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THE LEAST DEVELOPED COUNTRIES REPORT 2014

Growth with structural transformation: A post-2015 development agenda

CHAPTER 5

STRUCTURAL TRANSFORMATION, LABOUR PRODUCTIVITY AND DEVELOPMENT POLICIES IN SELECTED NON-LDC DEVELOPING COUNTRIES

UNITED NATIONS
New York and Geneva, 2014

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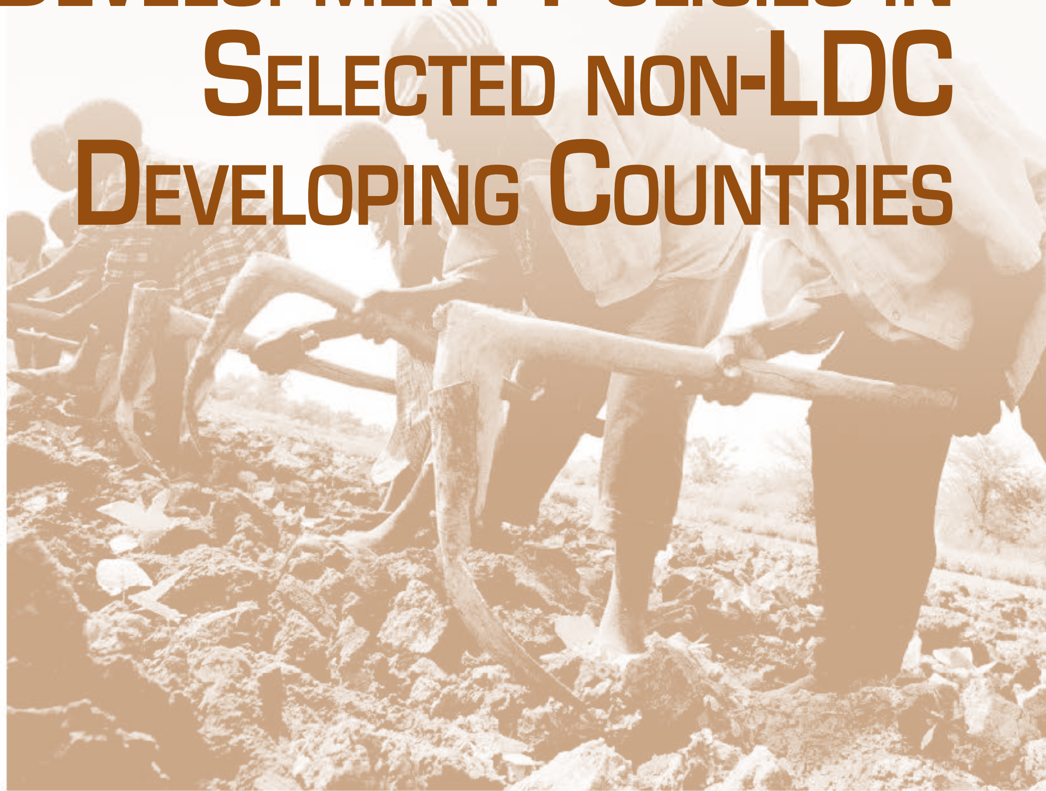


A. Introduction

Structural transformation requires policies that encourage investment in a variety of higher productivity sectors and activities, and in increasing the productivity of existing production, both of which involve different types of innovation.

Three broad and interrelated areas of domestic policy are critical for sustaining the economic transformation process:

(i) resource mobilization, which provides the resources needed for investment;

(ii) industrial and sectoral policies, which aim at changing the structure of the economy; and

(iii) macroeconomic policies, of particular importance to public investment, credit the real exchange rate and domestic demand.

To inform development policymaking in the least developed countries (LDCs) during the period covered by the planned Sustainable Development Goals (SDGs) (i.e. 2015–2030), it is useful to look beyond the LDCs themselves to some other economies that have undergone successful economic transformation in recent decades. Their transformation enabled those countries not only to perform well against the Millennium Development Goals (MDGs), but also to set in motion a lasting development process. This chapter considers what lessons may be drawn for LDCs from domestic policies adopted by four such countries: Chile, China, Mauritius and Viet Nam.

Besides their successful economic and social development, these countries were selected partly because they represent a wide range of conditions and circumstances in terms of such factors as size, location, politics, history and demographics. The range of their gross domestic product (GDP) per capita figures at the initial stages of their respective processes of economic reform is similar to that of LDCs in 2013. These countries are from three developing regions, range in population from 1.3 million in Mauritius to 1.4 billion in China, and have very different political, cultural and historical backgrounds and social structures. Their production structures also vary widely: while China has established itself as the manufacturing workshop of the world, Chile's economy remains strongly based on primary commodities, and Mauritius and Viet Nam have a mix of the two.

Above all, structural transformation requires policies that encourage investment in a variety of higher productivity sectors and activities, and in increasing the productivity of existing production, both of which involve different types of innovation. While there are innumerable instruments for this purpose, the four country cases highlight three broad and interrelated areas of domestic policy that are critical for sustaining the economic transformation process. The first of these is resource mobilization, by both the public and private sectors from domestic and foreign sources. This refers to instruments that seek to increase the resources needed for investment, including in economic and social infrastructure. It is also important to ensure that these resources are channelled into sectors and activities that will contribute to economic transformation. Financial and banking systems are crucial, not only for mobilizing resources but also for influencing their allocation.

The second policy area concerns industrial and sectoral policies, which aim at changing the structure of the economy. These encompass horizontal policies applied across all sectors (for example to address economy-wide market imperfections and externalities) and vertical policies applied only in selective sectors or activities, although there is a substantial degree of overlap and complementarity between the two.

Third, successful structural transformation requires appropriate macroeconomic policies. While such policies are typically seen as focusing on the short-term management of aggregate variables, they also have long-term impacts, which may be critical to successful structural transformation. Of particular importance are their effects on public investment, the availability and cost of credit and the real exchange rate, as well as their impacts on domestic demand.

This chapter is organized as follows. Section B discusses the extent to which the policy experiences of some countries can provide guidance to policymaking in others, and the potential for learning by example. Section C analyses the performance of selected non-LDC developing countries — Chile, China,

Mauritius and Viet Nam — in terms of structural transformation and labour productivity. This is followed by an analysis of the development policies enacted by Chile (section D), China (section E), Mauritius (Section F) and Viet Nam (Section G) in the three main policy areas outlined above. Section H summarizes and concludes.

B. Learning by example?

Every country is unique, and its particular circumstances and initial economic conditions have important implications for its development path.

Learning from the past development experiences of one set of countries to inform strategies in another clearly requires considerable caution. Any analysis of dynamic country experiences involves risks, and can be prone to reinterpretation over time (Page, 1994, 2011, 2014). Some academics have questioned the usefulness of such exercises in the light of weaknesses in government institutional capacities, changing external policies and economic environments, and/or historical misreading of the nature and processes of economic development (Weiss, 2011, 2005; Naudé, 2010a, 2010b; Naughton, 2010; Altenburg, 2011; Hobday, 2011; Milberg et al., 2014). The very term, "economic miracle", applied to conspicuous development success stories, implies that such cases can be neither explained nor replicated.

Unquestionably, every country is unique, and its particular geographical, historical, demographic and social circumstances have important implications for its development path, as do its initial economic conditions. Equally, the international economic environment has changed considerably over the past 30 years. The development of the multilateral trading system, for example, may mean that paths pursued by the four success cases examined here are no longer possible, although LDCs have greater flexibility in this regard than do other developing countries. And, as discussed in chapter 6 of this Report, the international context will undoubtedly change further in the decades to come, not least as a result of the post-2015 development agenda.

Policymakers in successful countries have often looked to the experiences of others.

Equally, however, it would be imprudent to assume that no conclusions can be drawn from successful cases, or "that there is no point in learning about their growth paths because the lessons cannot be applied at home" (Commission on Growth and Development, 2008: 20). Certainly, policymakers in successful countries have often looked to the experiences of others (Mahbubani, 2009; Virmani, 2006). For example, it has been argued that China and India — two of the most successful developing countries in recent history — owed their success precisely to their attentiveness to the limitations of the mature market economy model and its standard policy prescriptions, and sought to adapt it to their own unique conditions and circumstances (El-Erian and Spence, 2008).

Some indirect and context-specific policy lessons can be gleaned from successful cases.

Some indirect and context-specific policy lessons can indeed be gleaned from successful cases (Wade, 2010; Chang, 2012). The experiences of successful countries may be an important complement to imperfectly formulated economic theory, highlighting the role of key growth drivers and helping to identify relevant variables that could improve the analytical approach to assessing policy. Even some observers who rightly stress that no lessons can be directly learned, or models imitated, have acknowledged that "there may well be some subtle and useful insights from the Asian experience" (Hobday, 2011: 17).

The question is what kinds of lessons can and cannot be drawn, and how they can be applied in different contexts to positive effect. Evans (1998: 78–79) captures well the potential and the limitations of the process:

> If transfer were defined literally as the implantation of East Asian institutions in developing countries of other regions, then it would make

no sense. The concrete institutional forms associated with East Asian success vary substantially across individual countries for good reason. Achieving analytically similar results in different historical, cultural and political contexts requires adaptive 'reverse engineering'. Policies may be sometimes transferable in the mechanistic sense of replication, but institutions rarely are … Other countries will have to use East Asian models as creatively as East Asians used the models that their American advisors presented them with in the 1950s.

