. Reduction in the subsidies to SOEs, as noted above, also resulted in the layoffs of 80,000 persons in three years.

In addition to the increase in the tax revenue, the reduction in current expenditure has contributed to the decline in fiscal deficits. Since 1991, the budget deficit has been financed only by borrowing from the public and from external sources. Financing the budget deficit by printing money has been rejected (See table 3).

Improvements in the budget balance and new measures to finance the deficits have helped to contribute to overcoming runaway inflation since 1992.

***(d) Export promotion***

The experience of economic development in East Asia has shown that export of manufactured products can promote efficiency of investment and thus contribute to rapid growth.[6/] Broadly speaking, there are three policy areas which can promote exports. The first one is industrial policy or industrialization strategies which facilitate or induce the development of comparatively advantaged industries. The second area includes macroeconomic policies (exchange rate policy in particular) and policies for developing institutional frameworks or industrial organizations which encourage export activities. The third policy area is a set of measures which directly push the export of manufactured products, such as export credit, duty-free imports for exporters and their suppliers and tax incentives. The establishment of export

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[6/] See, for example, World Bank, The East Asian Miracle: Economic Growth and Public Policy, Oxford University Press (1993), Kosai and Tran, Japan and Industrialization in Asia: an Essay in memory of Dr. Saburo Okita, the Journal of Asia Economist, Vol. 5, No. 2. (1994).

processing zones can be included in this category. A review of these three policy areas in Viet Nam is in order.

Viet Nam's population density is very high, much higher than China or Thailand. Natural resources are also not abundant in terms of per capita. Currently, unemployment rate is estimated to be about 6 per cent and if the redundant labour in rural areas was properly estimated, this rate would be much higher. In the future, along with the rise in productivity of the agricultural sector, there will also be an increase in the labour force seeking jobs in the second and tertiary sectors. Furthermore the overall population seems to be continually gaining at a rate of 2 per cent, causing the labour force to increase. Taking into account these factor endowments, it is possible to say that at least until the year 2000, the Vietnamese comparative advantage is in the areas of labour-intensive industries. These industries include the processing of agricultural, forestry and marine products. In a longer perspective, along with the strengthening of human resources development, and given a sea coast of 3200 km in length, Viet Nam may grade up its comparative advantage structure to include technology and capital-intensive industries.

The industrialization policy in Viet Nam since the 1980s has shifted from a socialist approach, emphasizing the development of heavy industry, to an international specialization approach which encourages the development of light manufacturing industries. The Sixth National Congress of CPV in 1986 emphasized the development of agriculture and light manufacturing industries, by promoting the so-called "Three Big Economic Programs", i.e., the production of foodstuffs, consumer goods and export products. This development strategy was reconfirmed by the Seventh National Congress of CPV (June 1991) which adopted the "Strategy for Social and Economic Development toward the Year 2000". In this strategy, Viet Nam will promote industrialization based on labour-intensive industries and natural resources. This strategy is quite similar to that of a newly agro-industrializing country, as in the case of industrialization of Thailand since the 1970s.

In July 1994, the Congress of the Central Executive Committee of the Communist Party of Viet Nam adopted a Directive on industrialization until the year 2000. Except for the emphasis of some capital-intensive industries such as cement and machinery which support the construction of infrastructure and mechanization of agriculture, the Directive was in line with the strategy adopted in 1991. Given the present factor endowments of Viet Nam, this strategy will exploit the comparative advantage of the country and thus promote manufactured exports from Viet Nam.

With regard to the second area of export promotion, the policy of exchange rates tended to discourage exports. Here, it is of interest to consider the organization policy on export activities. Until 1989, all export and import activities had been conducted by state-owned trading companies which received quotas and licenses from the Ministry of Commerce. Since 1990, private companies have been allowed to export and import but their export was limited to the products they themselves produced and their imports were limited to the inputs of their production activity. That means that private trading companies were not permitted. From late 1993 to early 1994 however, two reforms have emerged regarding the administration of trading activities. First, all but two export products were liberalized from the quota system. Two exceptions were fabrics and cassava products which are still under quotas by importing countries. Second, with some exceptions, trading activities have been shifted from an approval basis to a reporting basis. In the case of exports, with the exception of crude oil, coal and rice, all products can be exported without advance permits from the government.

The organization policy has been considerably improved in terms of administrative procedures. However, there is still a lack of a competitive framework which can promote exports. The establishment of private trading companies, particularly private firms specializing in export of manufactured products, should be permitted soon.

Regarding the third policy area, so far Viet Nam has not provided incentives to promote exports. On the contrary, until recently, there had been some measures which discouraged exports. For example, until October 1991, export businesses receiving revenue in hard currencies had been forced to sell part of their revenue to the Government at a price set up by the state bank, usually 2-3 per cent lower than the market prices. This policy discouraged exports and induced exporters to deposit their hard currencies in overseas banks.

In sum, Viet Nam is adopting an industrialization policy which is in line with the country's comparative advantage. However, there is still no competitive environment to stimulate exports, and there are no incentives to encourage exports, particularly for manufactured products. In the meantime, the only instrument which is expected to promote exports of manufactured products is the introduction of foreign direct investment.

### *(e) Foreign direct investment (FDI)*

As a major component of the *doi moi* strategy, a new Foreign Investment Law was promulgated in December 1987. Immediately after promulgation of the law, France and other Western European countries actively responded by investing in oil and gas exploration as well as tourism and services. In more recent years, FDI by Asian newly industrializing economies (NIEs) in labour-intensive industries has become the mainstream. Since FDI tended to concentrate on the southern part of the country, from 1991, more fiscal incentives and other promotion measures have been provided to FDI projects undertaken in the northern part and other areas outside Ho Chi Minh City. The rents of leased land have also been adjusted so that the northern areas are cheaper than those surrounding Ho Chi Minh City. The results of FDI projects approved in 1992 and 1993 suggest that those measures have been quite effective. In 1990, Viet Nam decided to set up export processing zones (EPZ) to attract FDI. By October 1993, five EPZs had been approved. In Tan Thuan, the earliest EPZ, located in Ho Chi Minh City, some factories have already started operations. Another EPZ in this city as well as the EPZs in Da Nang and Hai Phong are in the process of infrastructure building. One more EPZ is in Can Tho, the largest city in the Mekong Delta region. This area however, seems to be much less attractive because poor transportation facilities make access to the harbours costly. Most EPZs are attempting to attract FDI in labour-intensive industries. This is a good policy to promote manufactured exports. The current problem, however, is that infrastructure building in most EPZs are time-consuming due to the shortage of capital.

Viet Nam is increasingly emphasizing the role of FDI in the development of the economy. Since 1992, Viet Nam has tried to improve the investment climate in order to attract more FDI. The minimum wage, for example, in May 1992, was reduced from US$ 50 to US$ 35 per month. In December 1992, the National Assembly passed a number of important amendments and additions to the Foreign Investment Law. Some of the major changes in this law are: First, the standard period of enterprises with foreign invested capital (i.e., a joint venture or fully foreign owned enterprises) was extended to 50 years (from the current 20 years), with the possibility for a maximum period of 70 years. Second, in special cases where encouragement of investment is needed, preferential tax treatment will also be provided to enterprises with 100 per cent foreign ownership (previously only joint ventures were able to receive such treatment). Third, Vietnamese private firms may now be a party to a joint venture or business cooperation contract with foreign investors (previously private firms were not allowed to do so unless state-owned enterprises participated in the project).

Since the beginning of 1994, efforts have been made in the simplification of screening process of FDI application projects, in the facilitation of land procurement and construction approval for projects which have received permission for investment.

According to the new economic planning announced in July 1994, from 1994 to 2000, Viet Nam will need US$ 48 to 50 billion for investment to attain the target of doubling the per capita GDP between 1991-2000. From that amount, apart from domestic saving (20 billion) and ODA (10 billion), FDI is expected in the range of US$ 18 to 20 billion. On average and on a disbursement basis, annual inflow of FDI is expected to be US$ 2.5 to 3 billion. As column (6) in table 4 shows, in 1994, FDI inflow was US$ 850 million so that the target for 2000 appears quite difficult to meet unless great efforts are made in improving the investment environment.

**Table 4. Foreign Direct Investment (FDI) in Viet Nam (Million US$, per cent)**

| | *Approved (1)* | *With-drawn (2)* | *Planned (3) = (1) – (2)* | *Dis-bursed (4)* | *Disburse-ment rate (per cent) (5) = (4)/(3)* | *Actual inflow of FDI (6)* |
|---|---|---|---|---|---|---|
| 1988 | 366 | 132 | 234 | 239 | 101 | * |
| 1989 | 539 | 209 | 330 | 366 | 110 | 160* |
| 1990 | 596 | 114 | 482 | 349 | 72 | 200 |
| 1991 | 1 288 | 129 | 1 159 | 513 | 44 | 260 |
| 1992 | 1 939 | 17 | 1 922 | 471 | 24 | 450 |
| 1993 | 2 728 | 12 | 2 716 | 146 | 5 | 850 |
| Total | 7 456 | 613 | 6 843 | 2 084 | 31 | 1 920 |

*Source:* Calculated from Viet Nam *Dau Tu Nuoc Ngoai, 1-28 February 1994*. Thoi Bao Kinh Te Saigon (Spring 1994 and 10 February 1994).

*Notes:* 1. Column (4 : yearly): investment disbursed until the end 1993 for approved projects.

2. Date for 1993 is calculated until 25 December; in column (6) until 15 December .

3. Date for 1989 in Column 6 is included in the figures for 1988.

## 3. An assessment of economic reforms

### (a) *Indicators of success in economic stability and development*

It is noteworthy that economic reforms in Viet Nam have shown encouraging results in many aspects. First, hyper-inflation has been overcome. Inflation rates reached more than 700 per cent in 1986, 200 to 400 per cent in 1987 and 1988, fell to two-digit figures in subsequent years but were still at high levels (67 per cent) in 1990 and 1991. The combined monetary and fiscal reform measures have reduced the inflation rate to 17 per cent in 1992 and 5.3 per cent in 1993.

Second, during the transitional period, the Vietnamese economy has so far been able to achieve a considerable rate of growth. As shown in table 5, until 1991 the growth rate of the economy as a whole had been moderate and the growth of its component sectors had fluctuated considerably. Since 1992, however, GDP has shown a higher growth than the preceding period and this growth has been attributed to concurrent growth for most sectors of the economy. In particular, the consistently high growth of the industrial sector in recent years is encouraging.[7/]

Third, the Vietnamese economy has increasingly opened up to the world, particularly to the dynamic Asian Pacific region. Exports have steadily increased even after the collapse of the former USSR, the once all-important market of Viet Nam. As illustrated in table 6, exports to the convertible areas have expanded since 1989 and more than offset the sudden drop in the exports to the non-convertible areas since 1991. At present, Japan and Singapore are Viet Nam's top trading partners in terms of export and import respectively. FDI into Viet Nam has also been expanded since 1991 in terms of both approval and actual basis (table 4). Taiwan Province of China, Hong Kong and other Asian NIEs are among the top investors in Viet Nam. The number of foreign tourists to Viet Nam has also risen rapidly, from 41,829 in 1990 to 128,858

**Table 5. Growth rates of Vietnamese economy in recent years**
**(Per cent)**

| | *1986* | *1987* | *1988* | *1989* | *1990* | *1991* | *1992* | *1993* |
|---|---|---|---|---|---|---|---|---|
| **GDP** | 3.4 | 3.9 | 5.1 | 8.0 | 5.1 | 6.0 | 8.6 | 8.1 |
| – Physical production | – | – | 3.4 | 3.2 | 2.0 | 4.6 | 9.7 | 7.4 |
| • Agriculture and forestry | 1.9 | 0.6 | 3.9 | 6.9 | 1.5 | 2.2 | 7.2 | 3.8 |
| • Industry | 4.5 | 8.7 | 3.3 | –4.0 | 2.5 | 9.9 | 14.6 | 12.1 |
| • Construction | 0.5 | 6.0 | –3.1 | 3.7 | 4.7 | 5.2 | 11.1 | 18.3 |
| • Others | – | – | 5.5 | 1.9 | 3.7 | 2.7 | 3.0 | 4.7 |
| – Services | –3.4 | 0.0 | 8.9 | 17.7 | 10.4 | 8.3 | 7.0 | 9.2 |

*Source:* 1. Until 1990: *Tinh Hinh Kinh Te Viet Nam 1986-1991 tren co so so lieu cua he thong tai khoan quoc gia*, Nha xuat ban thong ke, Hanoi, 1992.

2. 1991 and after: Statistical Bureau, State Planning Committee.

[7/] In Vietnamese statistics, "Industry" covers not only manufacturing but also mining and energy areas such as oil, coal, and electricity.

## Table 6. Balance of payments, 1985-1992
## (US$ million)

| | *1985* | *1986* | *1989* | *1992* |
|---|---|---|---|---|
| **Exports, Total** | 497 | 494 | 1 320 | 2 475 |
| Convertible area | 336 | 307 | 977 | 2 475 |
| Non-convertible area | 161 | 187 | 343 | – |
| **Imports, Total** | –903 | –1 121 | –1 670 | –2 535 |
| Convertible area | –459 | –453 | –985 | –2 535 |
| Non-convertible area | –444 | –667 | –685 | – |
| **Trade, balance** | –406 | –627 | –350 | –61 |
| Convertible area | –123 | –146 | –9 | –61 |
| Non-convertible area | –283 | –480 | –341 | – |
| **Services and transfers** | –47 | –28 | –237 | 52 |
| Interest payments | –64 | –68 | –208 | – |
| Imputed interest on arrears | –26 | –26 | – | – |
| Private remittances | 32 | 30 | 9 | – |
| Freight and insurance | –11 | 1 | – | – |
| Official transfers | 20 | 27 | – | – |
| Others | 2 | 9 | –38 | – |
| **Current, account balance** | –453 | –655 | –586 | –8 |
| Convertible area | –170 | –174 | –218 | – |
| Non-convertible area | –283 | –480 | –368 | – |
| **Capital account balance** | 192 | 363 | 300 | 271 |
| Disbursements | 367 | 517 | 763 | 487 |
| Convertible area | 51 | 10 | 87 | – |
| Non-convertible area | 316 | 507 | 675 | – |
| Scheduled amortizations | –231 | –265 | –350 | –435 |
| Convertible area | –197 | –237 | –134 | – |
| Non-convertible area | –34 | –27 | –216 | – |
| Short-term loans (net) | 55 | 111 | –213 | –41 |
| Direct foreign investment | – | – | 100 | 260 |
| Errors and omissions | –8 | –23 | 66 | 6 |
| **Overall balance** | –269 | –315 | –220 | 268 |
| **Financing:** | 269 | 315 | 220 | 68 |
| Change in NFA (excl. IMF) | – | 2 | –105 | –464 |
| IMF credit (net) | –14 | –4 | – | – |
| Debt rescheduling | 252 | – | 34 | – |
| Change in arrears | 31 | 317 | 291 | 196 |
| **Memorandum items:** | | | | |
| Transferable rubles per US$ | 2.55 | 2.55 | 2.40 | – |
| **Current account balance exports (per cent)** | | | | |
| Total | –91 | –133 | –44 | 0 |
| Convertible area | –51 | –57 | –22 | – |

*Source:* IMF and World Bank, from data provided by the Vietnamese authorities.

*Note:* Figures are rounded.

in 1992 and 209,650 in 1993. Foreign businessmen visiting Viet Nam also quadrupled in the 1990-93 period.

Fourth, an increase in domestic savings is also noteworthy in recent years. According to table 7, until 1989, the overseas net resources (net imports of commodities and services) had accounted for about 10 per cent of the total supply of the economy. In recent years, along with the increase in exports of crude oil, rice and other primary products, as well as the restraint of imports, the ratio of overseas net resources has declined to 4-6 per cent. On the demand side, table 7 shows that the share of investment in total demand has been constant at around 10 per cent. The trends in the ratios of overseas net resources and investment suggest that by 1989, there had been almost no domestic savings and therefore investment had been almost entirely financed by overseas resources. Since 1990, domestic savings have increased and accounted for about half the investment financing. Investment and saving ratios as percentages in GDP showed almost the same trends as well (table 8). The saving ratio was almost zero in 1986 but rose to 15 per cent in 1993. The interest rate policy and improvements in the financial system, which were discussed earlier, have contributed to the rise in saving.

**Table 7. Aggregate supply and demand in the Vietnamese economy (Unit : billions of dong )**

| | *1986* | *1987* | *1988* | *1989* | *1990* | *1991* | *1992* | *1993* |
|---|---|---|---|---|---|---|---|---|
| **A. Total supply** | 572 | 2 721 | 14 971 | 27 175 | 41 101 | 80 632 | 115 051 | 145 012 |
| 1. GDP | 512 | 2 469 | 13 266 | 24 307 | 38 166 | 76 707 | 110 535 | 136 571 |
| 2. M-X | 60 | 252 | 1 705 | 2 868 | 2 935 | 3 925 | 4 516 | 8 441 |
| 3. 2/A (per cent) | 10.5 | 9.3 | 11.4 | 10.6 | 7.1 | 4.9 | 3.9 | 5.8 |
| **B. Total demand** | 572 | 2 721 | 14 971 | 27 175 | 41 101 | 80 465 | 114 812 | 144 370 |
| 4. Gross capital formation | 60 | 270 | 1 906 | 2 817 | 4 385 | 11 506 | 19 498 | 28 007 |
| 5. Consumption | 525 | 2 520 | 13 291 | 24 358 | 37 376 | 68 959 | 95 314 | 116 363 |
| 6. Errors and omissions (4 +5 –B) | 13 | 69 | 226 | 0 | 660 | –167 | –239 | 642 |
| 7. 4/B (per cent) | 10.3 | 9.7 | 12.5 | 10.4 | 10.2 | 14.3 | 17.0 | 19.4 |

*Sources:* 1. For figures in 1989 and earlier: Compiled from *Tinh hihn kihn te Viet Nam 1986-1991 tren co so so lieu cua he thong tai khoan quoc gia*, Nha xuat ban thong ke, Hanoi, 1992. (in Vietnamese).

2. For figures in 1990: Compiled from data provided by Tong Cuc Thong ke (Statistical Bureau), the Government of Viet Nam.

3. For figures in 1991 and after: *Viet Nam Statistical Yearbook 1993*, Statistical Publishing House, Hanoi, 1994.

*Notes:* 1. M-X: Net import of goods and services.

2. Figures are based on current prices.

3. Calculation methods of figures for 1991 and after are slightly different from other figures.

**Table 8. Investment-saving balance and current account balance**

| | *1986* | *1991* | *1992* | *1993* |
|---|---|---|---|---|
| GDP (billions of dong) | 636 | 76 707 | 110 535 | 136 571 |
| **Ratios as per cent of GDP:** | | | | |
| – Gross investment | 9 | 15.0 | 17.6 | 20.5 |
| - Saving | 0 | 10.0 | 14.0 | 15.0 |
| - Current balance | –9 | –5.1 | –4.1 | –5.3 |

*Source:* State Planning Committee.

### *(b) Factors behind successful reforms*

Viet Nam's economic reforms have been conducted under severe international conditions. In addition to the United States embargo policy and the absence of financial assistance from advanced countries or international organizations, the interruption of aid from the former USSR certainly caused adverse effect on the Vietnamese economy. Aid from the former USSR, on a net basis, accounted for 5 per cent of GDP in 1989, the year which marked the peak of such aid to Viet Nam. This important aid was completely interrupted in 1991. Viet Nam also suddenly lost its Eastern European market; exports to this region recorded 2.5 billion rubles in 1990 but fell to only 70 million in 1992.

Even with these disadvantages, reforms have contributed to success in many important areas. Some factors in these successes may be: first, that social and political stability has been maintained, and thus the momentum of reforms has not been disturbed. Second, initial emphasis was put on reforms in the most important sector of the economy — agriculture.[8] Successful reforms in this sector have not only helped to provide enough food for the people, it also provided a considerable amount of foreign exchange since 1989. Rice exports amounted to US$ 420 million (17 per cent of total exports) in 1992. Third, the discovery of oil has been a windfall for Viet Nam during severe times. Export of crude oil started in 1987 at US$ 30 million, but this rose to 200 million in 1989 and to US$ 790 million (32 per cent of total export) in 1992. Oil and rice are currently the first and the second largest export products of

[8] Due to the limited scope of the paper, reforms in this sector are not discussed in any detail. See, for example, the paper by Idei in Tran Van Tho, ed (1990), The Economic Development of Viet Nam in an Asian Pacific Perspective, Research Report No. 1, the Japan Center for Economic Research, Tokyo.

