WTO Accession and Domestic Reform

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ABSTRACT

Vietnam has announced its determination to join the WTO, and already begun implementing policies that will facilitate its eventual accession. These policies have far reaching implications for the country's integration with global markets and, ultimately, for the pace and scope of domestic market-induced development. This paper summarizes a set of assessments of the long term economic effects of Vietnam's WTO accession. Generally speaking, our results indicate that Vietnam would benefit from accelerating its participation in more open multilateralism. However, it is also clear from our analysis that these benefits will remain modest in the absence of comprehensive and complementary domestic economic reforms. Passive external liberalization, even when coupled with determined domestic reform, is inferior to WTO participation combined with negotiated market access and other activist multilateral agreements. Finally, our analysis shows that capital insufficiency is a very serious constraint on Vietnamese economic growth and diversification. Capital market reform can play an essential role in dynamic and sustained economic development for the country.

1. Introduction

Vietnam's initiative to enter the WTO has far reaching implications for its domestic economy, as well as for its place in regional and global trade. If the current offers by Vietnam are successfully negotiated in Geneva and implemented by the government, there will very substantial alignment between international and domestic prices. If WTO standards for market openness and institutional transparency are also implemented, both domestic and international economic interests can be expected to

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dramatically increase their commitment to accelerated and sustained economic growth in the country.

Using a dynamic forecasting model of the Vietnamese economy, our estimates indicate that, while WTO accession is essential to economic modernization and fuller participation in the global economy, it is only a partial step toward realizing Vietnam's economic potential.

2. Data, Model, Scenarios and Results

The forecasting model is calibrated to a very detailed social accounting matrix for Vietnam, representing 97 production activities and commodities, 13 factors of production (labor and capital), 5 household types, and 94 international trading partners. Because of the high level of detail in the SAM data base, the model is implemented with a flexible aggregation facility that consolidates data for more focused individual research activities. For this WTO assessment, the model has been implemented with an aggregation of 18 sectors including sectors of importance to Vietnam at this early stage of economic modernization, including food grains, textiles, and apparel. The model itself is fully documented elsewhere, but is relatively typical of single country CGE models.[1]

After specification and construction, the model was first calibrated to a baseline time trend for the period 2000-2020. This means the model was calibrated statically to the 1999 Vietnam social accounting matrix (SAM) and then run forward annually at growth rates corresponding to Business as Usual (BaU) consensus real GDP growth forecasts for Vietnam.[2] This time path was then used as a baseline for dynamic counterfactuals of five different types.

2.1. WTO

In this scenario, it is assumed that Vietnam's current offer to the WTO is accepted, the country joins the organization and conforms to these commitments, but the domestic economy is not reformed and Vietnam remains on BaU trends for productivity growth. In this case the benefits of fuller participation in the international

[1] See Roland-Holst and Tarp (2002) for more details.

economy are severely limited by the economy's inability to adjust to new market realities. International prices are transmitted more efficiently to domestic institutions, but structural rigidities prevent resource reallocation and structural adjustment to develop the economy's relative strengths and defer less efficient production to foreign sources.

2.2. WTO+Reform

This scenario includes the same external policy, i.e. WTO accession and implementation of the agreed offer, but also assumes that domestic reforms are implemented to achieve productivity growth rates comparable to other dynamic reforming economies. This scenario is calibrated to protection rates from the Vietnamese WTO offer, and also to sectoral productivity growth estimates for China over the period under consideration (2000-2020). Particularly from its relatively early stage of development, Vietnam should be quite capable of replicating Chinese productivity growth if it demonstrates a real commitment to extensification and intensification of domestic economic reform. Should this double reform scenario prove politically feasible, benefits of globalization would be dramatically increased for Vietnam.