Developing appropriate development strategies within each country requires pragmatism, experimentation, capacity-building and a progressive refinement of strategies.

The lessons that can be learned relate primarily to what, broadly, needs to be achieved for successful structural transformation, and what general types of policies, institutional arrangements and instruments may contribute to that process. However, the particularities of such changes, and the appropriate means for undertaking them, must necessarily be based on the specific circumstances of each country.

Developing appropriate development strategies within each country requires pragmatism (i.e. a willingness to do what works in the local context), experimentation based on the lessons of past experiences, capacity-building and a progressive refinement of strategies in the light of experience as the process progresses. This is a well-trodden path taken by successful developing countries. Even China adopted such a process in achieving its "economic

Box 4. Chinese policy reforms: Learning by doing

When reforms started in China in the late 1970s, it was a low-income country, with a real per capita GDP similar to that of the poorest LDCs in 2013. The population was largely rural, and agriculture was the largest sector in terms of employment. Like most low-income countries, it had relatively abundant natural resources and unskilled labour, and a scarcity of human and physical capital; and it relied on exports of raw materials such as crude coal, crude oil, minerals and agricultural products to earn foreign exchange. Agriculture and processed agricultural products accounted for more than 60 per cent of its foreign exchange earnings (Lin and Wang, 2008; Lin et al., 1996; Perkins, 1988).

At the time, China's leaders had no detailed "blueprint" for reforms; only a general sense of policy direction (and where they did not want to go). They had an ingrained scepticism towards the kinds of economic theories and policies proposed by the more developed industrialized nations, which partly reflected ideological differences. They therefore tended to look for practical lessons from the international arena through case studies and their demonstration effects, and these remain important to their decision-making even today (Ravallion, 2009).

As El-Erian and Spence (2008: 8) observe,

> The fundamental fact that was recognized early on was that the models with which China was equipped to predict the effects of policy actions were very imperfect and partial, and hence the policy makers had to navigate higher subjective ex ante uncertainty about policy predictions than we are used to in advanced countries. The response was probably as expected. If the dynamic system you are trying to influence has uncertain characteristics and if you are pretty sure that it is changing over time (a kind of system-wide learning curve, with the object changing while you are learning), then you experiment, take small steps, learn and refine your understanding of the economy, and try to avoid high-risk moves and big mistakes.

China's policy experiments clearly provided its leaders with valuable knowledge about development processes. According to Rodrik (2009: 45),

> The China example is important because it illustrates, in a vastly significant real-world instance, how the experimental approach to policy reform need not remain limited in scope and can extend into the domain of national policies. China, of course, is a special case in many ways. The point is not that all countries can adopt the specific type of experimentation… that China has used to great effect. But the mindset exhibited by China's reform process is general and transferable — and it differs greatly from the mindset behind… presumptive strategies.

Equally, the idealized notion that East Asia's success was engineered by a set of impervious super-bureaucrats obfuscates the reality that "Economic change often happens not when vested interests are defeated, but when different strategies are used to pursue those interests" (Rodrik, 2013). It has been part of a gradual, decades-long process of building capable State institutions, requiring a willingness and commitment to invest both political and economic resources (Gilson and Milhaupt, 2011; El-Erian and Spence, 2008). While this process has certainly needed close cooperation, coordination and information exchange between government and business, relations have not always been based on a "bland, tension-free consensus" (Evans, 1998: 74).

miracle", experimenting, learning and adapting over time, rather than rigidly following a predetermined blueprint (box 4).

In making policy recommendations for LDCs (or any other large group of countries) collectively, it is also important to take into account their interdependence. LDCs are both trading partners and competitors for markets and inward investment. Consequently, there are both synergies and tensions between their development paths. Successful development by one LDC may benefit others — particularly neighbouring landlocked countries — and boost intraregional trade, but it may also undermine prospects for others, or limit the options available to them, especially in export markets. It may not be advisable for all LDCs to move simultaneously into the production and export of the same commodities or manufactures, since this could exert downward pressure on the international prices of these products.[1]

Rather than all LDCs pursuing an identical model of structural transformation, each needs to develop its own model based on its particular circumstances, assets and disadvantages.

This reinforces the need to avoid offering "one-size-fits-all" policy prescriptions. Rather than all LDCs pursuing an identical model of structural transformation, each needs to develop its own model based on its particular circumstances, assets and disadvantages. Thus, the quest for structural transformation should not involve a search for a blueprint. Rather, the objective should be to establish the means for each country to identify the best course available to it, and the instruments needed to pursue that course.

C. Structural transformation and labour productivity in selected countries

This section examines the performance of the selected non-LDC developing countries in terms of structural transformation, output and employment growth. Output per capita grew steadily in all these countries throughout the period 1991–2012. The performance of China and Viet Nam was particularly impressive, with average annual per capita GDP growth rates of more than 9 per cent in China and 5.5 per cent in Viet Nam, while growth rates in Chile and Mauritius averaged around 3.9 per cent and 3.5 per cent respectively.

In Chile, China, Mauritius and Viet Nam, there was a shift in employment towards the services sector, but only in China and Viet Nam did employment also move towards industry.

These variations in growth rates are closely associated with significant changes in the basic structures of the four economies. In all four of them, there was a shift in employment towards the services sector, but only in China and Viet Nam did employment also move towards industry (table 17). In China, the share of employment in agriculture fell from 60 per cent in 1991 to 33 per cent in 2012, while the shares of employment in industry and services reached 30 per cent and 37 per cent respectively. In Viet Nam, similarly, employment in agriculture fell by 29 percentage points over the two decades, from 76 per cent to 47

Table 17. Structural transformation in selected developing countries, 1991–2012

Country	Employment shares (Per cent)						Real value added shares (Per cent)						Annual labor productivity growth (Per cent)			Divisia decomposition index			Aggregate productivity change (Per cent)
	1991			2012			1991			2012			1991-2012			1991-2012			
	Agri-culture	Industry	Services	Agri-culture	Industry	Services	Agri-culture	Industry	Services	Agri-culture	Industry	Services	Agri-culture	Industry	Services	Direct	Re-allocation	Terms-of-trade	
Chile	19	26	54	10	24	66	4	43	54	4	34	62	11.3	1.9	2.3	52.8	4.8	-0.4	57.2
China	60	21	19	33	30	37	27	35	38	8	49	42	11.9	24.8	12.0	1041.0	222.8	889.7	2 153.4
Mauritius	15	42	43	8	28	65	11	31	58	5	24	71	3.8	7.0	3.4	97.7	13.6	1.6	112.9
Viet Nam	76	8	16	47	21	32	30	25	45	16	38	46	6.6	3.0	2.0	94.7	75.4	9.6	179.7

Source: UNCTAD secretariat calculations based on data from UN/DESA, Statistics Division, *National Accounts Main Aggregates Database* for national accounts data (accessed June 2014); ILO, *Global Employment Trends 2014* database for employment data (accessed June 2014).

per cent. Even in Chile and Mauritius, despite their more diversified production structures initially, the share of employment in agriculture was halved, but in their case, the shift in employment was exclusively towards the services sector, while the share of employment in industry remained relatively constant. All four economies experienced a rapid rate of transformation, the performance of the two Asian economies being the more impressive as they started from productive structures markedly skewed towards the agricultural sector.

In China and Viet Nam, the share of industry in total output grew dramatically, primarily at the expense of agriculture.

The sectoral composition of output has followed a similar pattern (table 17). In China and Viet Nam, the share of industry in total output grew dramatically, primarily at the expense of agriculture, while Chile and Mauritius saw major increases in the share of the services sector.

The other key component of successful structural transformation is growth in labour productivity. In this respect, China has overshadowed the other three economies, recording double-digit average annual growth rates of labour productivity in all three major economic sectors. The performance of industry has been particularly impressive, with labour productivity growing by 24.8 per cent per year during the period 1991–2012. Except for agriculture in Chile, none of the other three countries experienced double-digit growth in any sector. The greatest improvements in labour productivity in Mauritius and Viet Nam were in the services and agricultural sector respectively.

In China and Viet Nam, changes in labour productivity within and between sectors have occurred together.

Applying the methodology used in chapter 4 of this Report (the first Divisia index decomposition), overall productivity growth in the four countries can be decomposed into three main components: labour movements between sectors, increases in productivity within sectors, and the effects of variations in relative prices. In China and Viet Nam, changes within and between sectors have occurred together, movement between sectors contributing 75 percentage points to the expansion of aggregate productivity in Viet Nam and more than 200 percentage points in China (table 17). Conversely, the experience of Chile and Mauritius has been characterized by a much less balanced process of productivity increase, the contributions from reallocation effects being only 4.8 percentage points and 13.6 percentage points respectively.

The experience of Chile and Mauritius has been characterized by a much less balanced process of productivity increase.