Viet Nam. Fourth, with a good geographical location, social and political stability, and great potential due to a relatively high quality labour force, the economic reforms and open-door policies in Viet Nam have received positive responses from foreign governments and firms, particularly those in East Asia. East Asian countries have shown interest in strengthening their economic ties with Viet Nam. This provides a good start for Viet Nam to further participate in the future division of labour in this dynamic region.

*(c) The remaining problems*

Despite good performance of the reforms, Viet Nam is still encountering a number of problems.

First, the unemployment problem, which was mentioned earlier has not significantly improved. As shown in table 9, from 1985 to 1993, the labour force increased by 6.7 million workers but most of these (4.7 million) remain in the agricultural sector. This is because the industrial sector is still not developed enough to absorb labour from the rural sector. As suggested by table 10, for approximately the past 10 years, the increase in agricultural production has mainly come from expansion of cultivated land and land productivity due to increasing intensity of fertilizer usage, rather than from improvements in labour productivity.[9] Even if the share of the agricultural sector in the total GDP has declined (table 9), this can largely be attributed to the increasing share by the construction and service sectors, which have been stimulated by the infrastructure building and businesses associated with foreign visitors. The GDP share of the industrial sector has remained low. From a developmental point of view, these phenomena are not desirable.

Second, even though it has increased, the ratio of investment to the GDP is still low. This ratio rose to 20 per cent in 1993 but this level is comparable with most East Asian countries in the early 1960s. Two reasons for this low level of investment are the low saving rate which is discussed below and the lack of an environment which stimulates domestic private investment. Foreign direct investment has been the main source of private investment so far.[10]

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[9] There are some other problems associated with the agricultural sector, such as the poor infrastructure resulting in slow distribution of products, the poor investment for the post-harvest facilities (drying, stocking, ....) and the lack of product diversification, which tends to keep relative prices of agricultural products at low levels.

[10] FDI accounted for as much as 25 per cent of total investment in 1993. Since the weight of private investment in total investment is small, FDI should account for more than 50 per cent of private investment.

## Table 9. Economic structure of Viet Nam

| | *1985* | *1990* | *1993* |
|---|---|---|---|
| **Population (million)** | 59.9 | 66.2 | 71.0 |
| **Labour (million)** | 26.0 | 30.3 | 32.7 |
| In agriculture | 19.0 | 21.9 | 23.7 |
| In industry | 2.8 | 3.4 | 3.5 |
| **GDP (billions of dong)** | – | | 136 571 |
| Per cent of agriculture and forestry | – | 38.6 | 29.3 |
| Per cent of industry | – | 19.1 | 21.5 |
| Per cent of construction | – | 3.8 | 6.9 |
| Per cent of service | – | 37.7 | 41.2 |
| **Industrial establishments (year-start)** | – | – | (1992) |
| State-owned | 3 050 | 2 762 | 2 268 |
| Central | 711 | 589 | 537 |
| Local | 2 339 | 2 173 | 1 731 |
| **Non-state-owned** | | | |
| Cooperatives | 35 629 | 13 086 | 5 723 |
| Private | 920 | 770 | 1 114 |
| Private household | 0 | 376 900 | 368 000 |

*Source:* 1. Population, Labour and international establishments: *Statistical Yearbook 1993*, Hanoi, 1994.

2. GDP: Data from State Planning Committee.

## Table 10. Agricultural production

| | *1985* | *1990* | *1991* | *1992* | *1993* | *1992/85 Average (per cent)* |
|---|---|---|---|---|---|---|
| Production (1 000 tons) | 18 200 | 21 489 | 21 990 | 24 215 | 24 500 | 4.3 |
| Per capita food output (kg) | 304 | 324 | 325 | 349 | – | 2.0 |
| Cultivation areas (1 000 ha) | 6 492 | 6 993 | 7 008 | 7 293 | – | 1.7 |
| Labour force (1 000 ps.) | 18 808 | 21 863 | 22 276 | 22 998 | 23 700 | 2.9 |
| Average land productivity (ton/ha) | 2.80 | 3.07 | 3.13 | 3.32 | – | 2.4 |
| Labour productivity (kg/person) | 968 | 983 | 987 | 1 053 | 1 076 | 1.2 |
| Fertilizers (1 000 tons) | 1 819 | 2 644 | 3 166 | 3 239 | 3 250 | 8.6 |
| Fertilizer intensity (kg/ha) | 280 | 378 | 452 | 444 | – | 6.8 |

*Source:* General Statistical Bureau, *Statistical Date of Agriculture, Forestry and Fishery 1985-1993.*

The Domestic Investment Law which encourages domestic private investment was just passed recently (June 1994). It seems, however, that it will take time before the law can be effectively implemented, especially since the administration has previously tended to give privileges to SOEs and discriminate against private firms.

Third, the recent trend of the savings rate is encouraging, but the level is still low. Since the Government has managed to keep the deposit interest rate at a level higher than inflation, the savings rate has risen considerably from 1990 to 1993 (table 8). However, a substantial part of household savings are still in the form of in-house stocks of gold or dollars since people are not yet familiar with the banking system and the rural areas do not have access to financial organizations. In 1993, only 6 per cent of the population engaged in banking, and banks mobilized about US$ 400 million dollars and thus the per capita deposit was only US$ 6.

Fourth, in big cities such as Hanoi and Ho Chi Minh City, the market economy has been developing at an uncontrollable speed and the resulting disorder is generating many economic and social problems. Prices of land have jumped to a level which worsens the housing situation and raises investment costs. The current transportation system causes serious traffic accidents. Intervention and investment by the government in these areas have been less than optimal.

## 4. Impediments to economic reforms

Two areas which may be retarding the progress of economic reforms are: the nature and characteristics of SOEs and the relatively slow accumulation of certain levels of human resources.

### *(a) The nature of the reforms in state-owned enterprises*

It seems difficult for the government to have a clearcut reform policy for SOEs. In principle, Viet Nam is aiming at building a socialism-oriented economy, thus the maintenance of state ownership in the economy is necessary. Any reform which weakens state ownership is politically impossible. Therefore a search for a method to improve both maintenance of state ownership and efficiency of economic development is underway in Viet Nam.

Another characteristic of SOEs is that these firms are providing insurance, medical care and other social benefits to those involved. Therefore unless the overall government social welfare becomes more comprehensive and widespread, SOEs will continue to play these functions. In addition to the prevailing unemployment situation, this characteristic of SOEs tends to induce employees working there to strongly oppose any drastic reforms which result in the loss of benefits.

For these reasons, reforms in SOEs will take time and we will have to wait for many years to see any comprehensive change in the state sector.

### *(b) The relatively slow progress in the development of human capital*

Human resources in Viet Nam have a great potential and the accumulation of various types of human capital is underway. However, due to increasing needs in various fields, there is a shortage in supply. At the government level, more administrative skill and working language capability are required to manage a country which is increasingly market-oriented and open to the world, but the present supply is not adequate. Managerial expertise is also essential for the private sector to grow. In addition, due to the legacy of the old education environment, there is a mismatch in the supply-demand of human resources, that is, while many educated persons are unemployed, there is an excess demand for managerial and expert staff. In Ho Chi Minh City, for example, by 1995 the demand for foreign language experts, computers specialists, accountants and expert in other areas will rise to 14,000 persons, but at the same time, in 1993, there were 7,830 educated unemployed persons as well. The shortage of middle class managers is also serious.

The supply shortage of adequate human resources will retard the speed of economic reforms and development programmes.

## 5. Priorities for the future

From the mid-1990s toward the end of the decade, the main targets for reforms and development policies should be to maintain the nation's macroeconomic stability and to prepare for a sustained and high growth rate for the year 2000 and beyond. In the meantime therefore, investment priorities and other government efforts should be put towards creating a competitive environment in which resources can be efficiently allocated, and on the building of the physical and social infrastructure including human resource development. Some areas surrounding those issues need elaboration as follows.

### *(a) Social infrastructure and human resources development*

Investment in the physical infrastructure is currently emphasized in Viet Nam. The increasing inflow of official development assistance (ODA) and other financial resources is aiding such investment. In July 1994, the

Government revised the "Long-term Economic and Social Development Strategy for the Year 2000" with a new annual growth target of 9 to 10 per cent on average from 1991 to 2000, instead of the 7 per cent which the initial strategy adopted in 1991. Since the growth in the early 1990s has been less than 9 per cent (table 5), the annual average growth for the rest of the decade must be more than 10 per cent in order to attain the new target. Consequently, the priority of investment seems to be put upon physical infrastructure and industrial projects. However, the Government should conserve a considerable amount of resources for development of the urgently needed social infrastructure and human resources. Economic growth in the rest of this decade could reach about 8 per cent or 9 per cent and the priority of investment should be directed to human resources and social infrastructure development. If these fundamentals are strengthened, the economy can achieve a rapid growth in the year 2000 and beyond.

### *(b) Creation of a competitive environment*

Along with the construction of an improved legal framework in recent years, it is necessary to simplify procedures for the implementation of investment projects, including domestic investment and FDI. The Government should announce a "negative list" of industries in which private domestic and foreign investment would be restricted or prohibited. There should be no regulations and no approval system for other industries.

In this context, a comprehensive reform program for SOEs is essential. The following idea may serve as a compromise for the necessity to maintain state ownership and improve the efficiency of economic development. SOEs can be divided into three categories: The first category includes SOEs in strategic industries over which the Government should maintain direct ownership and management. Even in this case, however, some competition principles should be introduced to enhance efficiency. For example, competition can be introduced in the areas of labour management, the system to alter the top management and so on. The second category includes SOEs in non-strategic industries which the Government should pass over to the private sector. There should be a programme to speed up the privatization of SOEs in these industries. The third type of firm lies on the borderline between the first two categories, where "state ownership and private management" can be combined. In the future, these types of firms may gradually shift to the second category. The second and third categories should be exposed to competition with existing and new private firms as soon as possible.

### *(c) Mobilization of investment funds*

Along with improvements in the investment environment, an increase in the availability of funds to finance investment projects is equally important. For this it is essential to increase the capacity to mobilize savings and to channel these resources to investors at low costs.

For mobilizing saving, it is important not only to maintain deposit interest rates at a level higher than the inflation rate, but also to provide potential savers with access to financial institutions. Advertising banking activities, improving banking businesses and extolling the merits of using banks for saving are some measures which can be employed to mobilize capital resources. For mobilizing savings in rural areas, post offices and other such institutions can be utilized as financial institutions to absorb capital with lower service costs since the fixed cost is low.

There are two other problems in Viet Nam. One is that the banks tend to be reluctant to lend to small firms or small projects. This prevents the development of many labour-intensive industries which can generate employment and foreign exchange. To solve this problem, the Government should set up a bank specializing in providing funds for small businesses.

Another problem is the lack of long-term capital to finance long-term development projects (since short term interest rates are high), making the mobilization of long-term capital difficult. The lending interest rate in the informal sector is also higher than in the banking system. Therefore even though the demand for long-term investment is high, it is impossible to mobilize and to lend long-term capital at low interest rates. A solution to this problem may be that the Government could use a part of its saving and a portion of ODA and other foreign soft loans to set up a long-term credit bank.

### *(d) Liberalization of trading activities and export promotion*

The Government should further liberalize trading activities by allowing private firms to engage and specialize in trade. This will make the trading sector more efficient and contribute to the expansion of exports of manufactured products.

In the coming years, increasing inflows of foreign aid and FDI may increase pressure on the foreign exchange rate. In order to keep the exchange rate stable under such pressure, the realistic measures may be to liberalize imports and the exchange market. Demand for imports of machinery, materials and other investment goods is high, so that liberalization of the import of those products will result in strong demand for foreign exchange and thus appreciation of the dong can be avoided. This is essential to promote export.

In addition to maintaining a sound macroeconomic environment, various measures to promote exports should also be adopted. These measures, which have been mentioned earlier, include provision of credit and fiscal incentives to successful exporters. East Asia, the Republic of Korea in particular, provides abundant experience on the implementation of such export-promoting measures.

## B. THE LAO PEOPLE'S DEMOCRATIC REPUBLIC

In the Lao People's Democratic Republic, a mere 4 million-plus people are living on 236,800 sq. km. of land. This low population density creates the impression that the Lao People's Democratic Republic is better-off than other Asian developing countries such as Bangladesh or Nepal which actually have similar per capita GDPs ($220) (table 11).

**Table 11. Socio-economic indicators in 1992**

| | | |
|---|---|---|
| Population | 4.36 | million |
| Growth rate of population | 2.62 | per cent |
| Population density | 18 | per/km$^2$ |
| Estimated birth rate | 41.6 | per/1,000 |
| Estimated death rate | 15.4 | per/1,000 |
| Infant mortality | 117 | per/1,000 |
| Life expectancy | 49.7 | years |
| Enrolment ratio: elementary | 85 | per cent |
| – Junior high school (1989) | 13 | per cent |
| – High school | 5 | per cent |
| Literacy rate | 45 | per cent |
| GDP per capita | 220 | $ |

*Sources:* Lao Ministry of Economy, Planning and Finance, Basic Statistics about the Socio-economic Development in the Lao People's Democratic Republic, 1992, 1993. Zia-ul Islam, World Health Organization, Country Review-Laos, 1989.

The nation abolished its monarchy in December 1975 and established the Lao People's Democratic Republic with the intent to build a moderate socialist state through nationalization and collectivization of industry.

The First Five-year Plan was carried out in 1981-85, following the Interim Three-year Plan (1978-80). The highest priority for fund allocation was given to the transportation and communication sector (41 per cent), and to the agricultural sector (26 per cent). The annual growth rates of the agricultural sector and manufacturing sector attained 7.2 per cent and 7.5 per cent respectively. The average annual growth rate among all sectors was 7.6 per cent (table 12). Generally speaking, the First Five-year Plan was successful in terms of economic growth. Such high performance was attained by partly due to favourable weather conditions. According to estimates by the material product system, qualitative growth in terms of efficiency, technical aspects, price condition etc. was not considered good.

**Table 12. Economic growth rate for the first and second five-year plans (Per cent)**

| | *First Five–year Plan* | | *Second Five-year Plan* | |
|---|---|---|---|---|
| | *Plan* | *Actual* | *Plan* | *Actual* |
| Agriculture | 7.35 | 7.20 | 9.85 | 3.60 |
| Manufacturing | 7.20 | 7.50 | 13.65 | 8.70 |
| Transport/communication | 7.80 | 6.10 | 11.30 | 15.60 |
| Construction | 7.10 | 7.10 | 12.55 | 11.80 |
| Commerce | 10.20 | 18.40 | 7.70 | 7.30 |
| Service | n.a. | n.a. | n.a. | 6.40 |
| Average | 7.00 | 7.60 | 10.35 | 5.20 |

*Sources:* 1. Economic and Social Strategy and Planning Office, Ministry of Economy, Planning and Finance, Plan of the Lao People's Democratic Republic, Version as of 30 September 1990. p. 10.

2. International Monetary Fund, Economic and Financial Trends in the Lao People's Democratic Republic (Answers to I.M.P. Questionnaire), Vientiane, September 1991. p. 25.

*Note:* The First Five-year Plan is estimated by Material Product System (MPS.)

The main targets of the Second Five-year Plan (1986-90) are as follows:[11] self-sufficiency in food, promotion of agro-industry, and improvement of transportation networks.

The transportation and communication sectors, the construction sector and commerce sector all attained a very high growth rate. Unfortunately, a drought lasting from 1987 to the beginning of 1989 caused a serious decline in the rice harvest and the agricultural sector attained only. a 3.6 per cent growth rate. The experience from the Second Five-year Plan clarified the necessity for the following improvements. First, an irrigation system must be introduced and improved in order to continue more stable agricultural growth, because the rain-fed agricultural system is very vulnerable. Second, although the present fund allocation of capital expenditure is not nearly enough to establish a country-wide infrastructure network. But, it is difficult to increase capital expenditure under a tremendous growth rate with a chronic budget deficit. It is thus urgent to increase financial revenue and to decrease wasteful expenditure. Third, the Lao People's Democratic Republic must create export products in addition to electricity and timber in order to solve its chronic trade imbalance. The Government should encourage foreign direct investment to establish agro-industry and light manufacturing industries.

## 1. "The new economic mechanism"

Although the first Five-year Plan proved a great success, the trade deficit and budget deficit did not improve. So in 1986 when the Second Five-year Plan was launched, the Government introduced a plan of economic reforms called "The New Economic Mechanism" with the goals outlined below.[12]

(1) Introduction of a market mechanism;
(2) Liberalization of internal and international trade;
(3) Abolition of price controls;
(4) Privatization of state enterprises;
(5) Reduction of the government budget deficit:

(5.1) Reform of the tax system including abolition of transfer, introduction of profit tax, etc;

(5.2) Discontinuity of subsidies for agricultural cooperatives, etc.;

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[11] See Economic Strategy and Planning Office, Ministry of Economy, Planning and Finance, Lao People's Democratic Republic, Vientiane.

[12] See Chi Do Phan, Ed, Economic Reform in the Lao People's Democratic Republic: Current Trends and Perspectives (Answers to IMF Questionnaire), Vientiane, IMF, December 1991.

(5.3) Reduction in the number of public employees.

(6) Export promotion;
(7) Encouragement of foreign direct investment;
(8) Monetary reform:

(8.1) Strict control of money supply and implementation of a policy for high interest rates in order to control inflation;

(8.2) Stabilization of foreign exchange rates.

In the following, selected topics of the reform programme are overviewed and evaluated.

### *(a) Financial reform*

In 1992, revenues were 90.4 billion kip, while expenditures exceeded that amount by 1.7 times at 151 billion kip (table 13). Although the budget has run a chronic deficit since the establishment of the new regime in 1975, it expanded rapidly after 1988. One of the main reasons for the deficit is the increase in current expenditure, more specifically: (1) increase in retirement funds paid due to the reduction in government employees, and (2) wage increases for government employees in order to improve their quality. The payment of salary and wages in 1990 increased 3 times the 1988 level. The payment of annuities increased 19 times for the same period. Capital expenditure had increased by around 15 per cent of the annual growth rate until 1987, but in 1988 it grew 250 per cent higher than the previous year, and 41 per cent in 1989. Current tax and non-tax revenues are not enough to leave the government with any funds after allocations are made for salary, wages, and annuities of government employees.

The Government has taken stringent measures to reduce expenditures. First, the number of government employees in 1990 was reduced to 80 per cent of 1988 numbers and further reduced in 1992. Of course, this policy will give rise to a rapid increase in unemployment in urban areas. Second, the Government abolished subsidies to the Lao State Fuel Company as well as discontinued subsidies for agricultural machinery and fertilizer for agricultural cooperatives.

The Government is making efforts to increase revenues, too. First, a large scale and systematic reform of the tax system was carried out in 1989 and 1991. An outstanding reform was the abolition of state enterprise transfer (tax payment system to the government from state enterprises) and the

**Table 13. Government budget in the Lao People's Democratic Republic (Millions of kip)**

| | | *1990* | *1991* | *1992 (est.)* |
|---|---|---|---|---|
| I. | **Expenditure** | 151 079 | 151 079 | 174 641 |
| | 1. Current expenditure | 69 864 | 81 956 | 92 424 |
| | 2. Capital expenditure | 73 583 | 69 123 | 82 217 |
| II. | **Revenue** | 60 960 | 74 672 | 90 456 |
| | 1. Tax revenue | 37 644 | 54 355 | 63 513 |
| | (1) Profit tax | 7 956 | 13 272 | 14 615 |
| | (2) Income tax | 234 | 1 323 | 2 989 |
| | (3) Agricultural tax | 1 520 | 2 041 | 1 604 |
| | (4) Business licences | 1 160 | 136 | 120 |
| | (5) Turnover tax | 7 145 | 9 994 | 11 717 |
| | (6) Tax on foreign trade | 18 036 | 20 728 | 24 848 |
| | (7) Excise tax | – | 1 873 | 3 334 |
| | (8) Others | 1 593 | 4 986 | 4 286 |
| | 2. Non-tax revenue | 23 316 | 20 317 | 26 943 |
| | (1) Public enterprise transfer | – | – | – |
| | (2) Depreciation allowance | 4 589 | 4 755 | 4 138 |
| | (3) Others | 18 727 | 19 856 | 22 805 |
| III. | **Grant assistance** | 22 960 | 32 550 | 39 946 |
| IV. | **Overall balance (cash basis)** | –65 447 | –48 839 | –43 776 |
| V. | **Total financing** | 65 447 | 48 839 | 43 776 |
| | 1. Domestic financing | 5 107 | 19 287 | 4 828 |
| | 2. Foreign financing | 60 340 | 29 552 | 38 948 |

*Source:* Bank of Lao People's Democratic Republic and IMF Resident Representative Office, Current Economic Trends in Lao People's Democratic Republic under the Enhanced Structural Adjustment Facility. Vientiane, October 1993.

introduction of profit tax instead of transfer. As a result, the share of transfer among non-tax revenue had decreased from 83 per cent in 1986 to zero in 1990. And the share of profit tax among tax revenue had remarkably increased from 9 per cent in 1986 to 62 per cent. However, these figures are somewhat doubtful. It seems more like a nominal change from transfer to profit tax. As it is rather difficult for the state enterprises to estimate cost under the present situation, they cannot calculate the amount of profit. A system of accounting must become widespread in order to successfully introduce profit tax. The managers of private companies or officers of state enterprises must improve their understanding of costs and profits.