2.3. Parallel Trade Agreements: Vietnam-U.S. BTA (VNUS)

As it stands, the current Vietnamese offer to the WTO will lead to significant intensification existing of patterns of comparative advantage. This could compromise the country's development goals by increasing specialization, export market risk, and trapping the economy in traditional primary and unskilled labor intensive activities. To overcome this tendency, Vietnamese trade negotiators should actively pursue parallel bilateral, regional, and other trade agreements that can diversify its export orientation.

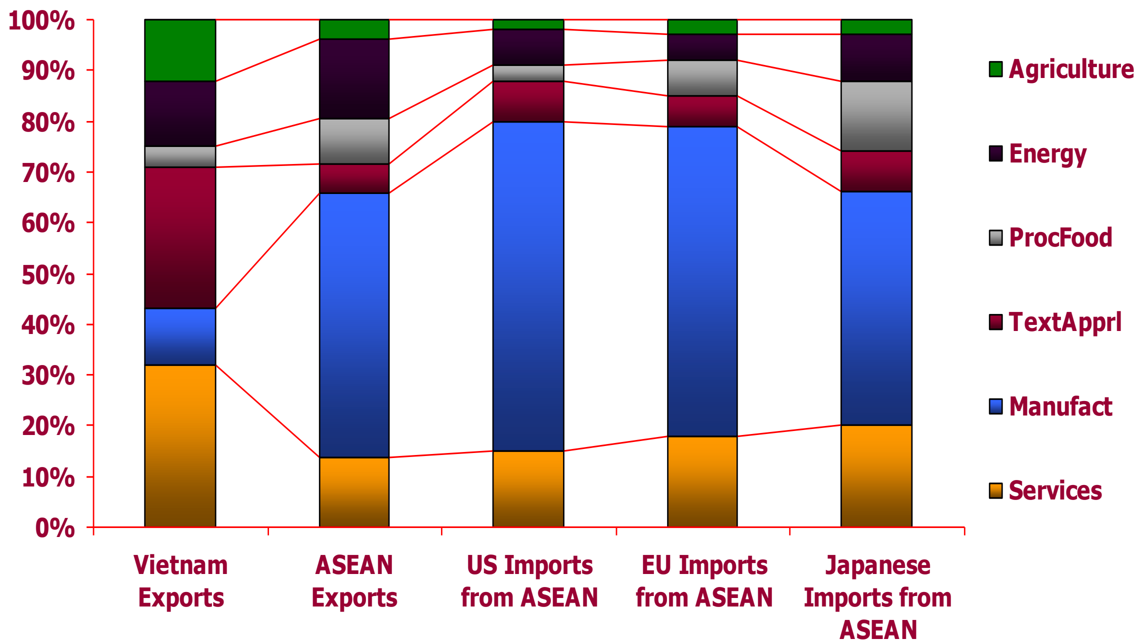
The following diagram shows the sectoral composition of Vietnamese exports in the 1999 base year. This reveals an unreasonably high dependence upon the Textile

[2] The latter estimates we obtained as averages from IMF, DRI, and Oxford Econometrics.

and Apparel (particularly, at the more detailed level, leather goods and footwear). Likewise, exports from sectors of more natural comparative advantage, like agriculture, and desirable “modernization” exports like Manufactures, are too small a share of total outflows. This is a prime example of the notorious “low wage trap” that awaits countries opening trade from a comparative advantage in low wage products.

Looking more closely at this trade composition graph, Vietnam’s current export patterns are not representative of the ASEAN region as a whole, nor do they fully exploit the diversity of import demand by the world’s leading economies. It could be argued that they represent an earlier stage of economic development than the average ASEAN level, with greater reliance on labor intensive and low skilled (low wage) agriculture, textiles and apparel, and services. More importantly, demand patterns from ASEAN’s largest trade partners offer more diversified opportunities, and Vietnam could benefit by shifting its production capacity in the direction of these large markets. It is certainly reasonable to expect that the Vietnam-US BTA will stimulate export growth and diversification for Vietnam

Export and Import Composition by Partner



Source: Roland-Holst (2004).