These findings reinforce the overall message of this Report regarding the importance of structural transformation. Even comparing highly successful economies, the Report finds that better economic performance is associated with more balanced contributions from increasing productivity within sectors and resource shifts between sectors. Success in transforming the structure of the economy is also reflected in the relative performance of the four countries against the MDG targets. While China and Viet Nam are on track to achieve by 2015 all the seven MDG targets analysed in this Report, Chile and especially

Table 18. Progress of selected developing countries towards achieving the MDGs

Country	Population below $1 (PPP) per day (Per cent)	Population undernourished (Per cent)	Children under five mortality rate per 1,000 live births	Maternal mortality ratio per 100,000 live births	Proportion of the population without improved drinking water sources (Per cent)	Proportion of the population without improved sanitation facilities (Per cent)
Chile	On track or achieved	On track or achieved	Medium progress	On track or achieved	On track or achieved	On track or achieved
China	On track or achieved	On track or achieved	On track or achieved	On track or achieved	On track or achieved	On track or achieved
Mauritius	-	Medium progress	Medium progress	Stagnation or reversal progress	On track or achieved	Low progress
Viet Nam	On track or achieved	On track or achieved	On track or achieved	On track or achieved	On track or achieved	On track or achieved

Source: UNCTAD secretariat calculations based on data from UN/DESA, Statistics Division, *Millennium Indicators Database* for MDG data (http://mdgs.un.org/unsd/mdg/Default.aspx, accessed September 2014), except for the poverty indicators, which are taken from World Bank, *PovCalNet* (http://iresearch.worldbank.org/PovcalNet/index.htm, accessed September 2014).

Mauritius are set to achieve only medium or slow progress on one or more targets (table 18). This again highlights the importance of the virtuous circle connecting structural transformation, economic growth and human development.

The following sections analyse the main policy orientations of the selected countries aimed at achieving their development goals.

While Chile is often cited as a model with respect to its adoption of market principles, the reality reflects a more pragmatic and flexible approach to market reforms.

D. Chile

While Chile is often cited as a model with respect to its adoption of market principles, the reality reflects a more pragmatic and flexible approach to market reforms. The sudden shift of economic policy in the 1970s, characterized by import liberalization and deregulation of the domestic financial market, was followed by a return to a more pragmatic policy stance in response to the 1982 crisis. Since then, Chile has achieved greater coherence between resource mobilization and industrial and macroeconomic policy, particularly in the 1990s. It has aimed at progressively diversifying its economy from mainly copper production to other parts of the mining value chain and at increasing the value added in natural-resource-based sectors, although there remain concerns about the scope and dynamism of its export sector (OECD, 2003, 2007).

1. Resource mobilization and financing

Chile's financial reforms began with the deregulation of the domestic financial market in terms of removing entry barriers, interest rate controls and lending policies.

In the early 1970s, Chile began implementing far-reaching financial liberalization, which culminated in effectively removing capital controls in 2001. At the same time, however, Chile also undertook extensive public investment in strategic economic sectors, creating special programmes in 1991 to fund collaboration between local firms and research organizations in order to catalyse learning and innovation within domestic industry.

Chile's financial reforms began with the deregulation of the domestic financial market in terms of removing entry barriers, interest rate controls and lending policies. In addition, a major privatization of public banks reduced State ownership of banks from more than 90 per cent before 1973 to less than 15 per cent in the early 2000s. However, BancoEstado, a State-owned commercial bank, remains a key player in Chile's financial sector, providing an array of financial services to small and medium-sized enterprises (SMEs) and small savers. Financial reforms gained renewed momentum in the 1990s, with the progressive relaxation of restrictions (removed altogether by 2001) that had prevented institutional investors[2] from holding international assets, and the easing of capital controls on portfolio inflows.

Several agencies took an active role in supporting the development of productive technologies and technology transfer.

These reforms were accompanied by a continuous growth of the Chilean financial market. By 1997, the financial assets of the banking sector were equivalent to just over half of GDP (55.1 per cent), while stock market capitalization that year was 100 per cent of GDP (Gallego and Loayza, 2000; Cifuentes et al., 2002).

Several agencies took an active role in supporting the development of productive technologies and technology transfer. The National Productivity and Technological Development Fund (FONTEC) and the Science and Technology Development Fund (FONDEF) were created in the early 1990s with funding from the Inter-American Development Bank. FONTEC was managed by the Chilean Economic Development Agency (CORFO), and later merged with CORFO's Innovation Development Fund in 2005 to create InnovaChile. FONDEF was managed by the Chilean National Research Council (CONICYT) under

the Ministry of Education. Together, these institutions directly stimulated the demand for and supply of technological learning, particularly through private research and development (R&D) activities that would not otherwise be able to take place, and R&D activities by entities jointly owned by universities and producers' associations. They also supported producers' associations in project design, implementation and monitoring.

Even today, copper mining remains a major component of the Chilean economy.

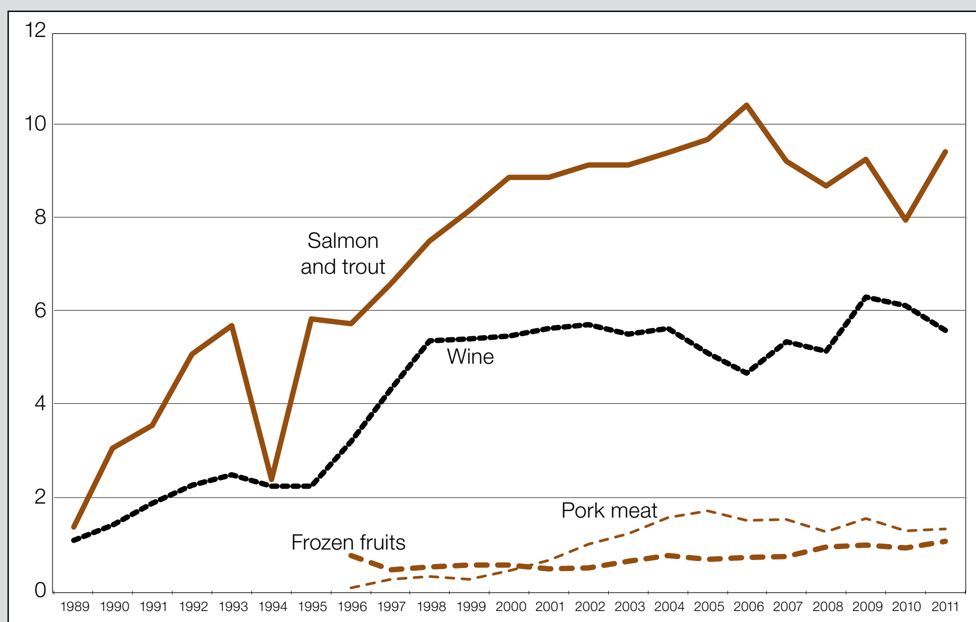
In 2006, recognizing the need for a long-term public innovation strategy, the Government created a National Innovation Council for Competitiveness to establish national guidelines and select specific industrial clusters for support. Funding will be boosted significantly by a new 3 per cent surcharge on profits from mining,[3] the proceeds of which are "unofficially earmarked" for an Innovation for Competitiveness Fund (ICF), to be managed by the Council (Varas, 2012; Agosin et al., 2010).

2. Economic diversification and industrial policy

The policy instruments and institutions, and the extent of incentives that sustained diversification, differed among industries according to their initial conditions.

Chile is a leading producer of copper, accounting for 35 per cent of world copper production and 31 per cent of global reserves. Copper constituted almost 90 per cent of Chile's merchandise exports in the early 1970s, and even today copper mining remains a major component of the Chilean economy. However, Chile has managed to gradually diversify its economic structure, reducing its reliance on copper. The mining sector accounted for an annual average of 14.8 per cent of GDP at current prices in the period 2003–2012, and copper mining for 13.6 per cent. Some non-traditional exports have increased faster than those of copper, particularly salmon, trout and wine, which grew rapidly through most of the 1990s, before appearing to lose steam during the subsequent decade. Other exports such as pork and frozen fruit have also grown rapidly, though from a much lower base (chart 34). In services, rapid growth in engineering services

Chart 34. Chile: Trends of exports of selected products, 1989–2011
(Per cent of non-mining exporters)



Source: UNCTAD secretariat, based on data from Central Bank of Chile, *Statistical Database* (accessed June 2014).

has resulted in their becoming Chile's leading service export (Fernandez-Stark et al., 2010).

The government policy instruments and institutions, and the degree of incentives that sustained this diversification, differed among industries according to their initial conditions. From the 1980s until the early to mid-2000s, Chile's industrial policy tended to give priority to "horizontal" (or "functional") policies aimed at tackling specific market failures across sectors so as to build on existing comparative advantages. Examples of horizontal policies included quality, safety and other regulatory standards, infrastructure provision, export promotion, R&D subsidies, financing for SMEs and start-ups, and training. A good illustration of Chile's horizontal approach was its use of the reintegro simplificado (until 2003), i.e. a 10 per cent tax rebate to subsidize new exports, which was automatically phased out as exports increased beyond a certain threshold (Ffrench-Davis, 2010).

From the 1980s until the early to mid-2000s, Chile's industrial policy tended to give priority to "horizontal" (or "functional") policies.

"Vertical" policies, involving strategic interventions and investments in selective sectors or firms, were also used, notably in the salmon industry. Fundación Chile, a semi-public institution, was pivotal in setting up an aquaculture programme in the 1980s, including the creation of firms (later privatized) to import and adapt technologies and undertake research. It demonstrated the commercial feasibility of large-scale salmon farming, breeding and production, and established salmon-farming centres. Other important adaptations of foreign technologies were financed by public agencies such as FONTEC (UNCTAD, 2006; Agosin, 1999).

By the mid-2000s, the emphasis had shifted more towards "vertical" policies.