Second, charges for utilities and public services such as electricity, water, telephone, postal fees etc. were raised. In 1991, charges for electricity were raised by 43 per cent on average and will be raised again. The charge for telephone and post were raised by 80 per cent. The Government plans to further raise charges for public services in order to cover costs and to invest in plants and machinery. However, collection methods must be improved to minimize leakage. Public service organizations need not necessarily collect charges by themselves. There is one way to minimize leakage by means of entrusting collection to other private companies.

The financial deficit has been covered by western bilateral and multilateral assistance. In other words, western assistance supports the expansion of capital expenditure to construct or maintain roads, bridges etc. the Lao People's Democratic Republic will be able to allocate scarce financial funds more efficiently by improving their absorptive capacity to accept foreign assistance.

Comprehensively speaking, although efforts towards reform of the tax system as a whole should be highly evaluated, these affect only urban areas like Vientiane, Savanakhet, Luang Praban etc. due to the present lack of monetarization in rural areas.

*(b) Trade reform*

In 1992, exports from the Lao People's Democratic Republic totalled US$ 132.6 million, while imports amounted to double that amount or $ 265.6 million. In addition to this trade imbalance, table 14 also shows that trade with non-convertible area countries shrank almost to nothing in 1992 due to the introduction of hard currency settlements. The present trade deficit is with convertible area countries.

The primary export products of the Lao People's Democratic Republic are electricity, timber and coffee. It is difficult to increase exports of such traditional products. First, the country cannot increase exports of electricity without construction of a new hydro-power dam, because domestic demand is expanding by 10 per cent annually. Second, it is very difficult to increase timber exports due to the risk of serious deforestation. Third, exports of coffee will not increase in the future because its main import partners are the Russian Federation and Eastern European countries. Since the Lao People's Democratic Republic must import a wide variety of products ranging from sundry goods to industrial goods i.e., cars, machinery etc., its trade structure naturally tends to give rise to a deficit.

**Table 14. International Trade in the Lao People's Democratic Republic (Millions of kip)**

| | 1989 | 1990 | 1991 | 1992 (est.) |
|---|---|---|---|---|
| **Trade balance** | –147.4 | –122.9 | –131.4 | –132.9 |
| I. **Total exports** | 63.3 | 78.7 | 96.6 | 132.6 |
| 1. Convertible area | 47.2 | 58.1 | 94.2 | 130.2 |
| Electricity | 15.0 | 19.2 | 21.3 | 17.0 |
| Timber | 4.0 | 3.2 | 3.0 | 9.7 |
| Wood products | 11.6 | 15.4 | 37.9 | 33.0 |
| Coffee | 3.6 | 1.4 | 2.2 | 2.4 |
| Metal | - | – | 1.3 | 2.2 |
| Garments/textiles | 4.0 | 7.0 | 15.1 | 27.3 |
| Agricultural/forest products | 9.0 | 7.0 | 3.7 | 7.3 |
| Motorbikes | – | – | – | 19.5 |
| Re-exports | 0.0 | 4.8 | 9.7 | 11.9 |
| 2. Non-convertible area | 16.1 | 20.6 | 2.4 | 2.4 |
| Coffee | 5.2 | 7.2 | 0.9 | 0.0 |
| Timber/wood products | 5.8 | 7.3 | 0.8 | 0.0 |
| Tin | 2.2 | 1.3 | 0.2 | 0.0 |
| Gypsum | 0.9 | 1.7 | 0.2 | 0.0 |
| Other | 2.0 | 3.1 | 0.4 | 0.0 |
| II. **Total imports** | 210.7 | 201.6 | 228.0 | 265.6 |
| 1. Convertible area | 135.7 | 130.7 | 223.4 | 265.6 |
| Rice/other food products | 9.2 | 7.1 | 13.0 | 31.6 |
| Provincial imports | 15.4 | 11.3 | 15.4 | – |
| Petroleum | 12.2 | 7.3 | 21.1 | 24.3 |
| Machinery/raw materials | 11.2 | 29.2 | 61.3 | 94.7 |
| Others | 30.7 | 20.4 | 48.1 | 50.5 |
| 2. Non-convertible area | 75.0 | 70.9 | 4.6 | 0.0 |
| III. **Tied aid imports** | 75.0 | 57.7 | 67.8 | 64.4 |
| 1. Convertible area | 57.1 | 55.4 | 64.6 | 68.4 |
| 2. Non-convertible area | 17.9 | 2.3 | 3.2 | 0.0 |

*Source:* Bank of Lao People's Democratic Republic and IMF Resident Representative Office, Current Economic Trends in Lao People's Democratic Republic under the Enhanced Structural Adjustment, Vientiane, October 1993.

The Government is making efforts to activate trade as a part of export promotion policies. First, it issued Decree No. 18 in 1988 which contains revisions of export and import procedure, reduction of imports duties, etc. In 1990, the Government reduced items on its strategic commodity list, which state enterprises had exclusively exported. Ironically, this measure weakens their business performance very seriously, while activating trade by the private sector. Second, the country has a comparative advantage for agricultural production because of abundant land and low wages. Although vegetables, in particular, can be good export products, the Thai Government imposed high import duties against Lao agricultural products. As a result of negotiation with the Thai Government, Thai import duties against 16 items among agricultural products exported from the Lao People's Democratic Republic decreased from 70 per cent on average to under 20 per cent. This is seen as a great step to promote agro-industry. Third, transportation problems must be solved in order to promote exports. The country has no options for third country trade other than to use the ports of Da Nang in Viet Nam and Bangkok in Thailand. Thus export competitiveness from the Lao People's Democratic Republic is weakened not only by its land-locked geography and poor road networks, but also because of the relatively expensive freight charges by the transport monopoly. The Thai Government agreed to a request to establish a joint venture, authorizing it in 1991. Freight rates between Thailand and the Lao People's Democratic Republic decreased by 21 per cent owing to the entry of this new company. Fourth, export promotion can be realized by the proper establishment of foreign enterprises. Foreign direct investment gave rise to a significant change among export items in the trade structure of 1992. Textile exports amounted to $ 27.3 million, ranking just below timber exports. These exports are made by Thai companies which invested in the Lao People's Democratic Republic to avoid an export quota from Thailand. In addition, assembly bike exports amounted to $ 19.5 million. These are made by Thai companies, too. In 1993, textiles became a first rank export product.[13/] At that time, no one would have expected this to occur.

### *(c) Encouragement of foreign direct investment*

A country like the Lao People's Democratic Republic which has few technical managers or people with the capital, technology and management skills needed for economic development would benefit from managerial training offered as a part of foreign cooperation assistance. Investment circumstances such as the infrastructure or the establishment of a modern legal system must also improve in order to attract foreign investment inflow. There are only twenty-one laws in the country at present, and the first law was related to foreign investment. This law was promulgated in July 1988, and revised

[13/] See Bank of the Lao People's Democratic Republic and IMF Reesident Representative Office, Current Economic Trends in Lao People's Democratic Republic under the Enhanced Structural Adjustment Facility, Vientiane, October 1993.

in March 1994,[14] and is an indication of high expectations by the Government for foreign investment. First, the revised law deletes Article 14 that the duration of wholly-foreign-owned enterprises shall not exceed 15 years and guarantees long term business operations. Second, it simplifies the profit tax rate structure from three strata (20-30 per cent for promoted sectors, more than 35 per cent for trading, hotel, and service, 35 per cent for other sectors) to a unit rate (20 per cent). Third, the new law gives better treatment for foreign investors who import equipment, etc. (Article 17). That is, they can import production equipment and means, spare parts, etc. by paying import duties at the rate of one per cent of the import material's value. Furthermore imported raw material and semi-finished products for processing or assembly of export products will be exempted from import duties. Those material or products imported for import substitution will benefit from a reduction of import duties in accordance with the government policy. These policies are useful not only in terms of export promotion but also for promotion of domestic light industry.

The amount of foreign direct investment (FDI) approved for the Lao People's Democratic Republic from September 1988 to June 1993 reached $533.6 million, in 344 separate investment cases (table 15). One hundred forty-one of these investments cases came from Thailand, about 4 times as many as the second biggest investor, France (table 16). But the second biggest investor in terms of amount is the United States ($82 million or 17.7 per cent), which has major investments in the mining/petroleum sector. Taiwan Province of China with a concentration on the wood products sector took third place, while China, which invested mostly in the manufacturing/ handicraft sector, took fourth place. Surprisingly, Russian private FDI took

**Table 15. Total licensed foreign investments**

| | *September 1988~* | *1989* | *1990* | *1991* | *1992~* | *June 1993* | *Total* |
|---|---|---|---|---|---|---|---|
| Number of investment | 6 | 40 | 48 | 69 | 102 | 79 | 344 |
| Aggregate value ($ 1 000) | 2 922 | 43 671 | 94 819 | 154 492 | 159 832 | 77 868 | 533 604 |
| Foreign capital (per cent) | 93 | 91 | 97 | 79 | 83 | 92 | 87 |
| Domestic capital (per cent) | 7 | 9 | 4 | 21 | 17 | 8 | 14 |

*Source:* Foreign Investment Committee, Investment Opportunities in Lao People's Democratic Republic, 1993

[14] See Lao People's Supreme Assembly, Law on Foreign Investment in the Lao People's Democratic Republic, No. 07/PSA, April 19, 1988.

## Table 16. Licensed investment by foreign sources

| | Number of cases | Composition (per cent) | Registered capital ($ 1 000) | Composition (per cent) |
|---|---|---|---|---|
| 1. United States | 20 | 5.5 | 81 852 | 17.7 |
| 2. Australia | 23 | 6.3 | 19 716 | 4.3 |
| 3. Austria | 2 | 0.5 | 118 | 0.0 |
| 4. Belgium | 1 | 0.3 | 140 | 0.0 |
| 5. United Kingdom | 7 | 1.9 | 11 973 | 2.6 |
| 6. Canada | 8 | 2.2 | 1 195 | 0.3 |
| 7. China | 26 | 7.1 | 17 214 | 3.7 |
| 8. Netherlands | 3 | 0.8 | 242 | 0.1 |
| 9. France | 34 | 9.3 | 36 718 | 8.0 |
| 10. Germany | 3 | 0.8 | 1 250 | 0.3 |
| 11. Hong Kong | 16 | 4.4 | 15 516 | 3.4 |
| 12. India | 1 | 0.3 | 350 | 0.1 |
| 13. Italy | 3 | 0.8 | 146 | 0.0 |
| 14. Japan | 8 | 2.2 | 2 305 | 0.5 |
| 15. Republic of Korea | 6 | 1.6 | 6 412 | 1.4 |
| 16. Lebanon | 1 | 0.3 | 214 | 0.0 |
| 17. Macao | 2 | 0.5 | 3 135 | 0.7 |
| 18. Malaysia | 5 | 1.4 | 21 877 | 4.7 |
| 19. Myanmar | 1 | 0.3 | 30 | 0.0 |
| 20. New Zealand | 2 | 0.5 | 93 | 0.0 |
| 21. Russian Federation | 13 | 3.6 | 16 834 | 3.6 |
| 22. Singapore | 7 | 1.9 | 4 689 | 1.0 |
| 23. Sweden | 5 | 1.4 | 456 | 0.1 |
| 24. Switzerland | 1 | 0.3 | 150 | 0.0 |
| 25. Taiwan Province of China | 20 | 5.5 | 44 161 | 9.6 |
| 26. Thailand | 141 | 38.6 | 173 364 | 37.6 |
| 27. Viet Nam | 6 | 1.6 | 1 479 | 0.3 |
| Total | 365 | 100.0 | 461 629 | 100.0 |

*Source:* Foreign Investment Committee, Investment Opportunities in Lao People's Democratic Republic, 1993.

fifth place, investing mainly in the agricultural sector, in contrast to its aid reduction.

Table 17 shows that the most popular sector for investors is manufacturing (except for garment and wood processing) with 66 cases. The import/ export sector is in second place with 55 cases. The garment sector takes the third place (51 cases). A noteworthy phenomenon is occurring in the banking/ insurance sector. Six out of eight cases involve investment in the banking sector, all of which are either fully Thai-owned and operated or are joint ventures with Thai capital. These six banks are: "Joint Development Bank",

**Table 17. Industry-wise number of cases of FDI and its registered capital**

| | | Number of cases | Composition (per cent) | Registered capital ($ 1 000) | Composition (per cent) |
|---|---|---|---|---|---|
| 1. | Agribusiness | 34 | 9.9 | 29 361 | 5.5 |
| 2. | Garments/textiles | 51 | 14.8 | 38 110 | 7.1 |
| 3. | Wood-based industries | 31 | 9.0 | 69 322 | 13.0 |
| 4. | Other manufacturing | 66 | 19.2 | 74 243 | 13.9 |
| 5. | Mining/petroleum | 17 | 4.9 | 79 148 | 14.8 |
| 6. | Import/export | 55 | 16.0 | 28 588 | 5.4 |
| 7. | Hotel/tourism | 26 | 7.6 | 109 695 | 20.6 |
| 8. | Banking/insurance | 8 | 2.3 | 36 000 | 6.7 |
| 9. | Consulting | 20 | 5.8 | 1 476 | 0.3 |
| 10. | Construct./trans. repair | 16 | 4.7 | 64 403 | 12.1 |
| 11. | Telecommunications | 1 | 0.3 | 500 | 0.1 |
| 12. | Other professional service, computer school, etc. | 19 | 5.5 | 2 758 | 0.5 |
| | Total | 344 | 100.0 | 533 604 | 100.0 |

*Source:* Foreign Inventment Committee, Investment Opportunities in Lao People's Democratic Republic, 1993.

"Siam Commercial Bank", "Thai Military Bank", "Thai Farmers Bank", "Bank of Ayudhaya", and "Vientiane Commercial Bank."

Finally, the characteristics of Thai FDI require mention here. Most investment into the country comes from medium- to small-sized companies in Thailand. Thailand is a country geographically, culturally, and linguistically similar to the Lao People's Democratic Republic, and thus has comparative advantages for investment there.[15/] Thailand has a greater potential ability and is in a special position to encourage Lao economic development in comparison with investors from other Association of Southeast Asian Nations (ASEAN) and developed countries.

## 2. Stabilization of the macro economy

Sound management of the macro economy is an essential factor to stabilizing the economy. The inflation rate in 1989 was exceptionally high

[15/] For further details, see Motoyoshi Suzuki, Present Economic Cooperation and Future Prospect for Laos and its Neighbouring Countries: "Trade, aid and FDI", Osamu Yamada, and other, Viet Nam, Laos and Cambodia: the Path to Economic Development, the Sasakawa Peace Foundation, February 1993.

**Table 18. Monetary indicators in Lao People's Democratic Republic**

| | *1988* | *1989* | *1990* | *1991* | *1992 (est.)* |
|---|---|---|---|---|---|
| Inflation rate (per cent) | 14.8 | 75.9 | 19.6 | 10.4 | 6.0 |
| Money supply (per cent change) | 37.1 | 89.3 | 14.0 | –2.1 | 13.0 |
| Parallel exchange rate (kip/$) | 477 | 691 | 734 | 714 | 715 |
| Interest rate (per cent) one year deposit | 14.0 | 36.0 | 36.0 | 18.0 | 18.0 |

*Source:* Bank of Lao People's Democratic Republic and IMF Resident Representative Office, Current Economic Trends in Lao People's Democratic Republic under the Enhanced Structural Adjustment.

(about 76 per cent) as seen in table 18, because (1) the increase of agricultural product prices due to drought, (2) changes in the salary and wage payment system for government employees from mixed payment including payment in kind to full cash payments in 1989, (3) wage increases for government employees in 1989 and 1990, and (4) expansion of credit demands from state enterprises with poor business performance. However, we could ascertain that the Lao macro economy has managed well compared with Viet Nam, Cambodia, or Eastern European countries. On the basis of Lao inflation rates during the First Five-year Plan, the macro economy was seen as stable within a range of 10-25 per cent except for 1989 and decreased only to 6 per cent in 1992. This successful macro performance was mainly attained by strict control of the money supply.

In September 1987, the foreign exchange rate was unified from multiple rates to a single rate. The official exchange rate was fixed at 350 kip per dollar. In February 1989, it was depreciated to 470 kip per dollar. The parallel exchange rate as a shadow price was depreciated very rapidly until the 1989 third quarter as a result of a loose monetary policy. However, as mentioned above, inflation rates have been well controlled through strict regulation of the money supply since the 1989 fourth quarter. The successful control of inflation gives rise to stabilization of exchange rates.

## 3. Impediments to reforms and stabilization

Generally speaking, the economic reform has been successful in the Lao People's Democratic Republic. However, there are many obstacles and impediments to overcome. First of all, while urban sectors will be strongly influenced there are many barriers to overcome before the New Economic

Mechanism can influence rural areas. Second, it is an agricultural country, where agricultural GDP accounts for roughly 60 per cent of total production (table 19), and where employees engaged in this primary industry comprise nearly 90 per cent of the total labour force. Agriculture in this country used to be totally at the mercy of the weather. As agriculture consists mainly of the informal sector, agricultural modernization policy may be difficult to effectively implement. Third, monetarization has not yet reached the mountainous areas, where self-sufficiency and barter trade are the principal economic activities of the people. This means monetary policy will only have a partial influence on the nation. Fourth, underdeveloped road infrastructure has divided the country into regional areas, and this situation has inhibited administrative reforms and caused stagnation of economic activity. In addition, it is difficult to connect farmers with markets. It is also quite natural that poor infrastructure, inadequate education system, small domestic demand etc. makes the Lao People's Democratic Republic less attractive for foreign investors. Fifth, the country may be influenced by Thai and Vietnamese internal and external policies, because it is a land-locked country surrounded by politically and economically stronger countries. Also it must depend on Thai or Vietnamese ports in order to trade and such transportation costs cut into its export price competitiveness.

**Table 19. Industry-wise GDP**

| | *Million of $ in 1990 price* | | | *Composition (per cent)* | | |
|---|---|---|---|---|---|---|
| | *1990* | *1991* | *1992 (est.)* | *1990* | *1991* | *1992 (est.)* |
| Agriculture | 371 835 | 365 347 | 395 537 | 61.2 | 58.2 | 58.8 |
| Manufacturing | 88 105 | 105 634 | 113 587 | 14.5 | 16.8 | 16.9 |
| Service | 147 427 | 156 993 | 163 038 | 24.3 | 25.0 | 24.3 |
| GDP (Factor cost) | 607 367 | 627 974 | 672 162 | 100.0 | 100.0 | 100.0 |

*Source:* Bank of Lao People's Democratic Republic and IMF Resident Representative Office, Current Economic Trends in Lao People's Democratic Republic under the Enhanced Structural Facility, Vientiane, October 1993.

Under these difficult conditions, what kind of strategy should the Lao People's Democratic Republic take in order to succeed in its economic reforms? Of course, economic reform is not an objective in itself. The objective of economic reform is to develop a country. In order to develop a country with scarce financial resources, projects must be prioritized according to their potential importance and efficient allocation of funding must be carried out.