2.4. Capital Market Liberalization - FDI

One of the most chronic constraints on economic modernization, diversification, and productivity/wage growth in developing countries is capital scarcity. By definition, low income countries are saving constrained, developing countries have low levels of installed infrastructure, and technology levels tend to be below global averages. For all these reasons, capital insufficiency can slow the rate of aggregate growth, the scope of diversification, and reduce rates of productivity/wage growth. For resource-rich countries like Vietnam, however, there are many possibilities for investment partnership with more capital-rich countries. These arrangements create win-win situations where the FDI recipient country enjoys more extensive economic diversification, technology assimilation, and more rapid growth of output, productivity, and wages from the same resource base.

To see the potential benefits of such an arrangement, we defined an FDI scenario, which allows inbound foreign investment to Vietnam to grow at twice the rate of real GDP growth over the period 2000-2020. Given the low current levels of FDI in the country, and by comparison to Asian growth economy standards, this is a relatively conservative scenario.

3. Results and Analysis

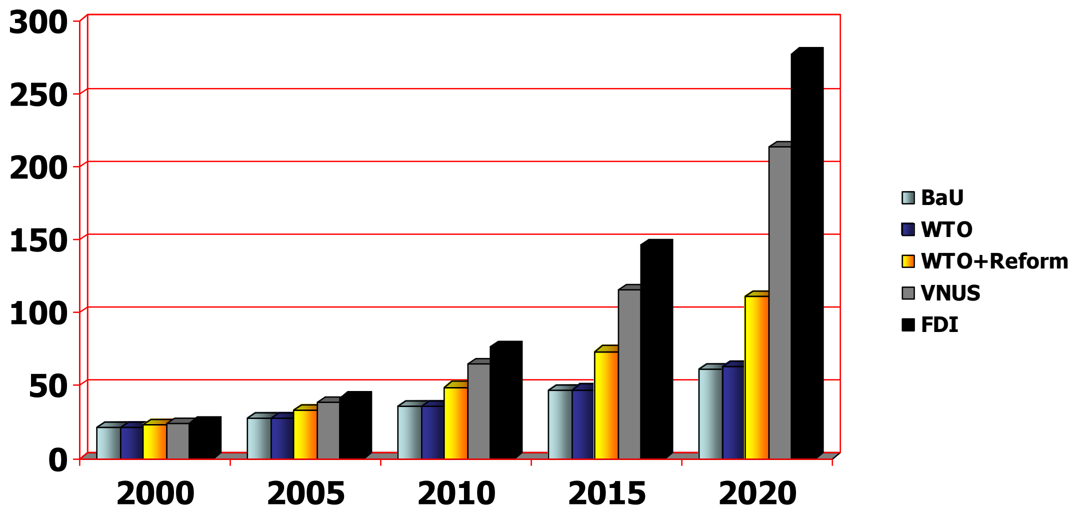
Macroeconomic effects of the five scenarios are represented in the next figure, which displays projected Vietnamese real GDP in 2020. In terms of aggregate growth effects, these scenarios clearly fall into three general categories: low, moderate, and high. The Business as Usual (BaU) scenario holds to consensus growth rates averaging 2-4% over the period 2000-2020. It is rather striking that the WTO scenario makes only a marginal improvement on this, but this fact reveals something important about the realities of global market participation – economic readiness. If the Vietnamese economy were to passively open itself to external markets, without at the same time committing to the reforms needed to enable domestic institutions to capture the opportunities globalization presents, most of the benefits would accrue to Vietnam's trading partners. This condition resembles the experience of some postcolonial economies, in Africa and elsewhere. They lacked the intuitional strength or sophistication after independence to be equal partners in trade-based economic development. The result of this was net resource transfers to their trade partners and chronically low investments in human and nonhuman capital. The experience of dynamic Asian economies was very different, largely because their governments made serious commitments to readiness in terms of market reform, institutional modernization, education, and infrastructure development.