By the mid-2000s, the emphasis had shifted more towards vertical policies. White papers produced by the National Innovation Council for Competitiveness in 2007 and 2008 highlighted strategic activities (copper mining, aquaculture, fruit production, beef, pork, and poultry, offshore services, tourism and processed foods) and cross-cutting sectors (financial services, transport and logistics, and construction). This policy approach combines the provision of sector-specific public goods with the strengthening of economy-wide factors such as infrastructure, training and finance, so as to "reduce, without entirely eliminating, the risk of placing bets on particular sectors" (Agosin et al., 2010: 14–15).

Capital controls were introduced in the early 1990s to avoid an overreliance on volatile short-term borrowing, while keeping the economy open to FDI.

Another important contribution to Chile's export diversification has been the role played by the Government in negotiating bilateral and regional free trade agreements (FTAs) with major importers of Chile's goods and services.

3. Macroeconomic policies

The coherence of macroeconomic policies with the overall development strategy, particularly in the 1990s, was also crucial. Following its banking sector reforms, and with historically high domestic interest rates, Chile was one of the first countries in the Latin American region to attract renewed capital flows in the early 1990s, and on a scale disproportionate to its small economic size. In response to this surge, capital controls were introduced to avoid an overreliance on volatile short-term borrowing, while keeping the economy open to foreign direct investment (FDI). The authorities also intervened in foreign exchange markets to limit real exchange rate appreciation, while sterilizing the effects of foreign exchange reserve accumulation on the money supply through the issuance of government bonds.

The primary instrument used to manage capital inflows was modulation of a price-based regulation known as the encaje (lock-in).

The primary instrument used to manage capital inflows was modulation of a price-based regulation known as the *encaje* (lock-in), an unremunerated reserve requirement (URR) that effectively raised the cost for specific short-term foreign

The operation of a copper stabilization fund established during the 1980s facilitated the management of capital inflows and aggregate demand.

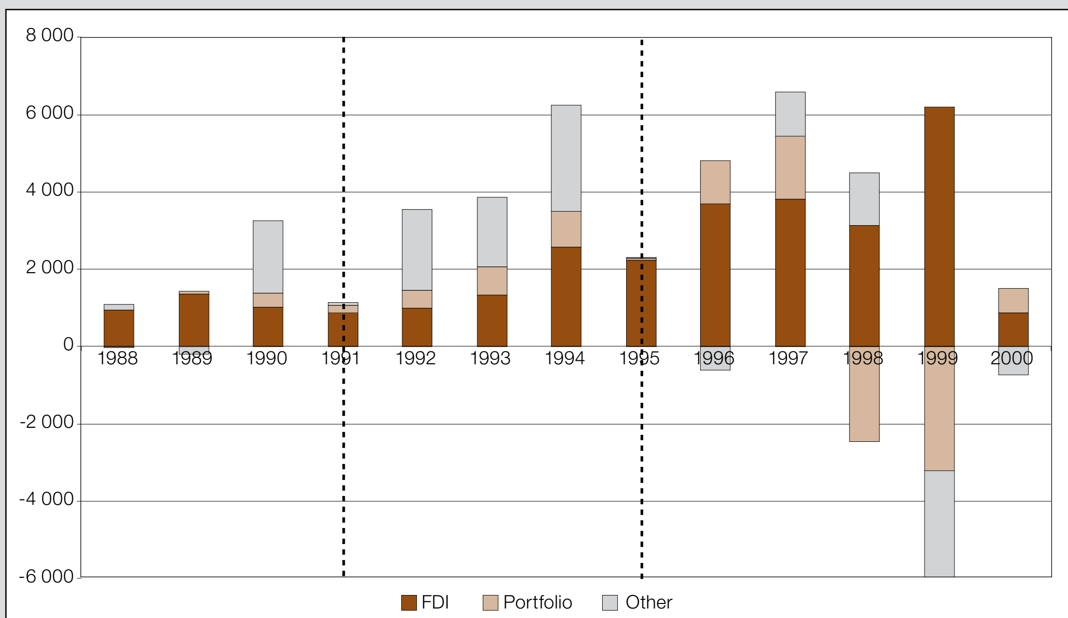
The 1992 move to a "dirty" floating exchange rate system also contributed to countercyclical macroeconomic policies.

currency liabilities. Though generally not considered as effective as quantity-based controls, such mechanisms have the advantage of being simple, non-discretionary and price-based (Stiglitz and Ocampo, 2008). Chart 35 shows the effects on the composition of net private capital flows of the two major episodes of URR implementation, in 1991 and 1995 (highlighted by the vertical lines). Capital controls appear to have had a significant if short-lived effect, particularly on the overall volume of capital flows. The effect of URR strengthening in 1992 was largely dissipated by 1994, and that of the 1995 adjustments lasted only a year. Despite essentially completing capital account liberalization in 2001, Chile retains discretion to reintroduce the URR should this be considered necessary.

Other administrative regulations on capital flows were also important as part of an overall package, including rules on the issuance of certain financial instruments, subjecting them to minimum amounts and minimum credit ratings, and requiring direct approval by the central bank. The fiscal stance was cautious, with the public sector deficit averaging an annual 2 per cent of GDP from 1990 to 1997. Combined with the operation of a copper stabilization fund established during the 1980s (replaced by the Economic and Social Stabilization Fund (ESSF) in 2007), this facilitated the management of capital inflows and aggregate demand (Ocampo and Palma, 2008; Ffrench-Davis, 2010). The ESSF played a key role in financing both a stimulus package, following the 2008 financial crisis, and an earthquake recovery plan in 2010 (Varas, 2012).

Changes in the exchange rate policy also contributed to countercyclical macroeconomic policies, notably the 1992 move to a "dirty" floating exchange rate system (i.e. a regulated float within a predetermined range). This made dollar-peso interest rate arbitrage less profitable by introducing greater short-

Chart 35. Chile: Composition of net private capital flows, 1998–2000
(Millions of dollars)



Source: UNCTAD secretariat, based on data from Central Bank of Chile, *Statistical Database* (accessed June 2014).
Note: Other capital inflows include: public/government, private non-banking, and private banking capital flows.
The lines represent the two major episodes of implementation of unremunerated reserve requirements.

term exchange rate uncertainty, while also providing greater overall stability to the peso value of proceeds from exports.

This policy approach was designed to protect a development strategy that focused on export growth and diversification, but its effectiveness was undermined by a failure to strengthen the policy stance in response to a renewed surge in capital inflows in the late 1990s. With capital controls largely removed by 2001, the ability to re-impose the URR mechanism was a major sticking point during the Chile-US FTA negotiations. Ultimately, a compromise was made, called the "cooling off" provision, whereby the United States cannot file a claim against violation of investment provisions until after a period of one year from the date the measure was implemented (Gallagher, 2010).

China has had an average annual per capita GDP growth of 9.5 per cent over the past quarter century, resulting in an increase in per capita income by a factor of seven.

E. China

China has enjoyed a spectacular economic rise over the past quarter century: its average annual per capita GDP growth of 9.5 per cent resulted in an increase in per capita income by a factor of seven, and raised China's status from a low-income to an upper-middle-income economy. This has been achieved by a gradual and strategic approach to economic reform involving three dimensions of economic transformation: from a centrally planned to an emerging market economy; from an agrarian to an industrial economy; and from a closed to an open economy.

China adopted various dual-track industrialization strategies.

Recognizing the absence of market-supporting institutions, policymakers adopted a cautious approach, while gradually establishing the necessary institutions for longer term economic reform (Gilson and Milhaupt, 2011; El-Erian and Spence, 2008) and experimenting with institutional arrangements to address constraints. As Ravallion (2008: 23–4) observes, "it has no doubt helped that China did not make the mistake of believing that freer markets called for weakening [State] institutions". It adopted various dual-track industrialization strategies, such as combining support for import-substitution in selected sectors with export-processing activities considered "new" to the domestic economy (McMillan and Rodrik, 2011). It thus blended an East Asian model of national enterprise-led growth with a South-East Asian model of global value-chain-led growth primarily orchestrated by multinational corporations (Hobday, 2011: 6).

China blended an East Asian model of national enterprise-led growth with a South-East Asian model of global value-chain-led growth primarily orchestrated by multinational corporations.

The discussion below focuses mainly on the early stages of reform, from the late 1970s to the 2000s, to highlight the dual-track institutional innovation that formed the basis of China's sustained economic transformation.

1. Resource mobilization

China's strategy for resource mobilization has been characterized by a gradual shift towards market-oriented allocation of credit and strong government guidance of FDI.

China's strategy for resource mobilization has been characterized by a gradual shift towards market-oriented allocation of credit and strong government guidance of FDI. A series of economic reforms during the 1980s and 1990s (see below) led to further increases in national savings that supported rising levels of capital formation, although both savings and investment levels were already relatively high by the 1980s (Ma and Yi, 2010; Hofman and Wu, 2009). While household savings ratios declined in the 2000s, this was offset by an increase in enterprise savings (retained profits), which rose to equal household savings after 2000 (Kuijs, 2005). Over the course of the reform period, gross fixed capital formation grew progressively from an average of 30 per cent of GDP in the 1980s to nearly 50 per cent in 2008 (Yu, 2010; Lardy, 2006). As in other centrally

planned economies, savers had little option but to deposit funds in State-owned banks (a situation referred to as “financial restraint”). Through much of the reform period, this and the retained profits of State-owned enterprises (SOEs) were the primary means of resource mobilization.