Presently highest priority is being given to infrastructure such as roads, communication, power distribution networks etc. In particular, road infrastructure is expected to provide great benefits to the economy as a whole. The second priority is education and public health. Long-term development can only be realized through improvements and reforms in the educational system. Economic reform will not be successful without well-trained human resources.

## C. CAMBODIA

The population of Cambodia is estimated at about nine million persons (table 20). Due to inadequate public health, infant mortality is very high; an estimated 200 out of 1,000 children die before reaching five years of age. The main industry is agriculture, which occupies a share of about half the GDP (table 21). Recently, high growth has been attained in the industry and service sectors (table 22).

The Cambodian economy was devastated during the civil war in 1970-75 and also during the Pol Pot regime from 1975-78. Reconstruction and rehabilitation have been going on since 1979. Economic reform in Cambodia can be considered as beginning in 1986 which was the initial year of the First Five-year Plan. Here, the two Five-year plans will be overviewed in order to analyse Cambodian economic reform.

**Table 20. Selected basic indicators**

| | |
|---|---|
| Total land area (km$^2$) | 181 035 |
| Population | 9,000,000 |
| Estimated birth rate | 40 per 1 000 |
| Life expectancy at birth | 49.7 years |
| Infant mortality at birth | 125 per 1 000 |
| Under five year mortality rate | 200 per 1 000 |
| Adult literacy rate | 70 per cent |

*Source:* The World Bank, Cambodia for Rehabilitation and Reconstruction, 1992, p. 8.

**Table 21. Industry-wide GDP 1989 constant prices**
**(Billions of riels)**

| | *1987* | *1988* | *1989* | *1990* | *1991* | *1992* | *1993* |
|---|---|---|---|---|---|---|---|
| Agriculture | 106.8 | 106.2 | 113.2 | 112.2 | 131.5 | 135.6 | 139.0 |
| Industry | 31.7 | 40.9 | 41.3 | 40.3 | 43.7 | 49.7 | 53.0 |
| Services | 69.3 | 94.4 | 92.8 | 94.5 | 105.0 | 117.5 | 127.5 |
| GDP | 207.9 | 241.5 | 247.3 | 247.0 | 280.3 | 302.3 | 319.5 |
| GDP per capita ($) | 132 | 161 | 110 | 140 | 203 | 204 | 210 |
| Agriculture (per cent) | 51.4 | 44.0 | 45.8 | 45.4 | 46.9 | 44.9 | 43.5 |
| Industry (per cent) | 15.2 | 16.9 | 16.7 | 16.3 | 15.6 | 16.4 | 16.6 |
| Services (per cent) | 33.3 | 39.1 | 37.5 | 38.3 | 37.5 | 38.9 | 39.9 |
| GDP (per cent) | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

*Source:* World Bank and UNTAC Rehabilitation and Economic Affairs.

**Table 22. Sector-wise growth rates**
**(Per cent)**

| | *1988* | *1989* | *1990* | *1991* | *1992* | *1993* |
|---|---|---|---|---|---|---|
| Agriculture | –1.6 | 6.6 | –0.9 | 17.2 | 3.1 | 2.5 |
| Industry | 29.0 | 1.0 | –2.4 | 8.4 | 13.7 | 6.6 |
| Services | 36.2 | –2.0 | 1.8 | 11.1 | 11.9 | 8.5 |

*Source:* The same as table 20.

## 1. Economic planning

### *(a) First Five-year Plan (1986-90)*

The First Five-year Plan was adopted during the Fifth People's Revolutionary Party Convention in October 1985. Its main thrusts are as follows:[16]

(1) Increase in agricultural production. The Government targeted a 7 per cent annual growth rate for food production, reestablishment of 50,000 hectares of rubber fields, production of 50,000 tons of latex, 130,000 tons of fish production, to attain 200,000

[16] Asian Development Bank, Cambodia: An Economic Report (1991), pp. 10-11.

sq. km. of forests and to expand the total area of jute fields to 15,000 hectares;

(2) Restoration of hydro-electricity capacity to attain the capacity of 300,000,000 kw.;

(3) Rehabilitation and expansion of communication networks, road networks, water networks and railroad networks;

(4) Diversification of export items and increase of export volume;

(5) Strengthening and consolidation of State procurement, distribution and control of principal commodities;

(6) Improvement of economic management through human resources development.

However, judging from economic performance in 1990 it seems that these objectives were not attained.

*(b) Second Five-year Plan (1991-95)*

The main thrust of this plan places great importance on the following sectors:

(1) Agricultural development through the provision of irrigation facilities and agricultural input;

(2) Increase of power generation and distribution;

(3) Improvement of transport and communication networks;

(4) Urban development;

(5) Improvement of health, education and culture.

The most remarkable difference between the First and the Second Five-year Plans is that the former aimed at expansion of physical production while the latter emphasizes economic reforms by introducing the market mechanism. Both plans, however, put the highest priority on the development of agricultural sector to attain self-sufficiency in rice production. It will take time, however, for Cambodia to resume the position of a net exporter of rice as it achieved in pre-war period, due to the lack of financial resources for establishment of irrigation and provision of fertilizers, machinery and other agricultural inputs.

Needless to say, in Cambodia, restoration and rehabilitation are more important than development.

## 2. The fiscal situation, monetary reforms and foreign trade

Government expenditure in 1989-92 and the budget plan for 1994 are shown in tables 23 and 24. The Asian Development Bank's *Economic Report* shows that the financial deficit during 1979-90 ranged from 10 to 15 per cent of the revenue.[17] By comparison the World Bank report stated that up until 1988, total receipts covered about 95 per cent of expenditures and the remaining 5 per cent was financed by money creation.[18] Although some estimation error can be seen in the percentage of financial deficit when comparing these two reports, it is an allowable margin of error in the sense that the percentage of deficit is rather small. However, since 1989 financial deficit has drastically increased to about 60 per cent of the expenditure and the full amount of the deficit was made up for by money creation.

The main reasons for the increasing deficit covered by money creation are as follows:[19]

**Table 23. Government expenditure (Million riels)**

| | *1989* | *1990* | *1991* | *1992* |
|---|---|---|---|---|
| Total expenditure: Current prices | 21 945 | 50 208 | 118 110 | 186 367 |
| **Percentage shares (per cent)** | | | | |
| 1. Investment | 15.8 | 13.8 | 4.4 | 2.4 |
| 2. Enterprises subsidies | 11.1 | 8.8 | 13.1 | 3.8 |
| 3. Trade and other subsidies | 10.4 | 1.9 | 4.2 | 8.6 |
| 4. Administrative expenditure | 30.0 | 38.4 | 37.6 | 43.8 |
| 5. Defence and security | 32.7 | 37.2 | 39.6 | 39.7 |

*Source:* The World Bank, Cambodia for Rehabilitation and Reconstruction, 1992, p. 42.

[17] Asian Development Bank, Cambodia: an Economic Report (1991), p. 14.

[18] The World Bank, Cambodia: Agenda for Rehabilitation and Reconstruction (1992), p. 38.

[19] Ibid. pp. 40-43.

**Table 24. 1994 Budget plan**
**(Million riels)**

| | | Per cent |
|---|---|---|
| **Revenue** | 890 000 | 100.0 |
| 1. Tax and non-tax revenue | 437 000 | 49.1 |
| 2. Grant | 275 000 | 30.9 |
| 3. Loan | 178 000 | 20.0 |
| **Expenditure** | 890 000 | 100.0 |
| 1. Royal exp. | 18 070 | 2.0 |
| 2. Parliament exp. | 5 488 | 0.6 |
| 3. Cabinet minister exp. | 54 085 | 6.1 |
| 4. International cooperation exp. | 23 324 | 2.6 |
| 5. Defence | 164 000 | 18.4 |
| 6. Interior exp. | 86 722 | 9.7 |
| 7. Economic and financial exp. | 32 365 | 3.6 |
| 8. Public investment and transport | 170 574 | 19.2 |
| 9. Industry and energy exp. | 8 634 | 1.0 |
| 10. Education and sports exp. | 76 304 | 8.6 |
| 11. Commerce exp. | 19 437 | 2.2 |
| 12. Agriculture exp. | 69 747 | 7.8 |
| 13. Public health exp. | 49 898 | 5.6 |
| 14. Post and communication exp. | 33 436 | 3.8 |
| 15. Social activity exp. | 29 670 | 3.3 |
| 16. Others | 18 246 | 2.1 |
| 17. Preliminary exp. | 30 000 | 3.4 |

*Source:* Japan Cambodian Association, Bulletin, 1994, p. 1.

(1) Rapid privatization has reduced the role of state-owned enterprises as a tax revenue source. Also the private sector is still too underdeveloped to contribute to fiscal revenue;

(2) Inflation occurred due to money creation which originally employed to cover the financial deficit. Unfortunately, inflation cancelled out the increment of revenue;

(3) The abolition of forced procurement at below market prices and the introduction of a new government procurement system determined by the market price gave rise to an increase in expenditures;

(4) The lapse of the Soviet credit to Cambodia in 1991. The Cambodian government benefitted from the sale of goods imported from the Soviet Union through credit, however nowadays such credit has disappeared.

## 3. An assessment of performance

### *(a) Fiscal reforms*

In order to improve the financial deficit, the following four tax laws were introduced in 1985: import and export duties, turnover and profit taxes, business license tax and excise taxes. In 1991, slaughter tax, registration fees and stamp duties were introduced.

An effort to reduce expenditure was carried out through reducing the number of government officials from 230,000 persons in 1989 to 56,000 in 1990, that is a reduction to 24.3 per cent of the 1989 level. Moreover, along with a furthering of the privatization policy, the Government is attempting to control the amount of loans to state owned enterprises, a main cause of the financial deficit.

It seems that the introduction of profit tax instead of transfer (payment from state owned enterprises to the government) will not give rise to substantial improvements in the budget. This is due to a lack of accounting systems throughout the country so that enterprises cannot even calculate their costs and profits. Thus, they pay "transfer" under the name of profit tax. Concerning the reduction policy in the number of government officials, this may bring about a serious unemployment problem, because the underdeveloped private companies cannot absorb this excess supply of labour.

### *(b) Money supply, inflation and foreign exchange rates*

Although national currency was abolished during the Pol Pot regime, the new Cambodian currency was reintroduced in March 1980. But since it was neither reliable nor popular after its reintroduction, ordinary transactions were carried out using Thai baht, Viet Nam dong, gold, silver, rice, or barter trade.

When a financial deficit is covered by money creation, problems occur. Table 25 depicts the trend of money creation, annual inflation rate and parallel (black market) exchange rates. The continuous increase of money supply seems to accelerate inflation, and depreciate the parallel exchange rate. A similar significant correlation among money creation, inflation and exchange rate depreciation was identified in the Lao macro economy, thus a monetary policy designed to decrease the money supply should be effective in controlling inflation and stabilizing the exchange rate.

**Table 25. Economic indicators**

| | *1988* | *1989* | *1990* | *1991* | *1992* |
|---|---|---|---|---|---|
| Money supply (billion riels) | 15 103 | 27 438 | 68 445 | 100 270 | 244 100 |
| Increasing rate (per cent) | – | 81.7 | 149.5 | 46.5 | 143.4 |
| Annual inflation rate (per cent) | n.a. | 42 | 143 | 200 | 73 |
| Parallel exchange rate (riels per $) | 148 | 268 | 537 | 818 | 1 520 |

A dual exchange rate system was adopted until the introduction of a hard currency settlement in 1990.[20/] The internal rate was used for commodity agreements with former CMEA countries. The market rate was used in trade settlements with other countries. In 1990 the exchange rate was unified.

The National Bank of Cambodia is supervised and controlled by the Council of Ministers. It simultaneously controls multiple monetary operations of the Governmental depository bank, a development bank, a foreign trade bank, and a commercial bank. In January 1991, the Government Treasury Department of the National Bank was transferred into the Ministry of Finance. However, the present reform of the banking system in Cambodia is incomplete. The National Bank should concentrate on serving as the monetary authority. However, it is very difficult for the authorities to supervise or control the money supply, while the Thai baht, Viet Nam dong and dollars are circulating in the market.

### *(c) Foreign trade*

There are four characteristics of Cambodian trade as follows:

(1) Drastic change of major trade partners. Since the establishment of Cambodia in 1979, the major trade partners were non-convertible areas such as Viet Nam, the former Soviet Union and Eastern European countries. The reduction in Soviet aid gave rise to the gradual introduction of a trade liberalization policy, thus trade with capitalist economies such as Thailand, Hong Kong, Singapore, Japan, France etc. has increased rapidly since 1988. This change in trade partners necessitates a switch from quantity to quality in trade products.

[20/] Asian Development Bank, Cambodia: an Economic Report, (1991), pp. 19-20.

(2) Alteration of settlement currency. Hard currency settlement has been introduced since 1990 instead of barter trade or soft currency settlement for non-convertible areas.

(3) Expansion of trade. Export to convertible areas increased 10 times from 2.5 million dollars in 1985 to 25.5 million dollars in 1991. On the other hand, imports from convertible areas increased 13 times from 4.1 million dollars in 1985 to 52.5 million dollars in 1991. But trade with non-convertible areas increased by only 31 per cent in export and 12 per cent in import in the same period.

(4) Accumulated trade deficit (table 26). Cambodian imports from non-convertible areas were at a level four to six times that of exports from 1985 to 1990. This trade deficit accumulated foreign debt. (table 27) Trade with non-convertible areas had ceased after the introduction of hard currency settlement and was replaced by trade with convertible areas. As a result, import value was double that of export for 1990. It seems that this tendency will increase.

The lapse of trade with the Russian Federation placed a heavy burden on the Cambodian economy, because it depended on Russian natural resources like fuel or industrial goods, and because its trade deficit was accumulated as a long-term loan with concessional conditions. In order to decrease the trade deficit, a country must follow an export promotion policy. The principal traditional Cambodian exports are rice, rubber, maize, pepper, peanuts, jute, sesame, fish etc. Now the export of kapok, leaf tobacco,

**Table 26. Foreign trade**

| | *Convertible area* | | | | | | |
|---|---|---|---|---|---|---|---|
| | *1985* | *1986* | *1987* | *1988* | *1989* | *1990* | *1991* |
| Exports (million $) | 2.5 | 6.9 | 4.7 | 11.5 | 17.4 | 14.6 | 25.5 |
| Imports (million $) | 4.1 | 10.2 | 7.4 | 16.6 | 24.1 | 12.0 | 52.5 |
| Trade balance | –1.6 | –3.3 | –2.7 | -5.1 | –6.7 | –2.6 | -27.0 |
| | *Non-convertible area* | | | | | | |
| Exports (million rubles) | 15.3 | 18.4 | 22.5 | 32.5 | 26.8 | 20.1 | n.a. |
| Imports (million rubles) | 92.1 | 109.2 | 113.0 | 110.3 | 110.9 | 103.3 | n.a. |
| Trade balance (million rubles) | –76.8 | –90.8 | –90.5 | –77.8 | –84.0 | –83.2 | n.a. |

*Source:* The Asian Development Bank, Cambodia An Economic Report, 1991, p. 21.

## Table 27. External debt
## (Million $)

| | *1982* | *1983* | *1984* | *1985* | *1986* | *1987* | *1988* | *1989* | *1991* |
|---|---|---|---|---|---|---|---|---|---|
| 1. **Long term** | 909 | 862 | 724 | 709 | 707 | 960 | 1 135 | 1 400 | 1 564 |
| (1) OECD | 237 | 233 | 231 | 236 | 241 | 249 | 244 | 244 | 248 |
| (2) Multilateral | 17 | 16 | 16 | 17 | 19 | 22 | 21 | 24 | 26 |
| (3) Eastern European countries | 655 | 613 | 477 | 456 | 447 | 689 | 870 | 1 132 | 1 290 |
| 2. **Short term** | 8 | 8 | 4 | 6 | 7 | 14 | 13 | 11 | 32 |
| 3. **Total** | 916 | 870 | 729 | 715 | 715 | 975 | 1 149 | 1 411 | 1 596 |

*Source:* OECD, Financing and External Debt of Developing Countries: 1990 Survey, 1991 and 1992.

soybeans, timber, shrimp etc. has resumed. Trade has been further activated with the opening of Kompong Som international port; and this has among other benefits, improved the shipping connection to Singapore.

## 4. Obstacles for reforms

It has not been long since Cambodia was locked in a horrible civil war. The chaos and massacres which occurred during the period between 1970-75 and the era of Democratic Kampuchea in 1975-79 gave rise to large numbers of refugees. Many of these were intellectuals, engineers, businessmen, professors, or skilled workers whose loss made rehabilitation and reconstruction extremely difficult. The civil war destroyed not only the infrastructure such as roads, communication or electricity, but also devastated social service such as education, health care, public administrative services. Under these difficult conditions, the sole stream of foreign assistance came from the former Soviet Union, Viet Nam, and Eastern European countries. International political isolation had hampered Cambodia from receiving Western assistance since 1982.

In September 1989, the evacuation of the Vietnamese army gradually improved the international political situation surrounding Cambodia, nevertheless military expenditures came to approximately 40 per cent of the budget in 1990. With the Soviet collapse in 1991, the conclusion of the Paris Peace Accord in 1992 and establishment of the the new Cambodian Government in 1993, Western assistance has resumed.

A necessary condition for reconstruction and rehabilitation is peace, but even if a lasting peace is reached, there are still myriad structural problems and obstacles such as financial deficit, trade deficit, inflation, unemployment, poor infrastructure etc. The Cambodian Government has struggled for the resolution of these problems in cooperation with multilateral and bilateral assistance, although progress cannot necessarily be evaluated as successful.

The population of Cambodia is about twice that of the Lao People's Democratic Republic and domestic demand is not on a small scale as in that country. Furthermore, the Lao People's Democratic Republic is a land-locked mountainous country, while Cambodia has sea ports. This means that Cambodia has a greater potential to develop international trade. Because of its rich delta plain, Cambodia has a comparative advantage for agriculture; Lake Tonle Sap provides rich inland fishery resources. Finally, there are historical tourism sites with great potential such as Angkor Wat. If only Cambodia can succeed in restoring political stability, it should be able to attain natural growth and development with its rich natural endowment.

# CHAPTER III. ECONOMIC REFORMS IN THE CENTRAL ASIAN REPUBLICS*

## A. GENERAL ENVIRONMENT FOR REFORMS

The Central Asian Republics (CARs) represent a distinct group among about 30 European and Asian countries that have embarked on the transition from a centrally planned to a market-oriented economic system. Economic reforms initiated in the CARs have many common features with those being carried out in the other former centrally planned economies (CPEs). They embrace a similar range of components such as reshaped monetary and fiscal policies within stabilization programmes, institutional and structural reforms including liberalization (price and trade), deregulation, privatization and building up an essential market economy infrastructure.

However, at the same time one can discern some features that are more specific. Compared with China, Viet Nam, the Central European countries and even the Baltic republics of the former USSR, the Central Asian republics have been exposed to the Soviet model of a command economy for much longer period. There were no memories of capitalism (or in other words, of an operational market economy) left as in Viet Nam, China and the European CPEs which were drawn to the centrally planned model later than the CARs and some of which started with market-oriented gradual reforms long before 1990. This, of course, makes the reform effort in CARs, more demanding in terms of forming both the institutions and the market attitudes.

Another feature which makes the economic reform in CARs more difficult and challenging is the fact that its "standard" tasks are superimposed on the process of building the institutions essential for national economic sovereignty. Transition to a market economy started in earnest at the time the CARs gained independence in 1991 and so the Governments of these countries had to tackle also the task of building up the capacity and institutional base for the national fiscal, monetary and trade policies. In some areas, such as customs administration, this had to start from scratch. The most important issue which emerged in this context was the issue of the introduction of the national currencies in the CARs which came to the forefront in 1993. These aspects will be discussed later in the paper. At this point let's just

* Prepared by Nikolaj Ordnung, consultant to the ESCAP secretariat.

point out that the other Asian CPEs — China, Viet Nam, the Lao People's Democratic Republic, Cambodia and Mongolia did not have to face these additional tasks stemming from the creation of newly established national economic entities.