The most prominent current example of this readiness is the economy of China, where government, maintaining a strict distinction between political and economy reform, has made dramatic progress in the latter area with determined liberalization and modernization. The result has been unprecedented and sustained productivity growth in a domestic economy that in many other ways resembled that of Vietnam. Assuming that Vietnam committed to the same path of economic reform, the real benefits of WTO accession would be captured at home and, by 2020, real GDP would be nearly double the BaU or WTO levels representing no domestic reform.

How might gains from external liberalization be even greater? To answer this question, we should reflect on factors that limit gains from trade-driven expansion. The main ones are excessive specialization in traditional (low wage) activities and capital insufficiency that limits the creation of domestic production capacity and higher skill/wage employment. As an example of the former, we shall see that passive WTO-style opening of the economy only intensifies Vietnam's tradional comparative advantages in resource intensive, low wage production. When, by contrast, Vietnam can negotiate market access for a spectrum of products that more nearly represents the ASEAN average, the growth effects are dramatic. Higher wage employment and capacity expansion to meet increased US demand again nearly doubles Vietnam's real GDP growth by 2020. Clearly, this kind of growth dividend might justify more determined negotiating efforts.

Trade and Economic Growth: Real GDP to 2020

(trillions of 1999 Vn Dong)



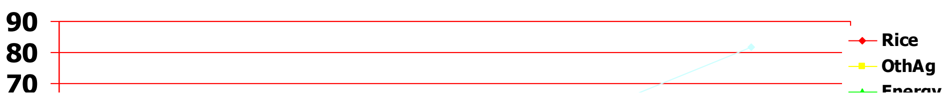
The problem of capital insufficiency is an acute one in Vietnam, effecting nearly every aspect of public and private sector activity. For example inefficient transport and communications infrastructure impose high transactions costs across the economy and reduce competitiveness. Low domestic savings constrain the pace and quality of private sector enterprise expansion and put modern technology and economies of scale beyond the reach of most production activities. More generally, capital scarcity seriously limits the private sector's ability to take the risks and initiatives necessary for broad based economic expansion. All these factors seriously undermine the country's ability to benefit from its commitment to the WTO and to sustained economic progress.

In the last scenario, we assume the government commits to the domestic and external capital market reforms necessary to increase direct foreign investment at twice the rate of real GDP growth over the next two decades. In the experience of other East Asian economies, this is a very modest expectation, but Vietnam will still need to significantly improve credit market access and transparency (for both Vietnamese and foreigners) to achieve this. Were this possible, however, our results indicate that the growth dividend would be about 25% higher in real GDP terms than under the VNUS scenario (with which it is combined here), or over 250% of WTO+Reform and about 500% higher than BaU or WTO without reform. Again the apparent payoff for more determined policy reform appears to be very high.

To better understand the economic adjustments that underlie the macro scenario results, consider the effects on sectoral output. In the next three figures, we present sectoral output trends for a representative aggregation of ten sectors under the three most dynamic scenarios, WTO+Reform, VNUS, and FDI. Under for former, production expands steadily in most sectors, led by Services, Textiles and Apparel, and Manufacturing. Services are the dominant sector of the economy, and its growth is generally proportional to real GDP growth. Textiles and Apparel expands largely because of external market demand. Manufacturing growth is responding mainly to domestic demand growth, but exports and other supply in this sector are constrained by capital scarcity. Apart from lower aggregate growth, the main shortcoming of this scenario is that international opening without reciprocal concessions in market access and foreign investment leads to intensification of Vietnam's traditional comparative advantage in low wage, resource intensive production.

Contrast this with the sectoral results for VNUS and FDI. In the VNUS case, greater external demand stimulates both real GDP and Service sector output more than under WTO+Reform. At the same time, more diverse export demand induces faster expansion of higher-wage manufacturing, with Textile Apparel Growth falling into third place. The main constraint now is on investment in the more capital intensive high wage manufacturing. This is alleviated in the FDI scenario, and the results are striking. Now Manufacturing is growth nearly as fast as lower wage Services, and Textiles and Apparel have fallen to fourth place behind Construction. The CGE model unfortunately does not capture the productivity gains of this more rapid expansion in infrastructure, but we know this makes an essential contribution to dynamic growth in all developing countries. Closer inspection of the trend lines in these three scenarios also reveals that, under FDI, output expansion is not only greater by 2020, but accelerating faster. This is consistent with the argument that human and nonhuman capital accumulation is the accelerator behind dynamic Asian growth.