Rising household savings rapidly increased the volume of funds available in the financial system and allowed experimentation in establishing basic financial markets.

The critical factor in credit allocation was a reform of the banking system that sought to move gradually from a mono-banking system towards a two-tier system, while taking measured steps to improve the commercial operations of State-owned commercial banks (SOCBs). The People’s Bank of China (PBoC) became the central bank and focused on monetary policy (i.e. currency issuance and inflation) and regulation and supervision of commercial banks, while four SOCBs took over the central bank’s commercial banking role to support different sectors.[4] Rising household savings rapidly increased the volume of funds available in the financial system and allowed experimentation in establishing basic financial markets such as an interbank money market, foreign exchange markets, bond markets and stock markets (Okazaki, 2007). Even today, however, China’s financial system activities consist predominantly of domestic bank lending (DRC and World Bank, 2013).

The China Development Bank financed large-scale infrastructure and industrial projects by providing long-term loans.

By 1993, further reforms created three policy banks,[5] improved the commercial orientation of SOCBs and reformed foreign exchange controls (among other measures). In addition, the SOCBs’ autonomy over lending decisions was increased with the abolition of the credit plan[6] in January 1998, while requirements for the management of the banks’ balance sheets were strengthened. Nonetheless, the PBoC continued to determine the total credit that the SOCBs could extend and to influence their loan portfolio management through “window guidance”. Window guidance is mainly a form of persuasion through oral or indirect pressure, but in practice, it is believed that it also includes lending-volume guidelines (Okazaki, 2007). The PBoC was not given independence from the State Council (China’s cabinet), and this remains true today.

While China’s successful mobilization of FDI inflows also played an important role in its economic development and its export success, its approach to liberalization of FDI was gradual and prudent.

By the late 1990s, SOCBs’ non-performing loans (NPLs) were estimated at 40 per cent of outstanding loans, and the banking sector was recapitalized using four asset management companies (AMCs) that purchased NPLs from SOCBs at face value (Ma and Fung, 2002). Following these measures, China’s three policy banks became increasingly prominent as providers of long-term investment financing. The China Development Bank, in particular, financed large-scale infrastructure and industrial projects by providing long-term loans and lines of credit, and was a major source of financing of large strategic projects (Martin, 2012; CDB, 1999).

China’s approach to liberalization has sought to synchronize it with the development of its institutional capacity.

While China’s successful mobilization of FDI inflows also played an important role in its economic development and its export success, its approach to liberalization of FDI was gradual and prudent. The first steps were taken in 1986, with an experimental opening up to FDI in selected coastal cities, special economic zones (SEZs) and industrial parks, focusing on export-oriented manufacturing.[7] FDI inflows at this time remained relatively limited and came mainly from investors in Hong Kong[8] and Taiwan Province of China. It was only from the 1990s that FDI began to surge, as a wider range of investors were attracted to China as a low-cost assembly platform, initially for light manufactures. Later, investment extended into electronics, machinery and telecommunications products, though generally with limited local value-added (Koopman et al., 2010). Since 2000, about 20 per cent of all FDI to developing countries has gone to China, though FDI inflows represented only 1.7 per cent of the Chinese GDP on average in 2009–2013.

More recently, while China has been quite open to FDI in many manufacturing and most service industries (World Bank, 2010), it has adopted a gradual

approach to liberalization, seeking to synchronize this with the development of its institutional capacity. By the mid-1990s, FDI "guidelines" categorized sectors as "encouraged", "restricted" and "prohibited". They were revised over time with more demanding technical thresholds to reflect improvements in domestic production capacities (UNCTAD, 2014). They remain in effect nowadays.

2. Rural development, economic diversification and industrial policy

China adopted a gradual and strategic "micro-first" and "dual-track" approach to economic reforms.

In contrast to European transition economies, China adopted a gradual and strategic "micro-first" and "dual-track" approach to economic reforms. The initial phase in 1978–1984 focused on price and institutional reforms aimed at enhancing productivity, while the second phase, from 1985 onwards, consisted of gradual market liberalization and integration into the global economy.

China's "dual-track" approach entailed smoothing the transition towards a market economy by gradually developing a free market system alongside the existing planned economy.

In the first phase, China took measures to improve micro-level incentives by granting partial managerial autonomy and profit-sharing to economic agents such as households and SOEs. These changes started in the agricultural sector, where collective farming was replaced by the household responsibility system (HRS).[9] Land remained collectively owned, but was subdivided into tracts contracted to individual households, who exercised control and income rights. By the end of 1983, 98 per cent of agricultural collectives had adopted this system, resulting in a dramatic increase in agricultural productivity.

China's "dual-track" approach entailed smoothing the transition towards a market economy by gradually developing a free market system alongside the existing planned economy. Prior to 1978, the Government set both prices and quantitative targets in most sectors according to a central plan. While State controls were maintained in key sectors of the economy, private enterprises were allowed to participate in markets at the margin. The "dual-track" system, introduced in 1980, allowed enterprises to sell surplus output at market prices (market track) once they had fulfilled their planned production quotas and sold them at State-set prices (planned track).

The agricultural sector diversified from a "grains-first" production structure to include ever-increasing proportions of higher value crops.

This process of liberalizing prices at the margin to provide market incentives, while maintaining State-established prices and quotas to stabilize production, has been described as a political mechanism for reform "without creating losers". While the market track provided the incentives for economic actors to benefit from an increase in their productivity (provided they fulfilled their obligations to the plan), the planned track provided implicit transfers to compensate economic actors who might otherwise lose from liberalization by maintaining existing rents and subsidies.

Agricultural diversification was accompanied by very rapid industrial development in rural areas that continued into the 1990s.

Following the introduction of these reforms, the growth rate of agricultural GDP accelerated sharply, from an average annual rate of 2.7 per cent during the period 1970–1978 to 7.1 per cent in 1978–1984, with a similar pattern across all agricultural subsectors. The agricultural sector diversified from a "grains-first" production structure to include ever-increasing proportions of higher value crops, horticultural produce, livestock and aquaculture. This was accompanied by very rapid industrial development in rural areas that continued into the 1990s. The share of rural industrial enterprises in total industrial production increased fourfold between 1978 and 1993, from 9 per cent to 36 per cent, largely through township and village enterprises (TVEs) (Jin and Qian, 1998: 777). While the State-owned Agricultural Bank of China and the Agricultural Development Bank of China provided some financing at the national level, local governments played a pivotal role in arranging investment financing through rural credit cooperatives, and rural cooperative funds at the local level.

The second phase of reforms, from 1985 onwards, involved progressive market liberalization.

The broad-based success of the agricultural reforms led to a similar approach to industrial sector reforms in the mid-1980s.

By the 2000s, China concentrated state ownership in strategic and "pillar" sectors deemed crucial to national development.

The restrictive approach to exchange rate policy and capital account opening reflected the twin objectives of maintaining domestic macroeconomic stability and rapid growth while exposing the economy to trade and capital flows.

Very large foreign exchange reserves proved pivotal in maintaining resilience during bouts of economic crisis and at key junctures of the reform process.

The second phase of reforms, from 1985 onwards, involved progressive market liberalization, including the liberalization of prices of selected commodities as their production responded to market incentives, allowing the plan to be phased out. Thus, procurement programmes and quotas were replaced by a combination of contract and market purchases, apart from a few products deemed important for national welfare.[10]

The broad-based success of the agricultural reforms led to a similar approach to industrial sector reforms in the mid-1980s. Those reforms included changing the incentive structure for individual firms, while improving the overall market environment in which they operated. As with the household responsibility system in agriculture, a contract responsibility system was established between enterprises and the State: enterprises agreed on levels of profits and taxes to give to the State, and in return were given extensive autonomy to finance investment from retained earnings, bank loans and other sources (e.g. joint ventures, stock market issuance and bonds). By the late 1980s, more than two fifths of SOE investments in fixed assets were financed from retained earnings rather than through government grants. Similarly, markets for industrial inputs and outputs were gradually created, so that by 1989 roughly two thirds of SOE output was channelled through markets rather than bureaucratic decisions (Nolan and Wang, 1999; Perkins, 1988).

By the 2000s, China concentrated state ownership in strategic and "pillar" sectors deemed crucial to national development: in upstream natural monopoly sectors, but also in competitive downstream manufacturing and service sectors. Foreign investment in these sectors is subject to, for example, foreign ownership limits (and joint ventures), technology transfer and local content requirements, and R&D expenditure targets. These measures culminated in the establishment of the State-owned Assets Supervision and Administration Commission of the State Council (SASAC) in 2003. SASAC was created to institutionalize the management and oversight of SOEs on behalf of the State, initially covering 196 firms (Szamosszegi and Kyle, 2011; Lin and Milhaupt, 2013).

3. Macroeconomic policies

Underlying China's industrial and financial reforms was a coherent macroeconomic framework. This policy framework was unorthodox, particularly in terms of exchange rate, capital controls and degrees of monetary independence, which were key to China's overall development strategy. The restrictive approach to exchange rate policy and capital account opening reflected the twin objectives of maintaining domestic macroeconomic stability and rapid growth while exposing the economy to trade and capital flows.