The gaining of political independence has not done away with the legacy of the deep integration of the CARs into the economic complex of the former USSR. In fact, the CARs' economies were to a high degree "export oriented" towards the market in the rest of the USSR especially to Russia. At the beginning of 1990s the share of net material product (NMP) exported to the USSR market amounted to 39.9 per cent of NMP in Kazakhstan, 41.8 per cent in Tajikistan, 43.2 per cent in Uzbekistan, 50.2 per cent in Kyrgyzstan, and, 50.7 per cent in Turkmenistan. In contrast, in the case of Russia, exports to the rest of the USSR represented only 18 per cent of the NMP. At the same time, the CARs were less open to the world markets: the share of non-Soviet trading partners in their total trade fluctuated between 10 per cent (Turkmenistan) and 16 per cent (Tajikistan). For the USSR as a whole this ratio was much higher — 45 per cent.[21/] Under these circumstances the disruption of the inter-republican trade following the break up of the USSR in 1991 had a profound impact on the CARs and significantly contributed to the decline of their GDP.

Another external shock which put additional strain on the efforts of the CARs to stabilize their economies was the discontinuation of the transfers from the former Union budget. The transfers were quite substantial, amounting often to around 10 per cent of the recipient republics GDP which was very important for balancing the republican budgets. More recently, the break up of the rouble zone resulted in the end of the extension of credits to CARs by the Russian Federation through the monetary system which was another form of transfer of resources. However, for Kazakhstan and Turkmenistan this loss was compensated for by the improvement in terms of trade which stemmed from the shift to world prices in the inter-republican trade. For Azerbaijan, Tajikistan and Uzbekistan the terms of trade impact of this shift appeared to be negative, for Kyrgyzstan more or less neutral.[22/] However, in reality the

[21/] All figures in this paragraph quoted from: N. Ushakova, Novye napravlenya vnieshnieekonomicheskikh svyazey centralnoaziatskikh respublik (New directions of external economic relations of the Central Asian republics) in: Mirovaya ekonomika i mezhdunarodnye otnoshenia, 1994, No. 2 p. 134.

[22/] Based on the World Bank analysis, the ESCAP Economic and Social Survey 1993 (p. 43) brings the following estimates of T of T impact on domestic income of moving from Soviet prices to world prices (percentages, 1990 base) Azerbaijan -7, Kazakhstan +19, Kyrgyzstan +1, Tajikistan -7, Turkmenistan +50, Uzbekistan -3.

developments took sometimes an unexpected turn: for example, Turkmenistan which was expected to benefit most from charging the world prices for the export of gas ended up in 1994 with accumulated claims for gas deliveries unpaid by Ukraine and other CIS countries, thus becoming an involuntary creditor.

When discussing the overall environment in which the economic reforms are being carried out in CARs and some of their specific features one should not ignore the fact that most of these countries are not ethnically homogeneous. This increases the importance of the assessment of the social impact of the various reform measures in order to maintain the political stability and public support for the reform efforts of the Governments. Up to now the CARs succeeded in general in maintaining a satisfactory degree of political stability. Certain exemptions, however, represent the cases of Tajikistan and Azerbaijan, where open conflicts along ethnical and/or religious lines took away a lot of resources, put the Governments' budgets under considerable strain and prevented the economic reform issue being given due priority. However, recently there have been indications of the tendency towards the solution of these conflicts, which would enable the Governments to focus on the stabilization of the economies and to pursue more vigorously economic reforms that had been initiated.

An intrinsic component of economic reforms in the former CPEs is usually the opening of the economy (trade liberalization) and reorientation of the trade and financial links from "traditional" partners (determined in part by other than economic considerations) towards "new" partners i.e., market economies. The aim is to secure the maximum possible benefit from increased integration into the world markets and to gain access to technology transfers and foreign investment sources. Looking at the CARs in this respect, one has to admit that their starting position is rather unfavourable. Lack of access to the sea and the skewed infrastructure which was built to serve primarily trade with Russia puts them at a disadvantage compared to Viet Nam and China, not to mention the Central European transforming economies. Thus a similar process of opening up the economies of the CARs will require a very active role of the Governments in building up the necessary infrastructure. Mere trade liberalization will not work in this case. Enlisting the participation of foreign investors and the support of international organizations (IBRD, ADB, EBRD etc.) will be of vital importance for the success of this endeavour. There are indications that in the area of exploitation of natural resources (especially oil and gas) for exports to new markets, the construction of required infrastructure i.e., pipelines is likely to proceed quite rapidly.

## B. MACROECONOMIC TRENDS

In a way, the macroeconomic trends can be considered as an important component of an "environment" in which economic reforms take place. The dynamism in economic growth (or lack of it), the degree of internal and external stability (or instability and disequilibria) and other aspects of the macroeconomic situation exert a significant influence on the shape of economic reforms and policies that are both desirable and feasible. This is not one way relationship, in turn, the reform measures adopted and policies pursued determine to a great extent the macroeconomic performance of the economies concerned.

In this brief review we will focus on two aspects of macroeconomic trends: output growth and inflation. This is because the dominant features of the macroeconomic scene in Central Asia over the last three years have been definitely the high rates of inflation and falling output levels.

In regard to the trend in levels of economic activity (output) the basic data are presented in table 1. It should be stressed that the data should be treated with caution, measurement of output in economies undergoing profound systemic and structural changes and cross-country comparisons are fraught with difficulties.[23/] However, they may serve as rough indicators of general trends.

**Table 1. Central Asian republics: Economic activity, 1990-1993**
**(Percentage change over the preceding year)**

| | *NMP or GDP* | | | | *Gross industrial output* | | | | *Gross agricultural production* | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | *1990* | *1991* | *1992* | *1993* | *1990* | *1991* | *1992* | *1993* | *1990* | *1991* | *1992* | *1993* |
| Azerbaijan | –11.3 | –0.4 | –28.1 | –13.3 | –6.3 | 4.7 | –24.0 | –6.8 | –0.1 | – | –25 | –17 |
| Kazakhstan | –0.9 | –10.3 | –14.2 | –12.8 | –0.8 | –0.9 | –14.8 | –16.1 | 6.8 | –8.0 | 1 | –3 |
| Kyrgyzstan | 4.8 | –5.2 | –19.0 | –17.4 | –0.6 | –0.3 | –26.8 | –24.2 | 1.3 | –8.0 | –5 | –8 |
| Tajikistan | 0.2 | –8.4 | –31.0 | –21 | 1.2 | –3.6 | –24.3 | –19.5 | 2.8 | –10.0 | –27 | –2 |
| Turkmenistan | 1.8 | –4.7 | –5.3 | 7.8 | 3.2 | 4.8 | –16.7 | 5.3 | 7.0 | –2.0 | –9 | 9 |
| Uzbekistan | 4.3 | –2.4 | –12.9 | –3.5 | 1.8 | 1.5 | –6.2 | –7 | 6.3 | –5.0 | –6 | – |
| **Memo items** | | | | | | | | | | | | |
| Eastern Europe | –7.9 | –12.3 | –7.4 | –3 | –15.1 | –18.1 | –10.0 | –4 | –3.5 | –2.1 | –14.1 | –1.9 |
| CIS | –3.4 | –12.2 | –19.9 | –13 | –1.1 | –7 | –18.2 | –14.6 | –2.6 | –6.9 | –9 | –2 |

*Source:* Economic Commission for Europe, Economic Survey of Europe in 1993-1994, New York and Geneva, 1994, pp. 52 and 63.

[23/] For more details on this see UN ESCAP, Economic and Social Survey of Asia and the Pacific 1993, pp. 41-42.

It can be seen that the decline in economic activities in the CARs started in earnest in 1991[24/] and further intensified in 1992. Except for Turkmenistan, decline in output continued in 1993 throughout the region with negative growth rates remaining at two digit levels in Azerbaijan, Kazakhstan, Kyrgystan and Tajikistan. It should be noticed that the decline in output in 1991 was mainly related to the agricultural sector which is very much influenced by climatic conditions. The industrial sector went into a deep depression a year later in 1992.

The time and structural profiles of the decline thus seem to confirm the assumption that the main factor of the deep CARs depression was the virtual collapse in inter-republican economic links which followed the break up of the Soviet Union in 1991. In view of the CARs high dependence on economic links with Russia it is of significance that in Russia decline in output reached the level of about 13 per cent already in 1991 and apparently with a certain time lag had an impact on the rest of the CIS including the CARs.

Some analysts identify as the other major factor in the declining output trend the extent to which the CARs got involved in the reform process. Thus, it is concluded that the cumulative decline in output over 1991-1992 was less in Turkmenistan and Uzbekistan where reform was slower and greater in Kazakhstan and Kyrgyzstan where reform proceeded faster.[25/] There were, of course, also other factors at play — in Tajikistan and Azerbaijan the civil unrest and military conflicts had extremely disruptive effects on economy.

Compared with other transition countries, the CARs quite naturally entered the "depression zone" later than the transition economies in Eastern Europe, some of which are at present already experiencing moderate recovery in economic activities. The data in table 1 also indicate that the depression taking place in the CARs tends to be much deeper than in Eastern Europe. This of course puts a lot of strain on the social fabric in the CARs and is necessarily reflected in the efforts of CARs Governments to limit the adverse social effects of the transition to market-oriented economy. The depth and persistence of the decline in output which is continuing in 1994 has led to the formulation of "anti-crisis" programmes in some of the CARs, the recovery of the real economy as the major objective.

Inflation, the other dominant feature of the CARs macroeconomic performance, was running at about hundred per cent per annum in 1991 with

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[24/] Azerbaijan is an exception, substantial drop in output took place already in 1990.

[25/] See UN ESCAP Economic and Social Survey of Asia and the Pacific 1993, p. 42.

relatively small variations among the individual countries.[26] At the outset of 1992 inflation accelerated dramatically with the monthly rate reaching in January and February several hundred per cent when all of the Central Asian republics followed the Russian Federation in removing many price controls and raising the remaining administratively fixed prices. Though the price rise became more moderate later on, the inflation rate for 1992 was several times over the levels recorded in 1991. As the figures in table 2 indicate, in 1993 inflation accelerated further in all the CARs though to a varying degree. However, there were quite wide variations among the CARs for example, Turkmenistan and Uzbekistan, whose initial price reforms were more cautious and which then retained widespread price controls and subsidies, had significantly lower open inflation rates.

It should be pointed out that as long as the CARs remained within the rouble zone they had only limited possibilities to control inflation. The currency supply was controlled by the Central Bank of Russian Federation and the arrangements on credit creation within the rouble zone were conducive

**Table 2. Central Asian republics: Consumer prices (inflation rates) (Annual percentage change)**

| | *1991* | *1992* | *1993* |
|---|---|---|---|
| Azerbaijan | 105.6 | 611.3 | 797.5 |
| Kazakhstan | 147.0 | 2 568.0 | 2 146.9 |
| Kyrgyzstan | 85.0 | 854.6 | 1 208.7 |
| Tajikistan | 111.6 | 1 156.7 | 1 869.9 |
| Turkmenistan | 102.5 | 492.9 | 1 860.0 |
| Uzbekistan | 105.0 | 528.0 | 761.0 |
| **For reference (memo items):** | | | |
| Russia | 92.7 | 1 353.0 | 895.9 |
| Estonia | 210.6 | 1 069.0 | 89.0 |
| Ukraine | 91.2 | 1 445.3 | 4 927.0 |

*Source:* IMF World Economic Outlook 1994, Washington D.C., April 1994.

*Note:* For some countries, figures for recent years are IMF staff estimates. The figures should be interpreted only as indicators of broad orders of magnitude because reliable, comparable data are not generally available.

[26] See data in table 2. It should be pointed out that there are wide variations in data on inflationary trends depending on sources chosen. For the sake of consistency the IMF data are used.

to inflationary trends.[27] Thus the high inflation rates in 1993 were the result of both the domestic (fiscal and credit policies within limited jurisdiction) and external impulses coming from the rest of the rouble area.

Looking at the more detailed data on monthly inflation rates in table 3, there are several phenomena that can be observed. It appears that with the exception of Kyrgyzstan inflation accelerated considerably towards the end of 1993 in all CARs. In Uzbekistan and Kazakhstan this development is likely to have been linked to the introduction of the new national currencies. In Turkmenistan, the quantum jump in consumer prices in November 1993 (by 429 per cent) was reportedly the result of liberalization of food prices and the general increase in 1993 inflation rate was also influenced by the strain on fiscal balance exerted by the drastic decline in revenues from gas exports. The high and volatile monthly inflation rates recorded in 1993 Tajikistan were undoubtedly influenced by the impact of civil war. In view of protracted hostilities in Nagorno Karabakh region this applies also to Azerbaijan where the monthly inflation rates in December 93 and January 94 went over the hyperinflation threshold (50 per cent monthly rate).

From the data available for 1994, it can be concluded that there was a certain tapering off the inflation from extraordinary high levels recorded at the end of 1993. However, in most CARs the rates of inflation remained above 20 per cent monthly rate which is still high, amounting to 900 per cent inflation in a year. Kyrgyzstan was the first country that succeeded in bringing inflation under control and reducing it substantially to the level of less than one per cent per month in July-September 1994. However, the tight monetary and fiscal policies that were behind this outstanding achievement apparently contributed to the deepening of the contraction in economic activities and incomes. Also Uzbekistan after introducing the new permanent national currency sum on July 1, seems to have brought inflation under control with retail prices even taking a downward turn in August-September 1994. More recently, Kazakhstan seems to have started reaping benefits of the more prudent fiscal and monetary policies by cutting inflation rate to under 15 per cent a month.

The data on Tajikistan in table 3 indicate that this is a rather special case. After consumer prices increased by hefty 111.4 per cent in December 1993 they showed a declining tendency throughout the first half of 1994. This strange phenomenon may have been linked to the exchange of old Soviet

[27] For more details see the ESCAP Economic and Social Survey of Asia and the Pacific 1993, pp. 44-45.

## Table 3. Central Asian republics: monthly changes in retail/consumer price indices, 1992-1994
## (Percentage change over preceding month)

| | *1992* | *1993* | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | *December* | *January* | *February* | *March* | *April* | *May* | *June* | *July* | *August* | *September* | *October* | *November* | *December* |
| Azerbaijan | 94.5 | .. | .. | .. | .. | .. | .. | .. | 8.6 | 13.7 | 16.8 | 49.0 | 58.9 |
| Kazakhstan | 21.0 | 29.8 | 29.0 | 27.8 | 21.5 | 16.3 | 17.3 | 15.1 | 25.8 | 39.0 | 35.8 | 52.0 | 38.5 |
| Kyrgyzstan | 22.9 | 35.9 | 39.2 | 23.0 | 16.0 | 24.6 | 16.6 | 15.8 | 25.2 | 36.1 | 32.3 | 21.6 | 16.8 |
| Tajikistan | 15.7 | 22.8 | 37.4 | 44.5 | 58.1 | 41.4 | 15.6 | 25.2 | 56.3 | 38.7 | 24.3 | 42.2 | 111.4 |
| Turkmenistan | 14.7 | 14.6 | 41.3 | 15.1 | 28.0 | 15.4 | 49.0 | 16.3 | 15.1 | 21.7 | 27.7 | 429.1 | 26.2 |
| Uzbekistan | 12.6 | 29.3 | 18.2 | 7.6 | 13.2 | 9.2 | 28.9 | 18.2 | 15.1 | 9.5 | 28.7 | 43.7 | 40.5 |
| **Memo item:** | | | | | | | | | | | | | |
| Russian Federation | 24.9 | 26.0 | 25.0 | 20.0 | 23.0 | 19.0 | 20.0 | 22.0 | 26.0 | 23.0 | 19.3 | 16.0 | 13.0 |

| | *1994* | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | *January* | *February* | *March* | *April* | *May* | *June* | *July* | *August* | *September* |
| Azerbaijan | 52.0 | 25.7 | 23.0 | 21.3 | 40.0 | 28.3 | 1.4 | 9.1 | 16.8 |
| Kazakhstan | 45.0 | 30.3 | 20.1 | 26.4 | 30.3 | 44.4 | 29.8 | 17.0 | 12.2 |
| Kyrgyzstan | 13.0 | 15.0 | 5.4 | 4.4 | 2.1 | 4.1 | 1.3 | –0.7 | 0.7 |
| Tajikistan | –19.0 | –12.3 | –4.2 | –1.5 | 0.0 | –1.5 | 4.5 | 2.9 | 8.4 |
| Turkmenistan | 23.0 | 18.7 | 38.4 | 23.8 | 18.8 | 18.5 | 26.1 | 35.6 | .. |
| Uzbekistan | 28.0 | 19.5 | 26.2 | 27.5 | 19.8 | 17.6 | 4.4 | –8.1 | –1.0 |

*Source:* For 1992-1993 Economic Commission for Europe, Economic Survey of Europe in 1993-1994, New York and Geneva, 1994, p. 76 for 1994: Calculated on the basis of data contained in: Statistical Committee of CIS, Statistical Bulletin Nos. 33 and 36, 1994.

*Note:* For 1994 for Azerbaijan and Tajikistan consumer price indices, for Kazakhtan, Kyrgyzstan, Turkmenistan and Uzbekistan retail price indices.

(1961-91) and Russian (1992) roubles for new 1993 Russian roubles effected in early January 1994 and the temporary freezing of deposits. It was also reported that rationing for ten basic consumer items was introduced in mid January 1994,[28] which might partly explain the decline in prices.

In conclusion it may be stated that in spite of some success achieved, the objective of bringing the inflation under complete control is yet to be met However, with the introduction of national currencies, the CARs (except for Tajikistan) have now at their disposal the instrument to control monetary growth which together with prudent fiscal policies can bring them closer to reining in the inflation.

## C. GENERAL OVERVIEW OF THE REFORM PROGRAMMES

The initial stage of economic reforms dates back to the late 1980s when under the Gorbachev policy of "perestroika" some reform measures were introduced throughout the USSR. In the Central Asian republics these centrally directed and rather cautious measures were adopted without any significant local experiments. Perhaps the most important reform measure undertaken in that period was the establishment of a two-tier banking system which was implemented in all six CARs in 1988.

The more comprehensive market-oriented reform programmes were initiated following the break up of the USSR in late 1991 and the CARs gaining independence. The first significant measure — which was conceived still under the USSR aegis — was the price liberalization that was implemented practically in all former Soviet Union (FSU) republics. The Central Asian republics joined in and from January 1992 started liberalizing prices and/or adjusting the administered prices closer to market determined levels. However, the extent of liberalization and deregulation of prices differed, with Kyrgyzstan and Kazakhstan proceeding faster, Uzbekistan and other CARs taking a more cautious approach. In general, the Governments tried to protect the consumers, especially the lower income groups, from excessive price shocks through maintaining controls over the prices of basic necessities like bread, some other staple food items, energy, and cost of public transportation and communication services. The rents remained also under control.

[28] EIU Country Report, 1st quarter 1994 p. 65.

However, the general trend was towards more liberalization.[29] The range of goods and services with regulated prices has been narrowed gradually, and, the size of subsidies was cut down bringing even the administered prices of items such as energy and public transportation closer to market price levels. The only exception seems to have been Turkmenistan where the basket of consumer goods with controlled and subsidized prices remains quite broad (19 items including bread, butter, vodka etc.). Certain other items, including electricity and gas are provided free to the population. It was recently reported that by 1996 bread should be added to the list of freely distributed goods.

Whereas in the area of commodity prices liberalization has proceeded quite far[30] thus contributing to the evolution of the really functioning markets, in regard to factor prices i.e., wages (labour) and interest rates (capital) the progress has been minimal. Wages in the state sector (which is still the dominant sector) remain rather strictly regulated and in regard to the pricing of capital only the very first steps have been undertaken in some CARs to switch from administrative methods of credit allocation at heavily subsidized interest rates towards market determined interest rates and credit auctions through the commercial banking system.[31]

Privatization, another important component of market-oriented reforms, first appeared on the agenda in 1991 when privatization laws were adopted in Kazakhstan, Uzbekistan and Tajikistan.[32] At the initial stages focus was on small-scale privatization in retail trade, services, some segments of agriculture and housing. In 1993-94 all CARs except Turkmenistan adopted more comprehensive and ambitious privatization programmes with extensive large-scale privatization components. These involve mostly medium and large-size industrial enterprises. Various methods of privatization are being used or envisaged. Within the National Privatization Programme for 1993-95 launched in Kazakhstan, enterprises are privatized through auction-sale of shares to private investment funds. Kazakh citizens have received points-

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[29] Admittedly there were some reversals. For example, in Kyrgyzstan after the introduction of national currency in mid 1993 there were imposed maximum retail margins on all goods to check the inflationary pressures. These controls were later gradually lifted so that by March 1994 maximum retail margins were applied only to bread.