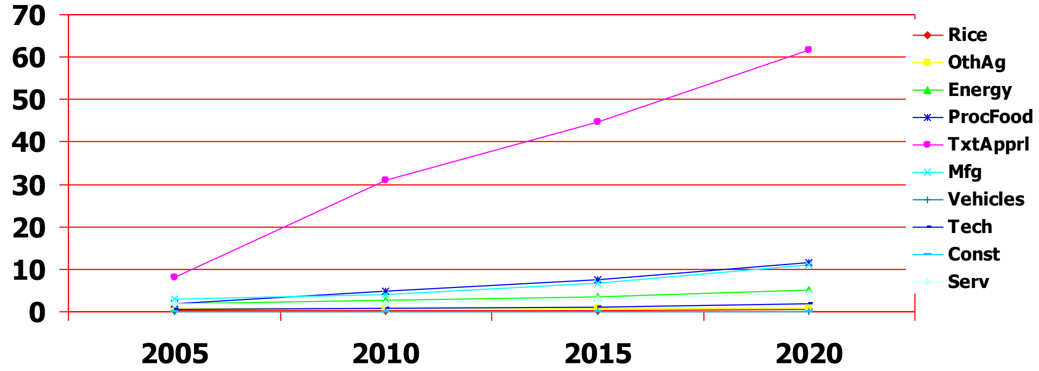
Sectoral Output Trends: WTO+Reform



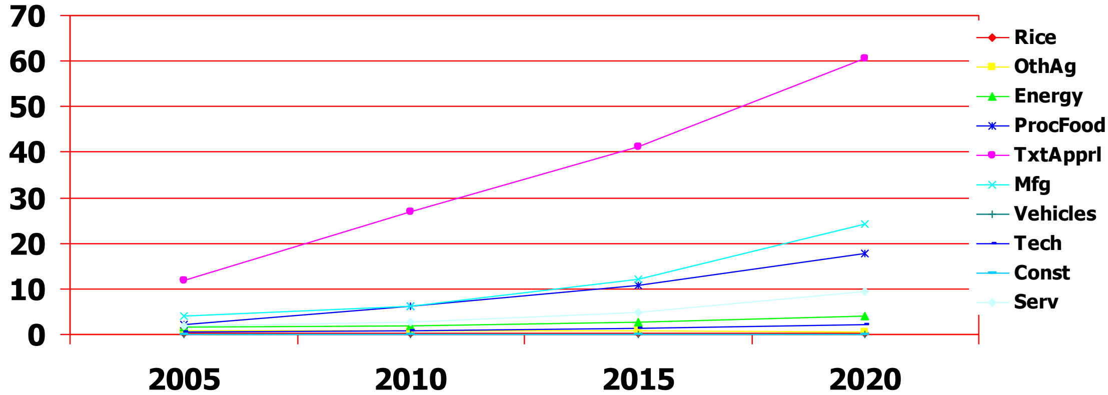
The next three figures show how the composition of exports changes under the same three scenarios, revealing the role of external demand in the macro and domestic output results. In the first diagram, the low-wage trap is very obvious. Vietnamese export expansion is dominated by Textiles and Apparel under the passive liberalization regime of WTO+Reform. Of course, we only mean passivity with respect to external markets in this case, since the scenario calls for determined domestic reform. Ironically, however, this approach appears to confer most of the benefits of domestic reform on foreigners, with Vietnam facilitating low-wage exports and asking relatively little in return. To put it another way, the effort to reform internally cannot be fully rewarded without external reform and, conversely, external reform efforts, like WTO accession, cannot be fully rewarded without commitment to complementary domestic reforms.