China adopted a managed exchange system in order to maintain a competitive and stable exchange rate,[11] allowing a substantial accumulation of foreign exchange reserves drawn from twin surpluses in trade and FDI inflows from the 1990s to the mid-2000s.[12] A fixed exchange rate coupled with a high mandatory surrender requirement on export proceeds — set at 85 per cent in the late 1990s and only gradually reduced — were pivotal to China's rapid foreign exchange reserve accumulation.[13] Very large foreign exchange reserves proved pivotal in maintaining resilience during bouts of economic crisis and at key junctures of the reform process, such as a banking bailout in the late 1990s.

This reserve accumulation has direct implications for monetary policy. To keep the exchange rate stable, the People's Bank of China plays a more proactive role in foreign exchange markets, purchasing foreign currency with local currency while sterilizing the effects on liquidity. Sterilization is generally

performed through open-market operations (selling government bonds or other local currency assets owned by the central bank), or less conventionally through adjustments to reserve-requirement ratios,[14] administered deposits and minimum lending rates, and the use of quantitative measures such as lending quotas, "window guidance" and administrative restrictions on investment. These latter measures were particularly useful in providing China with degrees of freedom in keeping short-term real interest rates low (Ma and McCauley, 2007).

The evolution of China's capital control regime exhibits two important features: an "FDI-first" orientation that favours FDI inflows, which are considered more stable, over portfolio inflows, which are perceived as more volatile; and a progressive shift from a regime biased against outflows, towards a more balanced approach (Ma and McCauley, 2007; PBoC, 2008). The general prohibition on foreign investors' buying equity in stock exchanges inside China in the 1990s, for example, gave way in 2003 to the qualified foreign institutional investors (QFII) scheme which granted limited investment quotas to approved foreign investors. QFII is seen as an intermediate arrangement that allows foreign capital to access Chinese stock markets without a complete removal of controls or renminbi convertibility (Yu, 2008; Ni, 2009).

The evolution of China's capital control regime exhibits two important features: an "FDI-first" orientation that favours FDI inflows, and a progressive shift from a regime biased against outflows, towards a more balanced approach.

F. Mauritius

Mauritius is another example of gradual and unorthodox economic opening based on a two-track strategy which keeps one part of the economy highly open and the other quite closed (Rodrik, 1998). As a small island economy, Mauritius' establishment of an export processing zone (EPZ) in 1970 and its openness to trade are regarded as key factors underpinning its economic performance (UNECA, 2014; Sachs and Warner, 1995, 1997). However, while trade has undoubtedly played a critical role, Mauritius has by no means adopted a laissez-faire approach to development and structural transformation (Collier and Venables, 2007; Frankel, 2010).

Mauritius is another example of gradual and unorthodox economic opening based on a two-track strategy which keeps one part of the economy highly open and the other quite closed.

1. Resource mobilization

The Mauritian Government and public agencies have played a key role in mobilizing resources for structural transformation and diversification. Throughout the 1980s, the authorities maintained strong controls over a financial system that consisted almost exclusively of commercial banks. Measures included ceilings on loan volumes, reserve requirements, and controls on deposit interest rates and lending rates to priority and non-priority sectors. While the role of non-bank financial institutions has expanded significantly with the removal of controls over the course of the 1990s, they mainly provide mortgage financing and purchase government securities; very few of them provide long-term financing to productive sectors (Bundoo and Dabee, 1999). The banking and financial systems remain highly concentrated, with two private commercial banks accounting for 60 per cent of total banking assets.

The Mauritian Government and public agencies have played a key role in mobilizing resources for structural transformation and diversification.

The Development Bank of Mauritius (DBM) was established in 1964 as an institutional source of long-term lending. It supported Government policy through subsidized credit, contributing significantly to the credit and start-up capital used to diversify the economy from its historical dependence on sugar. By the early 1980s, the DBM is estimated to have provided a quarter of the financing for investment in industry, while other institutions such as the State Finance Corporation provided financing for the sugar industry (Zafar, 2011; World Bank, 1982). Following the 2008–2009 crisis, the DBM was transformed

The Development Bank of Mauritius was established in 1964 as an institutional source of long-term lending.

into a micro-, small- and medium-sized enterprise bank, reflecting a shift in the Government's priorities (OECD, 2014).

On the one hand, foreign and domestic private investment in manufacturing and tourism were encouraged through the provision of physical infrastructure, fiscal and financial incentives, and credit facilities.

2. Industrial policy and economic diversification

Until the adoption of a policy of import substitution to spur export diversification in the mid-1960s, the primary industrial activity in Mauritius was sugar milling. On the one hand, foreign and domestic private investment in manufacturing and tourism were encouraged through the provision of physical infrastructure, fiscal and financial incentives, and credit facilities offered mainly by the DBM. On the other hand, a high level of protection was maintained, particularly for infant industries. To this end, the Government introduced the Development Certificate Scheme (DCS) in 1964, offering 5–8-year exemptions from corporate income tax and exemptions from duties on imported capital goods.

On the other hand, a high level of protection was maintained, particularly for infant industries.

In 1970, the emphasis shifted to promoting export-oriented manufacturing with the introduction of an Export Processing Zone Act. This Act provided an array of incentives, including exemption from import duties on capital goods and raw materials, corporate tax holidays and unrestricted repatriation of profits. Initially, in the 1980s, EPZ wages were 36–40 per cent lower than those in the rest of the economy, reflecting the de facto gender-based segmentation of the labour market between a predominantly female workforce in the EPZs and a predominantly male workforce in the remainder of the economy. However, the differential fell progressively to 7–20 per cent in the 1990s. EPZ firms were also allowed greater flexibility in dismissing workers, and rules related to overtime work were more relaxed. According to Rodrik (1998: 28), this segmentation of the labour market was crucial "as it prevented the expansion of the EPZ from driving wages up in the rest of the economy, and thereby disadvantaging import-substituting industries. New profit opportunities were created at the margin, while leaving old opportunities undisturbed".

In 1970, the emphasis shifted to promoting export-oriented manufacturing with the introduction of an Export Processing Zone Act.

Today, garments and textiles account for about two thirds of exports, the remainder being mostly resource-based products (refined sugar, fish-based preparations, and diamonds and jewellery), tourism, services relating to information and communications technologies (ICTs), and offshore banking. This is very similar to the export composition of the mid-1990s, reflecting the slow evolution of the manufacturing sector. While tradable services have been diversified somewhat with the further development of the financial system, the ICT-related services emerging in the past decade mainly comprise call centres that pay low wages (Yusuf, 2012; Zafar, 2011; United States State Department, 2013).

Today, garments and textiles account for about two thirds of exports, the remainder being mostly resource-based products, tourism, ICT services and offshore banking.

Despite its strong emphasis on the export sector, Mauritius remained a highly protected economy until the 1990s: overall tariffs were high and there was wide tariff dispersion across product categories. While the level of protection fell over time, this pattern persisted, with average tariff rates in 1994 of 30.1 per cent in manufacturing, 17.7 per cent in agriculture and 14.1 per cent in mining. Rates exceeded 50 per cent for clothing, furniture, footwear and rubber products, and were above 40 per cent for electronics and plastics (Lall and Wignaraja, 1998). Even in 1998, based on a classification scheme for trade policy restrictions developed by the International Monetary Fund (IMF), Mauritius rated 7, with 10 representing the highest level of restrictions (Subramanian and Roy, 2001).

Despite its strong emphasis on the export sector, Mauritius remained a highly protected economy until the 1990s.

This unorthodox opening process was underpinned by preferential market access for exports of sugar, and garments and textiles, which represented the bulk of Mauritian exports, ensuring the profitability of these sectors, particularly in the 1980s and 1990s. The Sugar Protocol of the 1975 Lomé Convention

granted Mauritius a large quota relative to its size for access to the European Economic Community market, and at a guaranteed price that exceeded the world market price by an average of 90 per cent between 1977 and 2000. In textiles and clothing, foreign investors re-located to Mauritius to utilize the country's quota regime under the Multi-Fibre Arrangement (MFA) on textiles and clothing. These investors were mainly from Hong Kong, which had already filled its MFA quota. Rents accruing to Mauritius from these preferential trade arrangements were estimated to be about 7 per cent of GDP in the 1980s and 4.5 per cent of GDP in the 1990s. These rents in turn were critical in sustaining high levels of domestic investment (Subramanian and Roy, 2001).

The coherence of Mauritius' macroeconomic framework with its industrial and diversification policies was important to its success.

3. Macroeconomic policies

As in the other countries discussed in this chapter, the coherence of Mauritius' macroeconomic framework with its industrial and diversification policies was important to its success. The Bank of Mauritius is not fully independent of the Government and is mandated to first ensure the competitiveness of the country's export sectors, and second, to maintain price stability. Monetary policy is based on multiple indicators, including interest rate and inflation differentials, growth rates, and exchange rates against major trading partners, referred by the IMF as "hybrid inflation targeting" (Bank of Mauritius, 2014; Zafar, 2011; Bundoo and Dabee, 1999; IMF, various years).

Having used various pegged exchange rate arrangements to stabilize the value of the currency in the 1980s, Mauritius adopted a free-floating system in 2008.

Having used various pegged exchange rate arrangements to stabilize the value of the currency in the 1980s and a managed float during the 1990s, Mauritius adopted a free-floating system in 2008. Capital controls are currently very limited, and the Bank of Mauritius intervenes in the foreign exchange market to reduce exchange rate volatility, but not to counteract market forces.