[30] The estimates of the share of items with liberalized prices on the total sales of consumer goods range between 80-95 per cent.

[31] See section on financial sector reform, monetary and credit policies, for more details.

[32] In Tajikistan, the implementation of 1991-92 privatization programme was stalled due to political instability.

denominated vouchers and have placed the vouchers under the administration of investment funds of their choice. So far two major waves of auctions have taken place. The privatization of largest enterprises should be effected on a case-by-case basis through tenders. In Kyrgyzstan large-scale privatization in based on transformation of enterprises into joint-stock companies as the first step, followed by privatization through competitive cash bidding (by individual investors for up to 70 per cent of the equity) and voucher auctions (open to individuals and investment funds for 25 per cent of the equity), while 5 per cent of the equity would be reserved for the labour collectives. In Uzbekistan the auctions-sales are combined with transformation of existing closed joint-stock companies into the open ones allowing ownership participation of outsiders. In conclusion it may be stated that the major progress has been achieved in the small-scale privatization area while the large-scale privatization is still at its initial stage. Private sector share in CARs economies is estimated at 15-20 per cent (except for Kyrgyzstan with 30 per cent share) which is much lower than in the Russian Federation (50 per cent) and most of the other transition economies.

However, it may be argued that privatization is not a panacea and that positive results in terms of increased efficiency can be achieved also by restructuring of the state owned enterprises. For example, the experience of China and Poland provides evidence that exposing the state owned enterprises to a competitive environment and hard budget constraints can induce positive restructuring, increased efficiency and vastly improved management methods in the firms involved. In this connexion it should be noted that not much has been done in the CARs in regard to enterprise restructuring of the state owned enterprises. To a large extent these continued to operate under "soft budget" conditions enjoying the subsidies and/or subsidized credits with very loose terms of repayment. To rectify this deficiency is yet another major challenge of economic reforms in the CARs.

The financial and fiscal reforms represent other crucial elements in transition to a market economy. Since these matters will be dealt with in separate sections below, let us here only very briefly indicate the major developments taking place. Undoubtedly the most significant development in this context has been the introduction of national currencies in all Central Asian republics (except Tajikistan) in the course of 1993. This — being a very challenging task in itself — provided the basis for pursuing the independent monetary policy and also put the reshaping of relations between the central banks and commercial banks into a different perspective. Other, completely new issues, like foreign exchange regimes and policies had to be tackled. In the area of fiscal reforms major steps have been taken especially on the revenue side through tax reforms. In all CARs the former turnover tax was replaced by value added tax (VAT), corporate and personal income taxes were reshaped to fit the needs of market economy. Reforms of the financial and fiscal systems proceeded under very adverse macroeconomic conditions of high inflation, declining output and increasing budgetary and balance of payments deficits. Under these circumstances the priority in policy area has shifted towards stabilization measures aiming at reducing and controlling inflation through tightening up the monetary and fiscal policies. Kyrgyzstan and Kazakhstan were the first among the CARs to cooperate with the IMF in designing and implementing economic policy programs with strong stabilization components. IMF extended technical assistance as well as financial support under the systemic transformation facility (STF) and stand-by credit arrangements. The other CARs which joined the IMF are at various stages of discussions and negotiations on formulating the reform-cum-stabilization programs which would be supported by the IMF. In view of very modest achievements, if any, in stabilization efforts both in terms of inflation control and stopping the decline in economic activities[33/] it is obvious that macroeconomic stabilization represents the most pressing task and challenge for the policy makers in the Central Asian republics.

In regard to reform measures aimed at opening up the CARs economies and enhancing their involvement in international trade and finance, the CARs took the first steps in liberalizing their foreign trade regimes, with liberalization proceeding farther on the import than on the export side. In all CARs quite liberal legislature on foreign investment has been adopted, providing incentives to foreign investors especially in terms of tax concessions.[34/] Very important contribution to the economic reform in CARs and their integration in to the international economic framework has been made by cooperation with IMF, the World Bank, Asian Development (EBRD) Bank (ADB), European Bank for Reconstruction and Development and other organizations. Progress in establishing working relationships with these institutions has been remarkable, resulting in extensive technical assistance and increasing financial support for concrete projects and programmes. The speed with which the Central Asian republics became active participants in a broad range of regional and global institutions is quite an achievement. It reflects both the abilities of CARs policy makers and their professional staff and the cooperative attitudes of the respective international organizations.

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[33/] See above the section reviewing macroeconomic performance of the CARs.

[34/] For more details see the respective sections of this paper.

In conclusion to this general overview of CARs reform programmes it may be of interest to present the results of a comparative study undertaken recently by the EBRD which evaluates progress achieved in the transition to a market economy in 25 East European and FSU countries. EBRD analysts chose a set of indicators reflecting the status achieved in various economic reform transition elements such as privatization, enterprise restructuring, price liberalization, trade and foreign exchange system and banking reform. In regard to each transitional element the situation in a given country is evaluated on the scale 1 to 4, the category 4 reflecting the most advanced status. The EBRD admits that the classification system is crude and builds on the judgement of EBRD economists and is likely to be revised and refined in the future.[35]

In table 4 below data for the Central Asian republics are given together with data for some other transition economies just for the sake of a rough comparison. According to EBRD's evaluation the reforms in the CARs advanced most in the areas of price liberalization and small-scale privatization whereas in reform of financial institutions and enterprise restructuring the least progress has been achieved.

In regard to inter-country comparisons, which it should be again pointed out are indeed very rough, the CARs lag behind the "fast reformers" represented in table 4 by Estonia and the Czech Republic. However, their performance is not out of the pattern observed among the other FSU republics (except the Baltic republics). Kyrgyzstan got the highest marks slightly above the level of the Russian Federation, while other CARs are above or at the level of "FSU slow reformers" represented by the Ukraine.

## D. REVIEW OF REFORMS IN SELECTED FIELDS

### 1. Fiscal reform and budgetary policies

In the area of fiscal reform, the Central Asian republics have made a major progress especially on the tax side. The hundreds of turnover taxes have been replaced in 1992 by a much simpler structure of the value added tax (VAT) in combination with excise taxes. Also the income taxes related to business sector and personal income taxes have been streamlined bringing the tax system closer to the needs of market oriented economy.[36] On the

[35] EBRD, Transition Report, London, September 1994, p. 11.

[36] For more detailed review of tax reforms in the CARs see the ESCAP Economic and Social Survey of Asia and the Pacific 1993, pp. 76-77.

**Table 4. Private sector share in GDP and progress in transition in selected economies in transition**

| | *Private sector share of GDP (percentage)* | *Progress in transition*[a/] | | | | | |
|---|---|---|---|---|---|---|---|
| | | *Enterprises* | | | *Market and trade* | | *Financial institution* |
| | | Large-scale privatisation | Small-scale privatisation | Enterprise restructuring | Price liberalisation | Trade and foreign exchange | Banking reform |
| **Central Asian republic** | | | | | | | |
| Azerbaijan | 20 | 1 | 1 | 1 | 3 | 1 | 1 |
| Kazakhstan | 20 | 2 | 2 | 1 | 2 | 2 | 1 |
| Kyrgyzstan | 30 | 3 | 4 | 2 | 3 | 3 | 2 |
| Tajikistan | 15 | 2 | 2 | 1 | 3 | 1 | 1 |
| Turkmenistan | 15 | 1 | 1 | 1 | 2 | 1 | 1 |
| Uzbekistan | 20 | 2 | 3 | 1 | 3 | 2 | 1 |
| **Other economies in transition** | | | | | | | |
| Russian Federation | 50 | 3 | 3 | 2 | 3 | 3 | 2 |
| Belarus | 15 | 2 | 2 | 2 | 2 | 1 | 1 |
| Ukraine | 30 | 1 | 2 | 1 | 2 | 1 | 1 |
| Estonia | 55 | 3 | 4 | 3 | 3 | 4 | 3 |
| Czech republic | 65 | 4 | 4 | 3 | 3 | 4 | 3 |

*Source:* EBRD, Transition Report 1994, p. 10.

[a/] The numbers indicate the extent of progress in transition according to classification in table 5.

## Table 5. Classification system for transition indicators

| *Transition element* | *Category* | *Description of the category* |
|---|---|---|
| Large-scale privatization | 4 | More than 50 per cent of state-owned enterprise assets privatized in a scheme that reflects support for corporate governmence |
| | 3 | More than 25 per cent of large-scale state-owned enterprise assets privatized or in the process of being sold but with major unresolved issues regarding corporate governmence |
| | 2 | Advanced comprehensive scheme almost ready to be implemented; some sales completed |
| | 1 | Little done |
| Small-scale privatization | 4 | Comprehensive and well designed programme implemented |
| | 3 | Nearly comprehensive programme implemented, but design or lack of central supervision leaves important issues unresolved |
| | 2 | Substantial share privatized |
| | 1 | Little done |
| Enterprise restructuring | 4 | Restructuring programme which substantially improves corporate governmence in operation; strong financial discipline at the enterprise level; large conglomerates broken up |
| | 3 | Structures created (for example through privatization combined with tight credit and subsidy policies and/or enforcement of bankruptcy legislation) to promote corporate governance; or strong action taken to break up conglomerates |
| | 2 | Moderately tight credit and subsidy policy; weak enforcement of bankruptcy legislation; little action to break up large conglomerates |
| | 1 | Lax credit and subsidy policies weakening financial discipline at the enterprise level; few other reforn to promote corporate governance |

**Table 5** *(continued)*

| *Transition element* | *Category* | *Description of the category* |
|---|---|---|
| Price liberalization and competition | 4 | Comprehensive price liberalization and price competition; anti-trust legislation in place |
| | 3 | Comprehensive price liberation and price competition |
| | 2 | Price controls remain for several important product categories |
| | 1 | Most prices remain formally controlled by the Government |
| Trade and foreign exchange system | 4 | Few import or export quotas; significant direct involvement in exports and imports by ministries and state-owned former trading monopolies; almost full current account convertibility at unified exchange rate; no major non-uniformity of customs duties |
| | 3 | Few import quotas; almost full current account convertibility at unified exchange rate |
| | 2 | Few import quotas; almost full current account convertibility in principle but with a foreign exchange regime which is not fully transparent (possibly with multiple exchange rates) |
| | 1 | Widespread import controls or very limited legitimate access to foreign exchange |
| Banking reform | 4 | Well functioning banking competition and prudential supervision |
| | 3 | Substantial progress on bank recapitalization, bank auditing, and establishment of a functioning prudential supervisory system; significant presence of private banks; full interest rate liberalization with little preferential access to cheap refinancing |
| | 2 | Interest rates significantly influencing the allocation of credit |
| | 1 | Little progress beyond establishment of a two-tier system |

*Source:* EBRD, Transition Report 1994, p. 11.

expenditure side of the governmental budgets the major shift was the reduction of the share of subsidies in connexion with price liberalization. With continuing transition to market economy the changing role of the State will be reflected in declining share of expenditure flowing to the business sector (both subsidies and investment) and increasing share of investment outlays to finance the infrastructure development. At the same time, in the area of social services like education and health the State will continue to play the crucial role and its responsibility in social security area is likely — at least temporarily — to increase because of the discontinuation of provision the security of employment and other benefits at the enterprise level.

When reviewing the fiscal policies applied by the CARs since gaining independence and starting economic reforms it has to be taken into account these policies were implemented under very adverse conditions.

First of all, with the break up of the Soviet Union the CARs were confronted with the loss of transfers from the Union budget which amounted to about 10 per cent of the GDP in CARs and their share in total governmental revenues were quite high — for example, in Kazakhstan and Kyrgyzstan amounting to about 30 per cent of the budget revenues. Undoubtedly, this was the major factor behind a sudden turn of essentially balanced budgets of pre-independence era into sizeable deficits. Deep decline in economic activities which was largely caused by a collapse in intra-CIS trade put additional strain on CARs budgets by reducing the revenue base. And all this was combined with prevailing high inflation which eroded further the revenue base in case of any delays in their flows to the budget.

These factors explain to a large extent the fiscal deficits recorded in 1992 by all the CARs, except Turkmenistan (see table 6). In the case of Turkmenistan the increase in revenues from gas exports combined with restrained expenditure policy was the main reason for the ability of the government to achieve a sizeable budget surplus (14 per cent of GDP). On the other hand, in Azerbaijan and Tajikistan the budgetary problems were intensified by the outlays and losses resulting from armed conflicts thus bringing the budget deficits to exorbitant levels of 26.8 and 37.0 per cent of GDP.

In 1993 the situation has changed. Turkmenistan's revenues from gas exports declined drastically mainly because of accumulating arrears of some FSU countries on Turkmenistan's exports. The budget turned into a deficit representing about 7 per cent of GDP. The other CARs, especially Kyrgyzstan and Kazakhstan tried to develop and pursue tighter fiscal policies in order to reduce the budgetary deficits. In Kazakhstan the Government approved a

**Table 6. Central Asian republics: General Government budget balances (Percentage of GDP)**

| | *1990* | *1992* | *1993* |
|---|---|---|---|
| Azerbaijan | –5 | –26.80 | –14.40 |
| Kazakhstan | 1.40 | –7.30 | –2.90 |
| Kyrgyzstan | 0.30 | –14.80 | –8.20 |
| Tajikistan | 4 | –37.00 | –37.00 |
| Turkmenistan | 1.20 | 4.10 | –7.00 |
| Uzbekistan | –1.10 | –13.00 | –15.70 |

*Source:* For 1990 EBRD, Transition Report 1994, for 1992-1993 IMF, World Economic Outlook 1994, p. 71.

comprehensive programme for 1993-94 aimed at containing the overall decline in output, reducing the inflation and strengthening the balance of payments and official external reserves positions. In regard to budgetary policy it set a target to reduce the overall deficit to around 6 per cent of GDP in 1993 with domestic bank financing of the deficit to be kept at no more than 4 per cent of GDP. The programme outlined the measures to broaden the tax base and increase the revenues. The programme called also for the implementation of a tight expenditure programme based on prudent wage policy and strict limitation of all budgetary transfers and subsidies to a level not exceeding 5.1 per cent of GDP.

It appears that the target for reduction of the budget deficit was "overfulfilled", according to the IMF figures the deficit was reduced to 2.9 per cent of GDP in 1993 (see table 6). However, the other macroeconomic objectives of the programme were not met: decline in output amounted to 12.8 per cent against targeted 7-8 per cent and inflation instead of being reduced to a 5 per cent monthly rate by the end of 1993 was actually running at about 40 per cent at the close of 1993. Of course, this was still partly the imported inflation from the rest of rouble area over which the Kazakh Government had no control. A certain degree of success in controlling inflation was achieved only in late summer of 1994.

Kyrgyzstan was another country among the CARs which succeeded in reducing the budget deficit in 1993 (to 8.2 per cent compared with 14.8 per cent of GDP in 1992 — see table 6). This was achieved within the framework of a comprehensive program of structural reform and macroeconomic stabilization supported by the IMF. Kyrgyzstan also became the first among the CARs to reduce substantially inflation rate, bringing it down to the level of 2.5 per cent a month in the summer of 1994. In case of Kyrgyzstan the success at "budgetary front" was (similarly as in Kazakhstan) associated with a failure to stabilize the "real economy" — the GDP declined in 1993 by 17.4 per cent.

This phenomenon leads some analysts to the conclusion that in the stabilization policy packages more attention should be devoted to the possible ways of arresting the decline in output and/or inducing a recovery. For example, in the case of Kazakhstan need has been voiced for the formulation of a programme which would put into the focus the achievement of recovery in the "real economy" combined with restructuring. According to this view the Government should take more active part in devising and implementing industrial policy to effect the desired structural changes and pursue export-oriented trade policies.[37/]

Similar views were expressed also in regard to Kyrgyzstan. In this case the analysts expressed concern about the impact which the decline in economic activities exerts on the revenue base of the budget. This, combined with the deficiency of the tax collection especially from the emerging private sector lead to a drastic decline in budgetary revenues. It is claimed that also the share of budgetary revenues in the GDP dropped from about 35 per cent in 1991 to an extremely low level of 14.2 per cent in 1993. This, of course, led to a drastic reduction in government expenditures, when especially the outlays on education and health were cut down (from 32.7 per cent of the total government expenditures in 1990 to 12.7 per cent in the first quarter of 1993). In this connection the analysts call for radically improving the tax collection capacity of the Government and also for giving a higher priority in policy mix to the measures that would stimulate economic recovery and restructuring (industrial policy is called for) to strengthen the revenue base of the budget.[38/]

It should be pointed out that these views do not deny the importance of achieving stabilization in monetary terms (especially reducing substantially

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[37/] See "Problemy rynotchnovo preobrazovanya ekonomiki Kazakhstana (Problems of market transformation of the economy of Kazakhstan)" by A. Koshanov, Director of the Economic Institute; Academy of Sciences of Kazakhstan, in: Voprosy ekonomiki No. 3/1994 pp. 91-102.

[38/] See Hansjorg Herr, Ian Prive, Strategya razvitia dla Kyrgyzstana-vklad v obsuzhdenye problemy (Development strategy for Kyrgyzstan — contribution to the evaluation of the problem), Berlin, June 1994.

inflation) for transition economies of the CARs type. They express concern about the depth of the depression of real economy and real incomes of the population in the countries concerned and call for certain policy measures that would tackle more directly these problems.

## 2. Financial sector reform

Reform of the financial sector started in the Central Asian republics in the late 1980 when the transition from a state monobank system to a two-tier banking system (consisting of a central bank and a cluster of commercial banks) was initiated in the whole of the USSR.

In a fully-fledged market economy, the separation of central banking and commercial banking functions is an essential feature of the financial sector. While the central bank's main concern is stability of the currency and prices, commercial banks serve as "go betweens" between savers, capital owners and investors, and are subject to market and competition rules. The central bank has a high degree of independence in shaping the monetary, exchange rate and credit policies by means of market compatible instruments like interest rates, reserve requirements etc. The central bank is not involved in sectoral allocation of resources, this is left to the commercial banks which compete for both the depositors as well as customers/investors.

It can be said that the CARs have taken first steps in moving towards the above outlined structure of the banking sector. After setting up a two-tier banking system in 1988 by taking out of the State monobank structure its territorial and/or sectoral branches and forming thus a group of commercial state owned banks, the CARs — especially after gaining independence in 1991— liberalized entry into the banking sector and adopted a series of laws defining more precisely the functions of the central banks as well as setting rules and regulations for commercial banks activities.

The rapid increase in the number of commercial banks that followed has been quite impressive. In Kazakhstan, by the end of 1992 there were already 158 commercial banks operating of which 48 were private banks. In 1994 the number of commercial banks surpassed 200 mark.[39/] In Uzbekistan there were over 40 banks in mid-1994, including a few private banks. Turkmenistan's banking sector includes 20 commercial banks, of which 8 are privately owned.

[39/] According to IMF evaluation, most of the new banks are small and were established by enterprises to channel to them preferential (subsidized) credit from the NBK. (IMF, Economic Review 5; Kazakhstan, June 1993 p. 27).

In Kyrgyzstan 15 new commercial banks have been established by (and are almost exclusively owned by) state-owned enterprises and ministries. A rather specific situation developed in Azerbaijan where since 1992, over 200 very small commercial banks have been created, however, due to new rules on capitalization adopted in July 1994 many of these new banks are not expected to survive. In Tajikistan in spite of the slowing down of economic reform due to lack of political stability, it was reported that 14 commercial banks were operating in 1994.[40]

The establishment of a great number of new commercial banks is undoubtedly a very positive feature, however its significance for the creating of a competitive banking structure should not be overestimated. Financial resources continue to be channelled to the corporate sector through a few biggest state owned banks usually of a sectoral character. Thus, in Kazakhstan the bulk of credits continues to flow through four specialized state banks, which together hold 80 per cent of assets in the country's banking system. Similarly, corporate banking in Uzbekistan remains dominated by Agroprombank and Promstroibank with about 90 per cent of total credit to enterprises. In Kyrgyzstan the banking system is dominated by three large state-owned banks: Agroprom, Promstroibank and Kyrgyzstan Bank, together accounting for about 85 per cent of total assets of the banking sector. In Tajikistan three large specialized banks — Agroprombank, Orienbank and Tajik Bank Business — account for over 96 per cent of bank lending. It should be pointed out that these banks that provide the bulk of credits to enterprises rely to a high degree on central bank financing. They usually do not have a significant capacity of their own to mobilize savings (from both household and business sectors). This, of course, increases the importance of the credit policies pursued by the central banks.