When actively negotiated bilateral trade materializes, this helps to diversify export composition significantly, but it is only when access to foreign capital improves that the fuller benefits of more dynamic and diverse exports can be realized. Vietnam can negotiate any market concessions that are politically feasible, but the reality of the economy's response will depend on the ability of the private sector to meet this external demand with internationally competitive quality and prices. This requires significant capital, from any source, but it brings with it domestic output and employment growth, technology assimilation and diffusion, and higher labor productivity/wages for Vietnamese workers.

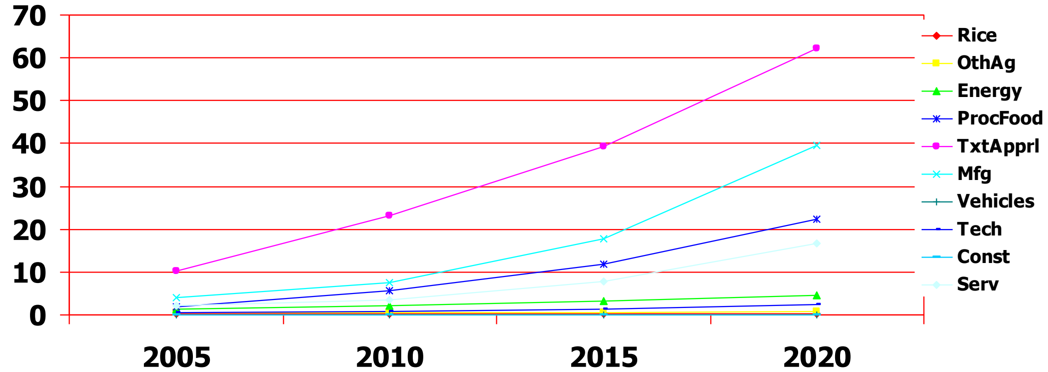
Sectoral Export Trends: WTO+Reform



Sectoral Export Trends: VNUS



Sectoral Export Trends: FDI

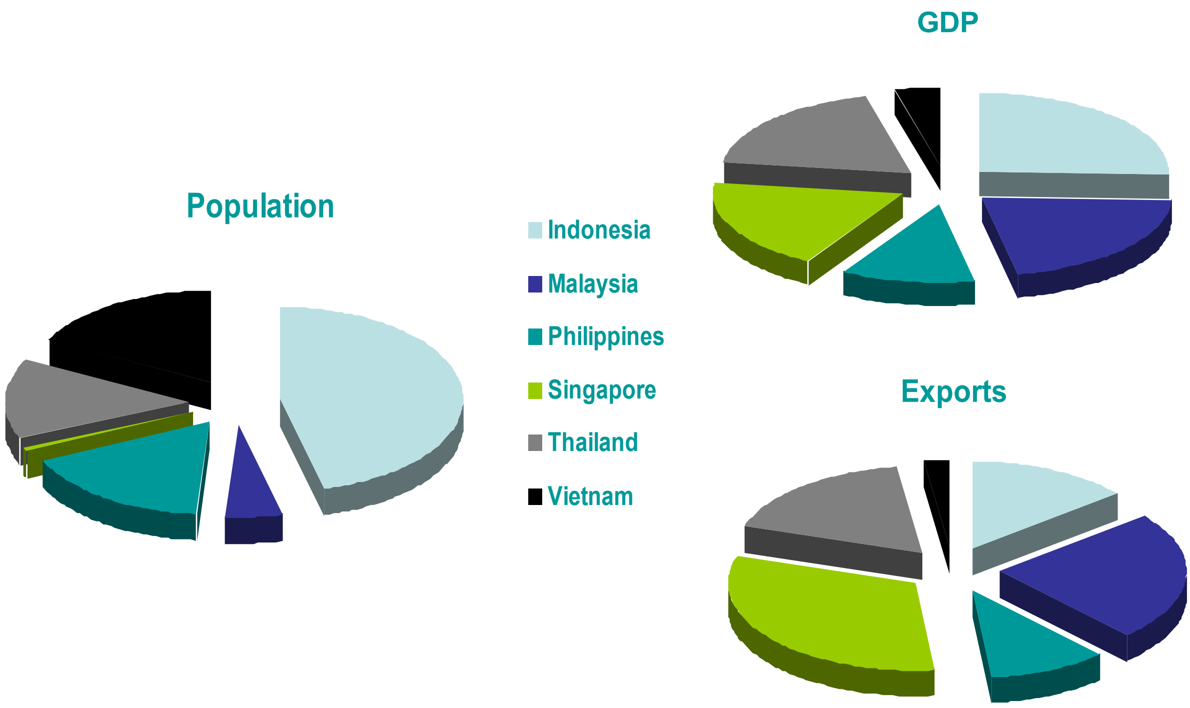


4. Scope for Trade-based Economic Expansion

Vietnam is already committed to WTO accession, but for a country deeply involved in domestic economic reform, it might be reasonable to ask whether energy devoted to external liberalization should be a high priority activity. This question can be easily answered by reference to other East Asian, and particularly ASEAN experience. Those countries that not only liberalized trade externally, but strongly informed their domestic reform agendas from external market precedents, have seen dramatic and sustained improvements in material living standards. It is also worth emphasizing that the nature of the commitment to economic reform was a much more essential determinant of these economic improvements than the underlying political system. Each of the dynamic Asian stories had a strong and relatively decisive central government, but their underlying political norms varied considerably.

To give a more tangible sense of the real and potential importance of trade to ASEAN economies, and what this infers about Vietnam, the last diagram contrasts Vietnam's GDP, Total Exports, and Population with that of other ASEAN partners in the 1999 base year of the model. It is readily apparent from this that Vietnam is far from its potential, both in terms of total economic activity and participation in the world economy. That trade can make a dramatic contribution is obvious from the case of Singapore, which is tiny in terms of regional population but huge in terms of trade and GDP.

Human Resources, Trade, and Development in Southeast Asia