Following the global financial crisis of 2008–2009, Mauritius implemented a fiscal and monetary stimulus package equivalent to around 5 per cent of its GDP in 2009–2010. This included infrastructure spending, financial relief to firms adversely affected by the crisis, and social and job protection measures. This package was partly financed by "rainy day" funds, set aside in previous financial years, amounting to around 3 per cent of GDP.

Viet Nam has aimed at fundamentally changing the organization and structure of the economy through gradual, "dual-track" economic reforms rather than a "big-bang" approach.

G. Viet Nam

Viet Nam has pursued a development path similar to China's. It has aimed at fundamentally changing the organization and structure of the economy through gradual, "dual-track" economic reforms rather than a "big-bang" approach. The similarities in policy between the two countries reflect close parallels between their respective economic and political contexts, as well as a conscious effort by policymakers in Viet Nam to learn from China's experience and adapt its policy approaches to local conditions where appropriate.

Banking sector reform in Viet Nam focused on diversifying the ownership structure and increasing the market orientation of an initially State-owned banking system.

1. Resource mobilization

Banking sector reform in Viet Nam focused on diversifying the ownership structure and increasing the market orientation of an initially State-owned banking system. Major reforms began in 1988 with the establishment of a two-tier banking system in which the central bank, the State Bank of Vietnam (SBV), focused on monetary policy and oversight of commercial banks, and commercial banks concentrated on the mobilization and allocation of financial resources.

Resource mobilization occurred largely through "financial restraint" arising from a public sector monopoly on commercial banking that left savers with few other places to deposit savings; and these resources were mostly channelled to financing SOEs at preferential rates in accordance with government policy objectives.

Viet Nam has been highly successful in mobilizing large-scale FDI inflows, which surged from 2.8 per cent of GDP in 1990 to 6 per cent in 1995–2010.

In 1988, there were four SOCBs serving different sectors: the Vietnam Bank of Agriculture and Rural Development (Agribank); the Industrial and Commercial Bank of Vietnam (ICB); the Bank for Investment and Development of Vietnam (BIDV), which provided long-term financing of infrastructure and public works projects; and the Bank for Foreign Trade of Vietnam (Vietcombank or VCB), which financed trade-related activities, managed foreign exchange and assisted SOEs (Ho and Ashle, 2011; Rosengard and Du, 2009). The SOCBs were only marginally commercially oriented; the SBV continued to set lending and deposit rates, and lending rate differentials were based on investment priorities between sectors and between working capital and fixed investment rather than on credit risk. Access to loans was a function of policy priorities rather than profitability or market potential; and savings rates differentiated between households and businesses and were not based on market prices or banks' liquidity needs.

Viet Nam's economic "renovation" (doi moi) strategy, launched in 1986, had two main objectives: (i) a transition from a centrally planned to a market-based economy; and (ii) to support export-oriented industries.

By the 1990s, however, bank ownership was diversified through the introduction of joint stock commercial banks and the establishment of foreign bank branches or (minority) joint ventures with domestic banks.[15] Foreign bank operations were limited in scope and in the products they could offer, and initially had higher requirements for start-up capital. Even in 2007, SOCB loans, mainly to SOEs, accounted for the largest share (54 per cent) of total loans (Leung, 2009; Rosengard and Du, 2009). The transition to commercial banking was beset with problems arising from the accumulation of non-performing loans, and by 2000, Viet Nam established four asset management companies (AMCs) to remove bad assets from the four main SOCBs, later coupled with the creation of the Debt and Asset Trading Corporation in 2003 (Rosengard and Du, 2009).

Viet Nam has been highly successful in mobilizing large-scale FDI inflows, which surged following the ending of the United States embargo in 1994, from 2.8 per cent of GDP in 1990 to 6 per cent in 1995–2010. This increase partly reflects Viet Nam's policy of openness as well as the size and rapid growth of its economy, supported by the establishment of industrial zones and EPZs. FDI led to an increase in the share of foreign-invested enterprises in industrial output, and contributed substantially to the rapid expansion of exports, from $5.4 billion in 1995 to $96 billion in 2011.

The "renovation" strategy began in agriculture, particularly rice cultivation.

2. Rural development, economic diversification and industrial policy

Viet Nam's economic "renovation" (*doi moi*) strategy, launched in 1986, had two main objectives. The first was a transition from a centrally planned to a market-based economy, allowing domestic prices to reflect world prices. This was intended to improve resource allocation, increase the number of entities engaged in trade, remove exchange rate distortions and reform enterprise governance to increase responsiveness to price signals. The second objective was to support export-oriented industries to counter the anti-export bias of the previous economic system.

In 1987, all sectors of the economy except defence were opened up to foreign investors.

The "renovation" strategy began in agriculture, particularly rice cultivation. Collective farming was dismantled in 1988–1989, with transferrable time-limited land use rights (though not ownership) allocated to farming households, which were recognized as the basic unit of agricultural production. Barriers to internal and external trade in agricultural goods were progressively relaxed, and

incentives were improved by the removal of administered prices in 1989, as the official price of rice in 1988 was about one tenth the free market price (Dollar and Litvack, 1998; Glewwe, 2004). The results were impressive: between 1985 and 1995, rice production grew by 57 per cent, largely due to increased yields and intensive farming, and Viet Nam started to export rice in 1989, later becoming the world's third largest exporter after Thailand and the United States (Minot and Goletti, 2000).

FDI projects are often required to conform to one or more 5–10-year sectoral "master plans".

Major enterprise reform was also undertaken, allowing greater autonomy over commercial activities, improving the overall market environment and permitting the entry of foreign-owned firms. In 1987, all sectors of the economy except defence were opened up to foreign investors, with up to 100 per cent foreign ownership, and generous tax holidays and duty exemptions. EPZs and industrial parks offered further incentives to firms, including preferential tax rates and exemptions from import and export duties. A new Investment Law was introduced in 2005 aimed at conforming with international commitments. It aligned incentives to foreign and domestic investors by designating sectors in which investment was "incentivized", "conditional" or "prohibited", as well as "geographical areas of investment incentives". Incentivized investment sectors covered a wide range, encompassing manufacture of new materials and high technologies, agriculture, forestry and aquaculture, and labour-intensive industries (National Assembly, 2005). FDI projects are often also required to conform to one or more 5–10-year sectoral "master plans" each of which sets targets for the industry concerned.

In 2011, SOEs accounted for more than one third of GDP, half of exports, and 40 per cent of industrial production

The SOE sector was reformed in 1988–1989, increasing SOEs' autonomy over production, prices and the hiring and firing of workers, while reducing direct subsidies (McCaig and Pavcnik, 2013), but the pace of SOE restructuring slowed down as of mid-2000. The number of SOEs (especially local-government SOEs) fell sharply between 1988 and the mid-1990s, from around 12,000 to 6,500. Meanwhile, rapid output growth by larger private firms was offset by a steep decline in output of non-State cooperative industries, as many cooperatives closed or changed ownership through purchase by individual members or corporatization (O'Connor, 1998).

In the 2000s, shoes, garments and textiles dominated exports, with some increases in the assembly of electronic devices.

Thus, even in 2011, SOEs accounted for more than one third of GDP, half of exports, 28 per cent of total domestic government revenue (excluding crude oil revenue and trade taxes), and 40 per cent of industrial production (OECD, 2013). Furthermore, the State Capital Investment Corporation was created in 2005 to oversee and manage state assets in all but the 19 largest SOEs (Rosengard and Du, 2009; OECD, 2013).[16]

Domestic reforms were reinforced by the signing of international trade agreements, including a preferential trade agreement with the European Economic Community in 1992, membership of the Association of Southeast Asian Nations (ASEAN) in 1995, a bilateral trade agreement with the United States in 2001, and accession to the World Trade Organization (WTO) in 2007. WTO membership nevertheless allows Viet Nam to continue to make use of flexibilities to maintain a proactive trade policy, including recently raising tariffs to the bound level for a range of products, particularly in the agricultural and horticultural sectors (USTR, 2012).

Viet Nam has adopted an unorthodox macroeconomic policy framework, combining a stable, competitive exchange rate with strong controls over portfolio capital flows.

In the 1990s, shoes represented one third of Vietnam's exports, petroleum for about 25 per cent, and agricultural and aquatic products (rice, coffee, rubber, shrimp, fish, etc.) accounting for much of the remainder. In the 2000s, the composition of Vietnam's export basket stayed roughly the same: shoes, garments, textiles dominated with some increases in the assembly of electronic devices (Perkins, 2013; Athukorala, 2009).

3. Macroeconomic policies

Exchange rate arrangements resulted in an increase in foreign exchange reserves from $1.3 billion in 1995 to $23.9 billion in 2008.

Viet Nam has adopted an unorthodox macroeconomic policy framework, combining a stable, competitive exchange rate with strong controls over portfolio capital flows, thus allowing a degree of monetary policy independence.

For much of the reform period, Viet Nam used a pegged exchange rate within horizontal bands to stabilize the economy while maintaining competitiveness. It changed to a managed floating exchange rate in 2001, and to a conventional pegged arrangement in 2005. While such exchange arrangements require the use of capital controls, and despite restrictions on short- and medium-term capital inflows, Viet Nam has attracted significant FDI inflows and remittances (Camen, 2006; Hauskrecht and Le, 2005; IMF, various years). Combined with surrender requirements on export proceeds (set at 50 per cent for all resident enterprises in 1999) until 2003,[17] these exchange rate arrangements resulted in an increase in foreign exchange reserves from $1.3 billion in 1995 to $6.2 billion in 2003 and $23.9 billion in 2008 (World Bank, 2008).