With a certain degree of simplification it can be stated that so far the central banks in most of the CARs pursued credit policies which contained a significant non-market element. First of all, refinance credits extended to commercial banks were provided at subsidized interest rates which were far below the market rates, and, also below the rates of inflation. The central banks usually had also the authority to determine the interest rate ceilings at which the commercial banks would relend the funds to enterprises. This, of course, resulted in great demand for such cheap credits provided at negative real interest rates. Second, the central banks were often practicing the rationing of credits and thus — because of the specialized nature of the main banks — determined

[40] Source of information quoted in this and the following paragraph is EBRD, Transition Report 1994.

the sectoral allocation of credit resources. The decisions on allocation were, of course, taken usually elsewhere within the governmental structure, the central banks were just executing them.

However, there has been progress in moving the interest rates closer to market levels and also to increase the allocative role of interest rates. For example, the National Bank of Kazakhstan (NBK) moved in 1993 away from the extension of loans at interest rates below its official refinance rate.[41/] Except for a two-year loan for replenishment of working capital of state enterprises at 25 per cent, virtually all NBK credits were provided at official refinance rate. This rate was substantially raised in July 1993 to 110 and subsequently to 140 per cent. In addition the NBK provided small amounts of credits through monthly auctions at market determined rates which in the first half of 1993 were 2-3 times higher than NBK official refinance rate. The Government approved a programme to increase substantially the share of new credit that is auctioned so that an average of 20 per cent of total NBK credit would be auctioned in second half of 1993, 35 per cent in the first quarter and 50 per cent during the second quarter of 1994. This was an important step to bring interest rates closer to market determined levels and increase their role in credit allocation.

Also in Kyrgyzstan the discount rate at which the central bank lends was gradually raised reaching the level of 160 per cent at the end of 1993. (This represents a monthly interest rate of 13.3 per cent).[42/] In view of the reduction of monthly inflation rate below 13 per cent in the first quarter of 1994 the above mentioned discount rate would turn positive in real terms.

In Uzbekistan the reform of banking sector was enhanced by the respective Cabinet of Ministers' resolution issued on March 18, 1994. Besides liberalizing the commercial banks operations, one of the main measures was the changing role of the savings bank (Uzberbank) which having been previously only a deposit-taker can now also lend. According to the resolution the Uzberbank is to be able to set its own interest rates. Concerning the National Bank of Uzbekistan (NBU) credit policy the decree stipulates that NBU is to raise its discount rate to 50 per cent (64 per cent compound annual rate)

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[41/] In 1992 over half of the credit was supplied by the NBK at preferential interest rates of between zero and 25 per cent while NBK regular refinance rate was 65 per cent as of July 1992.

[42/] EIU Country Report , first quarter 1994, p. 55.

and issue no more soft credits (certain exceptions apply).[43] These steps follow the general trend of liberalizing the interest rates and bringing then to more realistic levels, however, in view of the prevailing inflation rates the NBU discount rate seems to be rather low.

Another major issue in the reform of the banking sector is the position of the central bank. In connexion with the introduction of national currencies by the CARs it appears that the crucial role played by the central bank in ensuring the stability of the national currency, in conducting monetary and credit policies, and in regulating and supervising the banking system has been more appreciated. In several countries measures have been undertaken to strengthen the central bank's independence from the Government. However, it is yet to be seen to what extent the more or less automatic financing of the government budgetary deficits through soft credits from the central banks will be curtailed or discontinued. This is usually the acid text for the sincerity of intentions to change the central bank relationship with the Government.

Inflationary environment prevailing in the CARs resulted in the phenomenon of drying up the sources of long-term credits which could be used for investment. The commercial banks largely provide credits with maturities not exceeding one year. One way to solve this problem might be found in the establishment of development banks which would focus on the provision of long-term credits for investment projects. It was reported that such a bank has been recently set up in Kazakhstan. According to the reports, the State Bank for the Development of Kazakhstan financial resources will be guaranteed by the government and the new bank will be fully responsible for targeting and ensuring the efficient use of long-term credits as well as for implementing the investment projects which it finances.[44]

In connection with the observed trend towards tightening the monetary and credit policies, opinions have been expressed that in some cases the tightening has been excessive, for example, some analysts maintain that in Kyrgystan the extremely tight monetary and credit policy had very detrimental effects on real economy. The sources for investment credits were first to disappear thus foreclosing the chances for economic recovery and the lack of liquidity in the business sector resulted even in disruptions of the day to day

[43] Republic of Uzbekistan, Decrees and Resolutions, Tashkent "Uzbekistan", 1994, pp. 114-117.

[44] Kazakh TV, Almaty, 7 September 1994, quoted from BBC, Summary of World Broadcasts, SUW/0351 WB/4, 23 September 1994.

functioning of the economy.[45] The reports on 30,000 workers being on the unpaid leave and 65 large industrial enterprises at a complete standstill in summer of 1994 indicate the graveness of the situation.[46] Due to cash shortages there have been also considerable delays in payments of wages, pensions and other social security allowances. In response to this the president of Kyrgyzstan announced that he would shortly issue a series of decrees to alleviate the social and economic crisis in the country.[47]

### 3. Exchange rate policies

With the introduction of the national currencies the CARs Governments faced the issue of developing the adequate exchange rate policy. The exchange rate policy serves usually two distinct stabilization objectives. Firstly, it helps to maintain the competitiveness of domestic producers vis-a-vis foreign producers. In that role it is also the key instrument of restoring and maintaining external balance. Second, because of the impact of changes in the exchange rate on domestic prices of tradeable goods, the exchange rate policy is an important determinant of the level of domestic inflation.

The two goals of maintaining external and internal (price) balances may lead to conflicting exchange rate policy prescriptions. If the country suffers from current account deficit and domestic inflation at the same time, restoring external balance would require devaluation of domestic currency, which, however would result in further acceleration of inflation. The decision would thus depend on individual country conditions and policy judgements as to which imbalance should be cured in the first place. This is the kind of issues which the CARs Governments (or central banks) will be continuously tackling.

However, the first decision that had to be taken was the choice of the exchange rate regime which largely determines the methods and tools of the exchange rate policy. Essentially there are three different regimes that have been so far applied in transition economies: the fixed rate regime, the managed float regime and the adjustable (or crawling) peg regime.

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[45] See Hansjorg Herr, Ian Prive, Strategya razvitya dla Kyrgyzstana-vklad v obsuzhdeniye problemy (Development strategy for Kyrgyzstan — contribution to the evaluation of the problem) Berlin, June 1994.

[46] EIU country Report, 3rd quarter 1994.

[47] Kyrgyzkabar, Bishkek, 5 September 1994, quoted from BBC Summary of World Broadcasts SU/2094 G/2, 7 September 1994.

There are some rather attractive examples of transition economies (former Czechoslovakia and Estonia) which successfully applied fixed rate regime by pegging their national currency to a basket of currencies, or a single foreign currency. The fixed exchange rate helps to keep inflation under control and serves as a "nominal anchor" to the other macroeconomic variables, and, at the same time provides a firm orientation point for the economic agents in their decision making. However, to be successful it requires the capacity of the country involved to bring down and keep the inflation at low levels through prudent monetary and fiscal policies, and, to build up adequate foreign exchange reserves so that the central bank can intervene to protect the fixed rate in case of temporary external imbalances.

The CARs by and large opted for a floating rate regime of a managed float type. This seems to be a policy which is most adequate to the present fragile conditions of the CARs economies and relatively low levels of foreign exchange reserves. Exchange rates are usually determined on the basis of periodical auctions, however, in some countries the auctions were not held at regular intervals and exchange rate became more of an administered type, deviating considerably from the prevailing market rate. The depth of the foreign exchange market also differed among the CARs — in general it would be desirable to increase the number of participants and volume of trading in central bank managed foreign exchange auctions. The convertibility of domestic currencies in the CARs relates in general to current account transactions. There exist also some additional restrictions, which vary from country to country.

It may be rather early to evaluate the impact of the introduction of national currencies, however, some preliminary observations can be offered. First of all it appears that in fixing the initial exchange rates, in all the CARs a varying degree of "undershooting" took place, for example, the rates were fixed at too high, overvalued levels which could not be sustained. All the new national currencies were subsequently depreciated. However in Kyrgyzstan and more recently in Kazakhstan a certain stabilization of exchange rates took place in 1994.

In regard to the impact on inflation rates the introduction of the national currencies was associated with a temporary explosion of prices especially in the case of Kazakhstan, Uzbekistan and Turkmenistan which tapered off after 2-3 months.

The following paragraphs give a brief wise review of developments in exchange rates.[48/]

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[48/] For a review of the evolution of national currencies in CARs see ESCAP, *Economic and Social Survey of Asia and the Pacific 1993*, pp. 44-45.

### *(i) Azerbaijan*

The new national currency, manat' was introduced on 15 August 1992 as a parallel currency, equal to ten rubles. It was made sole legal tender on January, 1994. On 24 May 1994, Azerbaijan National Bank (ANB) severed the fixed 1:10 link of the manat to the Russian ruble and set the official exchange rate for the manat on the basis of a weighted average of exchange rates quoted by commercial banks authorized to deal in foreign exchange. The official rate is set in this fashion once a week. Since the banks' rates closely approximate the free market exchange rate, which represents a thin volume of cash transactions, the official exchange rate moved from 186 manats per US dollar on 23 May to 1100 manats per US dollar on 24 May. This is viewed upon as the first step toward the market determination of the exchange rate. It is worth noting that the free market rate, which was 1050 manats per US dollar on 24 May declined to 950 manats per US dollar on 27 May 1994. The official exchange rate was adjusted to 1,050 manats per US dollar on 1 June 1994. This is the manifestation of the phenomenon observed elsewhere that when the Government (or the Central Bank) moves towards a market-determined rate, the free (or black) market rate of foreign exchange declines.

### *(ii) Kazakhstan*

The national currency, tenge, was introduced on 15 November 1993 with exchange rate to be determined at weekly official foreign exchange auctions. The initial exchange rate was set at 1 tenge to 500 old rubles (the official exchange rate of the old against the new ruble preceding the issuance was 2:1) and at 4.68 tenge per 1 US dollar. The official rate had fallen to 7.52 tenge per dollar by early January and on the street the going rate had hit 14 per dollar by the end of the month according to some reports (EIU). In early March the official rate was at 15.8 tenge to dollar, which further depreciated to about 46 tenge to dollar in early July, 1994. Depreciation was taking place against the Russian ruble as well, from 119 rubles per 1 tenge in early March, 1994 to 43 rubles per 1 tenge in early July, 1994. However, it seems that in the summer the slide of the tenge was halted with tenge being traded at 48 rubles at Moscow Interbank Currency Exchange in late September.

### *(iii) Kyrgyzstan*

The new national currency, som was introduced on 10 May 1993 with the exchange rate set at 1 som = 200 Rub and 4 som = 1 US dollar. Immediately after the conversion period (10-17 May 1993), the som appreciated against both the US dollar and the ruble. This trend was quickly reversed, however, with the exchange rate of the som depreciating steadily to reach rates of som 6.3 per 1 US dollar and Rub 161 per 1 som by late September 1993. The nominal depreciation continued in the last quarter of 1993, however, the som was gaining ground against the US dollar in real terms. From its rate of som 7.1 per 1 US dollar on 14 October 1993 to som 9.5 per 1 US dollar on 2 February 1994. Assuming that inflation in the Kyrgyz Republic remained during that period around 20 per cent per month, the 25.3 per cent nominal drop against the dollar actually represents an appreciation in real terms of approximately 50 per cent. That followed a real appreciation of around 40 per cent recorded between May and September, 1993.

This trend was reversed in February 1994, when som slipped from 9.5 per 1 US dollar on 2 February to som 12.3 per 1 US dollar on 2 March 1994. This time, the nominal depreciation of 22.7 per cent resulted also in depreciation in real terms, as inflation in that month slowed to 17 per cent. However, it seems that after that the real appreciation of the som has been resumed. While the inflation slowed down considerably to 3.5 per cent in June, averaging 8.3 per cent per month in the first half of 1994, the nominal exchange rate stabilized. There are indications that som was traded at Moscow Interbank Currency Exchange (MICE) at the rate corresponding to som 12.3 per 1 US dollar in early July, 1994 which was identical with the above quoted rate of 2 March 1994. Subsequently som even showed a tendency to appreciate nominally, it was quoted at MICE on 23-27 September 1994, at the implicit rate of som 10.2 per 1 US dollar.

The som's exchange rate *vis-à-vis* the ruble has remained relatively stable in the half of 1994, showing a moderate nominal appreciation from 140 rubles per 1 som in early March, 1994 to 162 rubles per 1 som in early July 1994. Later, this trend accelerated with som being quoted at MICE at 241 rubles in late September, 1994.

On the whole, it may be concluded that the new Kyrgyz national currency held quite well under very difficult circumstances. It is worth noting, that the selling rate of cash dollars in Bishkek was hovering above the official rate by only a small margin of about 10 per cent.

Apparently the crucial factor behind the relative stability of som has been the strong, independent position of the National Bank which was granted exclusive powers as the sole manager of currency emission, credit issuance and regulation of the som's exchange rate. The ability of the National Bank to withstand all kinds of pressure and continue to pursue a tight monetary and credit policy led to an outstanding achievement of bringing the inflation rate down to about one per cent a month in the summer of 1994.

### *(iv) Turkmenistan*

The national currency, Manat, was introduced on 1 November 1993 with official exchange rate set at Manat 1 = Rus Rub 600 and Manat 2,00 = 1 US dollar. Subsequently the exchange rate was to be determined by a weekly foreign exchange auction market conducted by the State Central Bank of Turkmenistan (SCBT), with the participation of the authorised banks. At the end of the first weekly auction, the manat closed at 1.98 per US dollar; the SCBT sold USD 6 million in this market which exceeded demand by US 100.000. It looked like that Turkmenistan — thanks to its prudent budgetary policies of 1992/1993 period aimed at the accumulation of sufficient foreign exchange reserves — might succeed in securing the stable exchange rate of manat. However, the following months proved this kind of projection to be too optimistic. On 11 December 1993 the currency auctions were discontinued and when they resumed on 14 March 1994 the manat-to-dollar rate plunged to 10 manats to the dollar. On 2 May 1994 the national currency was further devalued and the official rate was set at Manat 60 = 1 US dollar. However, the black-market rate was reported to be even higher at Manat 80-85 to 1 US dollar in early May, 1994.[49/]

The basic cause of the failure of the SCBT to sustain the manat was the fact that the hopes to earn hard currency for exports of natural gas at increased prices (US$ 80 per 1000 cubic meters) did not materialize. The former Soviet republics often did not pay for deliveries and owe as much as US$ 1.4 billion for gas with Ukraine being the largest debtor at close to US$ 700 million.

### *(v) Uzbekistan*

The sum coupon, as a temporary national currency was introduced on 16 November 1993 and became sole legal tender on 1 January 1994. The sum coupon was officially at par with the ruble, however, it immediately depreciated against the ruble on the free market. In the bazaar the going rate was 3 sums per ruble in December 93 and sum 5-6 per rouble in mid January 94. The depreciation reflected in part lack of confidence in future monetary policy in view of the size of the budget deficit, and more immediately it reflected uncertainty. Since the Government announced that sum coupons were temporary and would be replaced by a permanent currency in the course of 1994, people were unwilling to hold new banknotes which might soon be

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[49/] EIU Country Report, 2nd quarter 1994, p. 65

declared invalid without full compensation. The new ruble was preferred since it was convertible, could be used for purchases in the Russian Federation and was widely accepted also in other CIS countries.

The US dollar was also in great demand and although the sum was officially trading at 1,240 to the dollar in mid January 1994, it was selling for 4,500-5,000 to the dollar in the black market. The sum's depreciation continued, in early March it was traded in Tashkent black market at 7-8 sum coupons to the ruble and about 11.000 sum coupons to the dollar.

On 1 July 1994, the new permanent national currency, the sum entered circulation. The rate of exchange was set at seven sums to one US dollar and 3.53 sums to 1,000 Russian roubles. However, these rates proved to be not sustainable and even the new sum began to depreciate. On 15 August 1994 the Central Bank of Uzbekistan set the official exchange rates at the level of 11.50 sums to the dollar and 5.46 sums to 1,000 Russian roubles. According to the local press reports (Khalq Sozi, Tashkent, of 15 September 1994) in trading at the Uzbek republican foreign currency exchange on 14 September the sum closed at 15 sums to the dollar. The Central Bank was trading the sum at the rate of 20 sums to the dollar.

## 4. Foreign investment policies

Policy measures to liberalize the entry for foreign investors and increase the inflow of foreign investment represent an important component of economic reforms in transition economies. The central role in this is played by enacting and improving the legislation which creates an environment conducive to foreign investors. In most of the transition countries, the main source on regulations surrounding a foreign investment is the foreign investment law. Typically, these laws provide details on approval procedures for both new investments and acquisitions of existing equity, tax incentives, rights to own land, profit repatriation, etc.

The Central Asian republics joined the other transition countries in adopting the foreign investment legislation usually in the form of special laws and/or presidential decrees. In general the CARs foreign investment laws provide special incentives to foreign investors, giving them special treatment in terms of tax holidays, reductions in profit tax, import duties concessions etc. This is in contrast to the so called "even field" approach to foreign investors which has been to an increasing degree adopted by some European transition economies. Russia, the Czech and Slovak Republics, and for all practical purposes Poland, Slovenia and Bulgaria provide no tax or subsidy discrimination in favour of foreign investors. The trend towards equal treatment of foreign and domestic investors is quite recent: Hungary ceased offering incentives to new foreign investors at the beginning of 1994; the Czech Republic had done this from 1 January 1993. The CARs thus adopted a more "friendly" approach in this respect.

However, as far as approval procedures for foreign investment are concerned, the CARs seem to adopt a "stricter" approach than some of the other transition countries. Foreign investors, for example, are not required to have their investment projects specially approved by a government agency in Hungary, Bulgaria and the Czech Republic and with a few exceptions, in Poland and Slovakia. Approval is thus automatic. In the CARs (and many other transition countries), in contrast, the approval is required by various governmental agencies, sometimes even by the Government itself. In fact, this is quite understandable in view of foreign investment being quite a new phenomenon for the CARs and, at the same time, the foreign investors showing greatest interest in taking part in exploitation of the natural resources (oil, gas, gold and other precious metals) which are, of course, considered to be the main national treasure.

In general, the CARs have adopted a relatively liberal approach in regard to sectoral and equity restrictions on foreign investment. In fact, restrictions on foreign investment where there is a public monopoly as with telecommunications are quite usual not only among transition economies but also among OECD countries. The same applies to restrictions in defence, security and broadcasting areas. The CARs also differ one from another in this sectoral restrictions aspect. In some countries foreign insurance companies are allowed to enter into joint ventures with local entities (e.g. Uzbekistan) whereas in other countries (e.g. Kazakhstan) insurance business is exclusively the domain of domestic firms.

However, the trend in foreign investment legislation in the CARs is generally towards greater liberalization and simplification of the rules and regulations. This does not mean that the set-backs sometimes do not occur. Especially when the basic laws are subject to revisions and/or additions through a multitude of legislative procedures (laws adopted by parliaments, regulations issued by ministries and other governmental agencies, presidential decrees etc.) the situation becomes rather difficult to be grasped by the foreign investors. The same applies to the cases when, for example, custom legislation (import duties) is not effectively enforced thus depriving the foreign investor of originally accorded preferential treatment and/or not providing him with protection in the domestic market which he expected on the basis of existing laws.

It may be of interest to provide more detailed information on the legislation affecting foreign investors in selected CARs. It is given in table 7 below and is based on the results of a much broader analytical exercise undertaken by the Economic Commission for Europe which covered most of the transition economies in Central and Eastern Europe and the successor states of the USSR.[50]

In regard to the remaining two CARs not covered by the ECE research: let us make a few brief observations.