5. Conclusions

Vietnam's offer represents a substantial reduction in nominal import protection and other barriers to trade, but the gains the country could enjoy from external liberalization will be seriously limited unless they coincide with comprehensive and sustained domestic economic reform.

Our results indicate that the current WTO offer reduces average protection levels incompletely but substantially, and such a reduction could realize about 80% of the gains from complete removal of protection. Thus, this first phase of trade liberalization is by far the most important for the Vietnamese economy. However, the need for complementary domestic reforms is even greater if external liberalization is more gradual.

In the absence of other measures, the offer will lead to intensification of Vietnam's traditional comparative advantages. This would narrow the basis for development, modernization, and productivity growth, and not be in the economy's best long term interest. It can be avoided by complementary policies that promote economic diversification and negotiated external market access. Particular attention should be paid to intensifying bilateral and regional arrangements with prominent trade partners.

Expansion of trade, via WTO accession and other negotiated arrangements, will not confer all its economic benefits on Vietnam unless capital markets are reformed to allow more efficient allocation of investment across the economy and greater foreign capital inflows.

The WTO has recently launched a fourfold initiative related to the Doha "Development Round," emphasizing the importance for developing country of WTO policies toward Trade and Investment, Trade and Competition, Transparency in Government Procurement, and Trade Facilitation. Each of these four components is of considerable relevance to Vietnam and should be on the agenda for future discussions with the WTO Secretariat.The most important insight emerging from this analysis is the essential complementarity between domestic and external economic reform. Both are necessary, but neither is sufficient, to realize the great economic potential of Vietnam. To put it another way, the effort to reform internally cannot be fully rewarded without external reform and, conversely, external reform efforts, like WTO accession, cannot be fully rewarded without commitment to complementary domestic reforms.

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