SOCBs accounted for three quarters of loans in the early 2000s, and other policy tools continued to be applied to influence interest rates.

Since the early 1990s, the fiscal deficit has generally been around 3 per cent of GDP, and sometimes lower; but off-budget expenditures (primarily bond-financed infrastructure investments) have also been substantial in several years since 2000, increasing the deficit to a peak of 7 per cent of GDP in 2003. Interest rates have gradually been liberalized since the mid-1990s, with the removal of deposit rate floors (except for foreign currency deposits) in 1996 and lending rate ceilings in 2000. These were initially replaced by reference rates announced monthly by the SBV. Interest rates were liberalized for foreign currency-denominated loans in 2001, and for domestic currency-denominated loans in 2002, thus allowing commercial banks to set lending and deposit rates according to market conditions (Camen, 2006).

The policy frameworks of the four country experiences reveal important common features which may inform policymaking in LDCs.

Although SOCBs did not fully incorporate risk in their lending rates, they accounted for three quarters of loans, and other policy tools continued to be applied to influence interest rates. Thus there was no discernible increase in interest rates for domestic currency-denominated loans following their liberalization. The basic interest rate announced monthly by the SBV is now effectively a reference rate on which banks base their lending rates. The SBV is not fully independent and is an integrated part of Government. For some other interest rates (e.g. on dollar deposits for corporate clients) de facto ceilings appear to persist, and larger SOCBs and joint stock commercial banks appear to cooperate in setting deposit rates to avoid excessive competition (Camen, 2006).

First policymakers were pragmatic in modifying the conventional economic policy advice of the time, adapting policy instruments and institutional arrangements to their particular interests, concerns and objectives.

Other indirect monetary policy tools introduced since the mid-1990s include reserve requirements, refinancing and discount lending facilities, open market operations and foreign exchange interventions. By the mid-2000s, reserve requirements were differentiated according to the maturity of deposits, the sectoral focus of banks and types of currency deposits (Leung, 2009). Open market operations related to the purchase and sale of SBV bonds and other securities, begun in 2000, have become “the single most important monetary instrument for controlling liquidity” (Camen, 2006: 236–237).

H. Summary and conclusions

While the four country experiences described in this chapter exhibit distinctive attributes, at a broader level, their respective policy frameworks reveal important common features which may inform policymaking in LDCs.

First, perhaps the most striking common feature of the four development experiences is their pragmatism. While the four governments had extremely diverse ideological standpoints, and this undoubtedly affected their respective approaches, they all demonstrated a willingness to set ideology aside, whether socialist or free market, in the quest for means of achieving their economic goals. In each case, policymakers modified the conventional economic policy advice of the time, adapting policy instruments and institutional arrangements to their particular interests, concerns and objectives. The emphasis was thus less on a generic "best practice" in policymaking than on best matches with national circumstances, priorities and capabilities.

Second, policies in the three key areas — resource mobilization, industrial policies and macroeconomic management — were not independent, but emanated from a holistic vision of development and structural transformation.

Second, policies in the three key areas around which these countries built their development strategies — resource mobilization, industrial policies and macroeconomic management — were not independent, but emanated from a holistic vision of development and structural transformation, and a coherent overall strategy. Their macroeconomic framework, for example, sustained their industrial and diversification strategies, with all four countries making extensive use of managed exchanged rates and using capital controls to favour FDI over portfolio investment.

Third, the four countries adopted a gradual approach to liberalization and integration into the global economy.

Third, the four countries adopted a gradual approach to liberalization and integration into the global economy. This was most evident in China and Viet Nam, where microeconomic reforms comprising price and institutional changes with a view to increasing productivity preceded market liberalization and increasing openness. Mauritius, too, made relatively few reductions in its trade protection until the mid-1990s, and even Chile took almost three decades to complete its financial liberalization.

Fourth, rural development provided much of the momentum for reform of the industrial sector.

Fourth, rural development provided much of the momentum for reform of the industrial sector. The impressive productivity growth in agriculture was a major feature of the Chilean experience, while rice and sugar were of crucial importance in Viet Nam and Mauritius respectively. China also illustrates this rural-industrial sequencing, the success of the household responsibility system in agriculture paving the way for the implementation of similar policies in other sectors, mainly manufacturing.

Finally, the diversification and upgrading of production has proceeded through a combination of private and public investment, and domestic and foreign resources.

Finally, the diversification and upgrading of production has not relied on any single financing source in any of the four countries; rather, it has proceeded through a combination of private and public investment, and domestic and foreign resources. The banking and financial sectors of the four economies underwent major reform processes, but the role of national development banks in fostering access to credit (in Mauritius and Viet Nam), strategic investments in innovation (in Chile) and allocation of private investment (in China) were equally important to the transformation process. Likewise, FDI constituted a source of or catalyst for growth, particularly of the export sectors in all the countries, reflecting the strategic approach of the four countries to FDI policy, guided by their respective national development priorities.

Notes

1 This is the so-called fallacy of composition, which is however limited by the small size of the economy of most LDCs (Cline, 2010).

2 These include pension funds, insurance companies, mutual funds and foreign investment funds.

3 Indeed, according to COCHILCO (2012: 72–73), the combined taxes paid by major private mining companies and contributions from publicly-owned mining companies spiked to 34.1 per cent of total government fiscal revenues in 2006 ($12.9 billion), and to 32 per cent in 2007 ($14.2 billion).

4 These were the Agricultural Bank of China (for financing the rural and agricultural sectors), the Bank of China (for financing foreign trade and investment), the People Construction Bank of China (for financing construction and fixed-asset investment) and the Industrial and Commercial Bank of China (for financing the business activities of SOEs).

5 These were the China Development Bank (CDB), the Export and Import Bank of China (Exim) and the Agricultural Development Bank of China (ADBC).

6 In the early 1990s, Chinese financial resources were still not channeled through capital markets, but remained mostly managed via administrative measures such as an annual credit plan imposed on financial institutions. The State Planning Commission, working jointly with the PBoC, determined the aggregate lending quota for the national economy, which was further sub-divided for each province and municipalities with provincial-level administrative status (Beijing, Shanghai, Tianjin). Under the credit plan, banks were frequently forced to provide loans to assist regional economic growth with little regard for credit risk, which led many of these loans to later become nonperforming, and could not effectively control total money supply (Okazaki, 2007).

7 For instance, foreign firms were permitted to use their renminbi earnings to invest in local export-oriented production, or convert the earnings into foreign currencies through swap markets that were opened in the late 1980s to assist foreign firms to balance their foreign exchange accounts (Yu, 2008; Epstein et al., 2004; Perkins, 2013).

8 Prior to the transfer of sovereignty of Hong Kong from the United Kingdom to China in 1997, Hong Kong was classified as a British Dependent Territory.

9 Though initially some government authorities resisted the HRS experiment by late 1981, it was widely accepted, and almost half of all production teams were dismantled.

10 By 1986, the central Government announced that it would reduce the number of agricultural procurement prices set centrally to 17 products and would set “guidance” procurement prices for another 11 products. At times, reforms have been fitful and reversed due to the Government’s concerns of loss of control and unanticipated outcomes, but these have been expedient detours rather than a return to previous practices (Sicular, 1988). The supply of other agricultural inputs, such as credit, and chemical fertilizers in particular, also increased substantially during the reform period (Lin, 1992; Stone, 1988). State control over procurement and prices of farm inputs was relaxed only gradually during the reform era, beginning in the mid-1980s with machinery, pesticides and plastic film, and in the early 1990s it was extended to key inputs such as chemical fertilizers (Huang et al., 2008). By the mid-1990s, about 50 per cent of fertilizers were sold by private traders (Rozelle and Swinnen, 2004).

11 China’s exchange rate system officially changed to a managed float in 1994, but the Chinese currency was de facto fixed to the United States dollar from 1995 until 2005, when the renminbi’s value was set with reference to a basket of currencies (Wang, 2004; PBoC, 2008).

12 In 2006, for example, the share of the trade surplus in the current account surplus was 87.1 per cent. That same year, China’s foreign exchange reserves surpassed $1 trillion for the first time.

13 By 2007, all export proceeds surrender requirements were eliminated.

14 The PBoC has adjusted the ratio 42 times since 1998, and in recent years it stood at 20 per cent, which is double the ratio for large banks in the United States (Yu, 2014; Martin, 2012; Ma et al., 2011).

15 Three policy banks were also created: Vietnam Bank for the Poor in 1995 (renamed Vietnam Bank for Social Policy in 2002), the Development Assistance Fund in 1999 (renamed Vietnam Development Bank in 2006), and the Vietnam Postal Savings Service Company, a subsidiary of Vietnam Post and Telecommunications Corporation, in 1999. A smaller SOCB, the Mekong Housing Bank, was formed in 1997, but was later converted into a purely commercial bank (Rosengard and Du, 2009; Camen, 2006).

16 The remaining large SOEs were restructured into different corporate groupings called State Corporation 90 (created in 1990) and State Corporation 91 (created in 1991) and other economic groups which act as state-holding companies.

17 In 2003, the surrender requirement was reduced to zero from 30 per cent.

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