The Kyrgyz Republic adopted in 1991 (amended in 1993) quite a liberal law on foreign investments granting preferential treatment to foreign investors. However, in view of a rather dismal performance in attracting larger investment inflows, the president of the Kyrgyz Republic issued recently (on 6 September 1994) a decree on additional guarantees to foreign investors.

The main aim of the decree is to stimulate the attraction of foreign investments and enhancing the efficiency of their use, as well as to carry out priority tasks to develop Kyrgyzstan's economy.

The decree states that:

1. The legal framework for foreign investments is preferential and in no case can it be less favourable than the legal framework for investments effected by national investors.

2. Foreign investors will be guaranteed that their capital can be repatriated and that they can export all or some of their profits unhindered in the form of foreign currency, their own products, or goods and services purchased in the market.

3. Five per cent tax on profits being exported (stipulated in the existing Law on Foreign Investments) is to be abolished.

4. The Government of the Kyrgyz Republic is ordered

   — to work out within a month the mechanism for a system of measures to attract foreign capital;

[50] For full results see: East-West Investment News, No. 2, Summer 1994, UN ECE, Geneva.

## Table 7. Foreign investment legislation in selected Central Asian republics (Status as of mid-June, 1994)

| *Country* | *Approval/ Registration* | *Equity limitations/ Restrictions* | *Taxation* | *Incentives* | *Repatriation of profits/Incomes* |
|---|---|---|---|---|---|
| Azerbaijan | State registration needed with procedure determined by CM; ecological and sanitary expertise required as well as an expertise in the case of large-scale construction projects; refusal in registration can be contested in court. | Wholly foreign-owned companies permitted; restrictions on FI activities in some sectors and territories to be defined by legal acts; authorized activities are to be defined by CM. | Tax rates are determined by law; 35 per cent general corporate tax rate; 20 per cent VAT. | Contributions in kind to JVs statutory capital by foreign partner and foreign employees property are imported customs-free; licence-free export of own products/services and import of inputs for own production by JVs with more than 30 per cent foreign participation and wholly foreign-owned companies. | Free repatriation of after-tax profits and proceeds from FIE liquidation; foreign employees can repatriate after-tax salary foreign currency. |
| Kazakhstan | State registration required from MF and given within 30 days. | No foreign equity limiations, except insurance where only local companies are permitted; FI is excluded from arms production and activities prohibited by law. | No special tax regime for foreign investors; 20 per cent VAT. | 5-year tax holiday if foreign investors hold over 30 per cent of FIE's statutory capital and operate in a priority industry (e.g. consumer goods and high technology industries); they enjoy 50 per cent tax reduction in subsequent 5 years; other JVs in manufacturing enjoy a 2 year tax holiday with no subsequent tax reduction. | Free repatriation of after-tax profits and proceeds from FIE liquidation. |
| Turkmenistan | Registration by CM needed; decisions must be taken within 30 days. expertise required. | Wholly foreign-owned companies permitted; FI forbidden in ecological expertise is unsatisfactory; companies considered as FIE or JV only if foreign investor owns a minimum of 20 per cent of statutory capital, or as determined by CM. | In foreign investor has contributed 30 per cent or more of his share in statutory capital in convertible currency, profit is tax-free over the pay-off period of investment; reinvested profits of all FIE are tax-free over the pay-off period of initial investment. | Contributions by foreigners in kind to FIE's statutory capital and material inputs for own production are customs-free; exports/imports do not require license if foreign investor holds 30 per cent or more of capital. | No relevant provisions. |
| Uzbekistan | Registration by the MF required; if foreign investor intends to take an equity stake in a local enterprise with fixed assets exceeding 100 mn SUR, approval of CM is required. | Wholly foreign-owned companies permitted; special authorization required for FI in some industries determined by CM; FI is forbidden in certain specific territories. | No special tax regime for FI; additional tax reductions may be granted by CM. | 2 years tax holiday for FIE's with foreign capital share exceeding 30 per cent (3 years for firms in designated sectors); no duties and taxes on imports of FI contributions in kind and of employee's property; license-free import/export of JV products. | Profit repatriation guaranteed; foreign employees income paid in foreign currency may be transferred abroad. |

*Source:* Economic Commission for Europe, East-West Investment News, No. 2, Summer 1994, pp. 8-12.

*Legend:* CM – Council/Cabinet of Ministers; FI – foreign investment; FIE – foreign investment enterprise; JSC – joint stock company; JV – joint venture; LLC – limited liability company; MF – Ministry of Finance; SOE – state-owned enterprise; SUR – (former) Soviet rouble.

— to define a list of priority areas in which additional privileges and benefits may be granted as a way of attracting foreign capital;

— to complete by the end of 1994 bilateral negotiations with foreign states on concluding agreements on reciprocal protection and incentives for investment, as well as agreement with international organizations on signing international conventions on protecting and insuring foreign investments;

— within three months, to prepare for consideration of the Parliament draft laws on amendments and addenda to the Law on Foreign Investment, on foreign concessionary enterprises, on free economic zones, and on mortgages.

This decree reflects many elements that are common to the efforts of the CARs to provide firmer guarantees to foreign investors, to continue with providing preferential treatment to them and to use bilateral and international treaties to make the environment safer and more attractive to potential investors.

Tajikistan adopted a Law on Foreign Investment in 1991 which was amended in 1992. It provides guarantees against nationalization, 2-year tax exemption for companies with over 30 per cent share of foreign investment, additional incentives for those operating in free economic zones and stipulates no restrictions on profit and capital repatriation. However, political instability leading at times to civil war made this piece of legislation largely irrelevant and potential foreign investors stayed away.

Many transition countries establish special agencies to facilitate and promote foreign direct investment. These agencies should help the potential foreign investors to get all the required information in one place, to overcome the eventual lack of transparency in existing rules and regulations and reduce the frustrations of dealing with frequent modifications and complex administrative processes. Among the CARs such foreign investment agencies have been already established in Kazakhstan and Kyrgyzstan.

Among the CARs, Kazakhstan was the first to attract significant interest of foreign investors. Under a contract negotiated in the final years of the USSR and signed in May 1992, Chevron will invest $ 1.5 billion in developing the Tenghiz oilfield; this was the biggest direct foreign investment project anywhere in the USSR at the time of signature. British Gas and AGIP are involved in a potentially even larger project to exploit the Karachaganak oil and gas fields in western Kazakhstan, and Elf Acquitaine has signed a contract to explore a large area in central Kazakhstan.

Another FDI mega-project is the recently (20 September 1994) signed agreement of Azerbaijan with a consortium of Western oil companies[51/] to explore and develop two Caspian off-shore oil fields (Azeri and Chirag fields) and the deep water section of the Guneshli field. The Russian oil company Lukoil is also a signatory to the agreement. Western companies will provide 80 per cent of capital investment which would amount to about $ 7.14 billion.[52/]

Other projects in the mining sector for which foreign investment amounting to several hundred million US dollars was pledged involve gold mining and enrichment plants in Kyrgyzstan and Uzbekistan.

In manufacturing among the major projects for which foreign investment has been already committed we find Philip Morris acquisition of 49 per cent share of the Almaty Tobacco Combinat in Kazakhstan (reportedly about $ 250 million), British American Tobacco planned investment ($ 140-150 million) in expansion and modernization of Tashkent tobacco factory in Uzbekistan. About $ 150 million are planned to be invested by Unilever and RJR Nabisco in margarine and confectionery factories which they purchased. In the several hundred million US dollar range can be included also the investments by Daewoo of the Republic of Korea into a car manufacturing plant in Uzbekistan.[53/]

However, the relatively large amounts of foreign investments that are pledged (or contemplated) to be undertaken in some of the CARs indicate the potential for the future flows. So far the actual inflow of foreign direct investment has been quite modest compared to other transition countries. According to the EIU estimates, cumulative paid — in foreign investments to end — 1993 amounted to $ 395 million in Kazakhstan, $ 95 million in Uzbekistan, $ 16.9 million in Turkmenistan, $ 9.8 million in Tajikistan and, $ 8.2 million in Kyrgzystan.[54/]

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[51/] Members of the consortium are BP, Statoil, Pennzoil, AMOCO, McDermott, Unocal, Ramco and the Turkish Petroleum company.

[52/] Azerbaijani TV, 20 September 1994, quoted from BBC, Summary of World Broadcasts, SU/2111 S1/1, 27 September, 1994.

[53/] Source of information on FDI projects: EIU Country Reports, 1st, 2nd and 3rd quarters, 1994.

[54/] Business Eastern Europe, August 22, 1994, p. 7.

Some of the European transition economies attracted much larger resources, Hungary leading with $ 5,441 million of FDI inflows in 1990-1993, followed by former Czechoslovakia with $ 2,600 million and Poland with $ 839 million. However one should take into account that the CARs entered the ranks of potential FDI recipients with at least a 2-year time lag and now face the task of "catching up". In this connection it should be noted that Kazakhstan on a per capita basis attracted more FDI in 1993 ($ 18) than Poland ($ 9), Bulgaria and the Russian Federation (both $ 7).[55/] There are indications that — if the CARs succeed in their efforts to achieve reasonable degree of macroeconomic stability — they could attract much larger volumes of FDI than so far. This, of course, is conditioned by the positive developments in two areas: political stability and consistent progress towards market-based economy. These factors appear to be more fundamental to attracting FDI than the specific tax and other incentives provided within the framework of FDI laws.

From the cursory review of the sectoral allocation of FDI it is quite clear that so far it has been heavily concentrated in oil, gas and mining fields with natural resources endowments of the individual CARs being the main determinant. All these projects are world market oriented and rather narrow domestic markets are of no relevance to them. In case of the FDI in the manufacturing sector it is likely that potential foreign investors would not be attracted so much by the size of the individual CARs markets as by the possibility of establishing a base for access to the market of Central Asia as a whole. That is why the measures to facilitate intraregional trade among CARs can have quite an important influence in attracting FDI into the region.

## 5. Trade policy reform

Transition to a market economy implies profound changes in the CARs trade systems inherited from the central planning area which were characterized by the system of state orders, implemented in tandem with the interstate trade agreements and with detailed plans for foreign trade flows at administered prices. This system gave rise to pervasive export quotas and licensing schemes and to administrative controls of imports combined with restricted access to foreign exchange.

The CARs initiated reforms to liberalize the trade systems and policies with the aim of making them compatible with the market economy requirements and to reap the benefits of more efficient integration into the international

[55/] EBRD, Transition Report, 1994, p. 123.

trade networks. The partial replacement of the state order system by voluntary supply contracts at negotiated prices is one of the elements in establishing market relations between producers and state trading organizations. Of great significance is the liberalization of entry into foreign trade activities which has been recently undertaken in some CARs. This is of vital importance to create competitive environment in the trading sector and also for the reorientation of trade patterns. The massive expansion of trade between Kazakhstan and China is due mainly to such liberalization measures.

The major progress has been recorded in liberalization of imports. In general, the tariffs on imports from FSU countries were abolished and the tariffs on imports from non-FSU countries lowered. In Kazakhstan import tariffs range from 0-50 per cent, mostly a 5 per cent rate is being applied. In Uzbekistan up to 40 per cent duties on imports from non-FSU countries in force in 1993 were reportedly suspended in early 1994 until mid-1995.[56/] Also in Kyrgyzstan import duties are either very low or none. In general the CARs apply few administrative restrictions on imports except for health and national security reasons. On the export side the liberalization has been much slower. Especially in regard to the so-called strategic exports the state trading is a dominant feature, exports are subject to quantitative restrictions and export taxes, which are also levied on non-strategic exports. Compulsory surrenders of certain portion of foreign-exchange export proceeds at rates below the market levels represent an additional tax on exports. However, there has been a tendency observed recently to lowering the export taxes, and surrender requirement ratios, and towards liberalizing the issuance of export licences. It is obvious that strict regulatory measures and taxing the exports go against the aim of export-oriented policies. However, one has to take into account that in many CARs the export taxes represent an important source of budget revenues which cannot be readily replaced. In case of strategic commodities exports it is not only the protection of domestic market needs but also the need to avoid the sales at dumping prices which makes some degree of regulation necessary.

For export promotion it would be desirable to lower substantially or even better to eliminate the foreign exchange surrender obligations and replace them with foreign exchange repatriation requirements. This would make the system more transparent and it will also eliminate the problem of multiple exchange rates.

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[56/] EBRD, Transition Report, 1994, p. 108.

Considering the further developments in trade policy area the need may arise to modify the import liberalization measures in such a way as to protect the domestic produces in certain sectors on branches. The experience of some transition economies in Central Europe shows that excessive import liberalization can have adverse effects on domestic agricultural and industrial structures. Some countries (e.g. Poland) thus came back to apply some selective protectionist measures. There are branches of industry that require temporary protection — well defined and limited in time — to adjust and become competitive by international market standards.

On the export side, the CARs are likely to aim at increasing the share of manufactures in their exports. Here the Asian newly industrializing economies provide a very attractive example of the positive role which the Government (and its agencies) can play in supporting the export-oriented expansion of the private sector. Various measures in the tax and credit areas together with assistance in building marketing infrastructure would be essential for the successful penetration by CARs exporters of the very competitive international markets.

## E. PRIORITIES FOR FURTHER ACTION

It is difficult to generalize on the priorities in the area of economic reform policies since there are substantial differences among the Central Asian republics in regard to relative severity of various problems, resource endowments of the Governments to tackle them, and, eventually also due to differences in development philosophies, such as putting different emphasis on economic efficiency *vis-à-vis* social development and stability objectives. However, with due respect to the variety of conditions found in the CARs it seems that there are quite a few common features in their economic reform processes and macroeconomic performance which allow to offer the following observations.

It seems that the reduction and control of inflation remains the key policy challenge facing all the Central Asian republics in the immediate future. Failure to reduce inflation undermines the whole reform process because of its adverse welfare effect on the broad strata of population and because of economic distortions and losses which high inflation imposes on a market-oriented system, where resources should be allocated in response to transparent relative price changes. High inflation induces speculative behaviour aimed at maximizing short term gains and hoarding of goods, discourages savings (real interest rate is usually negative) and investment with long-term horizons and via unavoidable depreciation of national currency encourages capital flight. High inflation is a serious illness even for a relatively mature market economy which the Governments try to treat as quickly as possible. It can be fatal for an emerging and as yet very fragile and incomplete market system being set up in the transition economies. The risk of a loss of political support for economic reform and of economic collapse which may be the ultimate result of uncontrolled inflation is quite real. The first priority in the CARs thus appears to be the elimination of the underlying sources of inflation by sharply reducing budget deficits and reining in credit growth. Progress on this front will require to continue with the tax reform especially with enhancing the tax collection capacity to increase the revenues, and, proceed with cutting down subsidies and targeting the social assistance outlays more effectively to keep expenditures within sustainable levels. Whatever budgetary deficits remain, the Governments should try to rely on non-inflationary means of financing such as selling treasury bonds and, eventually, drawing on external finance such as IMF lending and other ODA sources. The volume and especially the terms of external financing should be kept at levels which would not put excessive strain on the budget in the future. Falling into a "debt trap" should be avoided. Eliminating excessive credit growth will require financial markets rather than central banks, to allocate credit at market-determined rates.

When emphasizing the vital importance of tight monetary and fiscal policies for combating inflation one has to add a word of caution. If carried too far it can push the economy into a deeper recession than necessary, and cause the delay in recovery. This applies especially in a situation when inflation becomes rather of a cost-push than of a demand-pull type.[57/]

The success of macroeconomic stabilization policies is closely interrelated with the progress at micro economic level, i.e., in the area of privatization and enterprise restructuring. Here, one would suggest that the CARs should apply a two-pronged strategy: to combine privatization programmes and support for the newly emerging private enterprises with the measures to radically improve the performance of the existing state owned enterprises (SOEs). In regard to the latter, it is of vital importance to subject the SOEs to the "hard budget constraint", to put them on truly self-financing basis. This is absolutely necessary for eliminating one of the major sources of inflation and inducing SOEs management to respond to market incentives. In general, to reap the

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[57/] Some analysts maintain that in the Central European transition economies at this stage the inflation has turned into cost-push type (increased labour costs, imported energy and other inputs prices etc.) which cannot be cured by applying very tight monetary and fiscal policy aimed at controlling excessive demand. See example "Transition from the Command to the Market System: what went wrong and what to do now?", WIIW, Vienna 1993.

efficiency benefits of privatization and SOEs restructuring the Governments have to set up appropriate legal, regulatory and financial frameworks that provide competitive environment and market incentives for responsible management behaviour. In this context the CARs should continue with reforming and strengthening the banking sector, so that independent central banks would focus on their essential monetary policy, exchange rate management and supervisory functions whereas commercial banks with strengthened capital and risk assessment capacity would become the crucial points for financial intermediation and market determined credit allocation. Although most of the CARs already adopted laws on security markets, there are not yet functioning stock exchanges in place. The development of well regulated and liquid equity markets would improve the allocation of scarce financial resources by providing market-based information on the value of enterprises; it would also subject managers to shareholder discipline. However, in spite of the desirability of setting up the stock exchanges in the CARs the development and strengthening of the banking sector remains the top priority within the boarder reforms of the financial system in the medium term.

It is beyond doubt that the depression of CARs economies has been greatly intensified by the collapse in their trade with other FSU countries. This was largely the result of a failure to overcome the monetary and payments problems which arose in the wake of the break up of the Soviet Union and which finally led to the break up of the rouble zone in the latter half of 1993. In view of the high degree of specialization reflected in very high NMP — trade rations[58/] the CARs are highly dependent on the rest of the CIS as markets for a large portion of their output, and, as suppliers of energy, components and other inputs, broad range of manufactures, and to some extent also food. In the short term the possibilities of reorientation of these trade relations are quite limited. Therefore, it is of vital importance to economic recovery of the CARs to revive the intra-CIS trade and economic cooperation links. This, of course, must be done on a completely different basis which would reflect the marketization of the CARs economies and the existence of their national currencies. The first step in this direction has been taken by concluding an agreement on setting up an economic union among the CIS member countries (signed by all CIS members on 24 September 1993 except Ukraine which has associated status), however, it seems that the implementation will take longer time than expected. The CARs policy makers are aware of the need to promote intraregional trade and in this context the treaty on establishing single economic space (between Kazakhstan, Uzbekistan and Kyrgyzstan) entered into force in February 1994 and will be implemented over an unspecified period. At bilateral level, Kazakhstan and Kyrgyzstan agreed to lift all restrictions on transactions

[58/] See the data on NMP-trade ratios on p. 57.

in the som and tenge, their national currencies, throughout the two countries from 17 September 1994. Both currencies can now be used as legal tender in interbank and trading transactions and investments in either country. The agreement applies to both individuals and organizations.[59] It should be pointed out that the implementation of these integrational schemes in Central Asia might provide also an additional impetus for foreign investors to enter such an enlarged market. Emphasizing the importance of measures to revitalized the intra-CIS trade should not, however, distract the CARs from their efforts to expand their trade and economic linkages with both developed and developing market economies. In longer term, with necessary infrastructure in place, this may become a major factor in economic growth performance of the CARs.

However, a successful entry into the international markets will require an active support of the CARs Governments through devising and implementing export promotion policies. At the same time, export expansion can be greatly enhanced by cooperating with foreign investors in developing world market oriented marketing channels. In the area of oil, gas and other minerals these phenomenon has already become by far the major avenue for increasing the export proceeds of the CARs endowed with natural resources.

In view of the extreme depth and persistence of the decline in economic activities in some CARs it appears that the priority within the policy mix should be shifted towards measures that would stimulate recovery and especially investment.

This would have to be done in a very selective way so that recovery is combined with a positive restructuring of the economy. In other words the CARs Governments should discontinue an indiscriminatory support of state enterprises and should develop a consistent industrial (structural) policy focusing on viable enterprises and promising lines of economic activities. This is by no means an easy task but the experience of Asian NIEs proves that it is feasible and can be successful under certain conditions.

This shift in policy mix is necessary also for alleviating the social cost of the deep depression which led to a substantive decline in real incomes and living standards that reached in some countries crisis proportions. It would be desirable if the social protection measures adopted within the "anti-crisis programmes" are extensively combined with the expansion of public investments into badly needed infrastructure thus serving both the social and economic growth objectives.

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[59] Interfax news agency, Moscow, 19 September 1994, quoted from BBC, Summary of World Broadcasts, SUW/0351 WB/10, 23 September 1994.

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