

# Aid and Growth: Reflections on the Experiences of Vietnam and China<sup>1</sup>

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## 1. Introduction

I suspect that my invitation to participate in this conference came about from the review I wrote of Jeff Sachs' best-selling book, *The End of Poverty*, which appeared in a recent issue of the Canadian Institute of International Affairs' *International Journal*. My review was more favorable than most other reviews I have seen written by economists, but it did nonetheless take issue with the main thesis of the book—that African developing countries are caught in a “poverty trap” and that a doubling of ODA to Africa would work to break the poverty trap and lift African countries onto the bottom rung of the “ladder of economic development.” Perhaps the penultimate sentence in that review was the one that clinched the invitation. It read: “one cannot but wonder how many other countries (like Vietnam) might benefit more, in the long-run, from being cut off from aid than from a substantial increase in it.” This of course is anathema, with everyone from Bono to Blair demanding substantial increases in aid to poor countries, in particular those in Africa.

Lest I be dismissed as naïve and uncaring before I even begin these brief remarks, allow me to mitigate. I don't dispute that the rich countries of the world can afford to increase ODA, maybe even meet the 0.7 percent of GNP target for ODA. I also believe that more *humanitarian aid* should be given to impoverished people in developing countries. What I do not agree with is the proposition put forth in Sachs' book, and by other advocates of the UN Millennium Development Goals (MDG), that a doubling of aid would serve to break an alleged poverty trap and launch self-sustaining economic growth in those countries that have not yet achieved it. My doubts about the effectiveness of foreign aid as a spur to

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economic growth derive from studying the literature on the aid-growth nexus and from my experience working and living in Vietnam and other developing countries, most recently three years in China.

If not foreign aid, then what has enabled developing countries to achieve self-sustaining economic growth? The fact is that most developing countries outside of Africa have gotten a foothold on the development ladder and have climbed, or are climbing, on their own out of extreme poverty. How did developing countries accounting for about two-thirds of world population manage to escape the poverty trap and get a foothold on the ladder of development without large amounts of foreign assistance? The answer can only be that they were not 'trapped' in poverty in the first place, but instead were victims of their own misguided and inappropriate policies. In one country after another, economic policy reforms have led to rapid industrialization, an acceleration of economic growth, declining poverty and rising prosperity. Nowhere is this more evident than in the experiences of China, India and, for that matter, Vietnam. What has been the key to their varying successes and what role has ODA played? I do not have the time here to answer that question, even if I could, but it might be useful to cite some of the recent literature on aid and growth and reflect briefly on the experiences of Vietnam and China.

## **2. Aid and Growth: Cross-country analysis**

There is a voluminous literature on the aid-growth nexus going back to the 1950s and 1960s when aid was first promoted as the panacea for poverty. That literature cannot be adequately reviewed here, but it might be useful to cite one of the more influential studies, one undertaken by the world's largest aid agency, the World Bank itself, the Burnside-Dollar study.

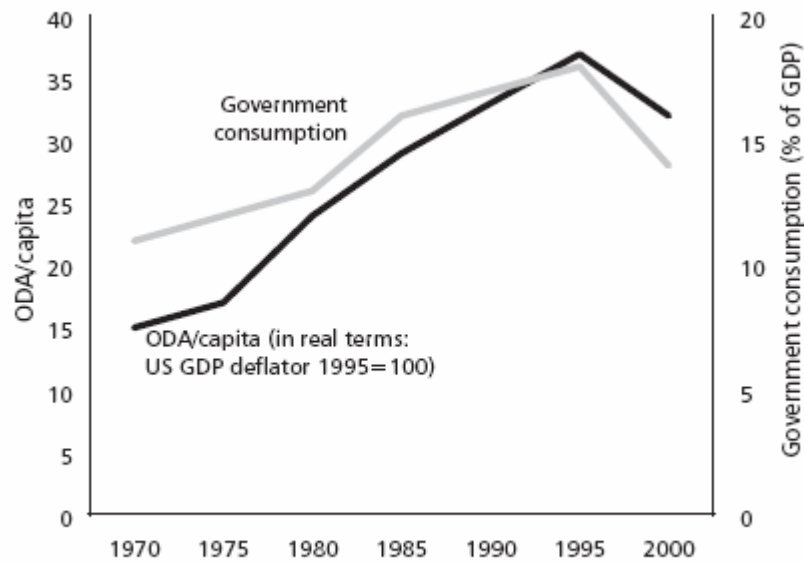
The main findings of Burnside and Dollar (2000) are:

1. No positive statistical relation between aid and growth, except in a sub-sample of countries with “good policies.” In other words, aid works only in countries that do not especially need it.
2. No positive statistical relation between aid and policy. This finding suggests that the premise of World Bank structural adjustment lending programs, that aid induces countries to adopt better policies, is false.
3. No statistical evidence that aid flows systematically to countries with “good policies” where, according to Burnside and Dollar, it might promote growth. Instead the allocation of aid is mainly determined by politics in donor countries (Alesina and Dollar, 2000).

Subsequent studies have challenged the Burnside-Dollar finding that aid works in countries with “good policies.” Easterly, Levine and Roodman (2004) and Rajan and Subramanian (2005-a and 2005-b) find that there is no robust association between aid and growth even in countries with good policies. These studies argue that while some aid has positive growth effects in the short-run, there is no discernable impact in the long run. In other words, aid has detrimental effects on growth in the long-run that offset the positive effects in the short-run. Rajan and Subramanian, both IMF staff members, provide two reasons for the detrimental effects of aid in the long-run.

1. *The negative effects of aid dependency.*
  - (a) Aid dependency induces countries to become lax in raising taxes and encourages government consumption, and hence leads to rising fiscal deficits that crowd out investment. (See Figure 1.)

**Figure 1: Aid and Government Consumption in sub-Saharan Africa  
(10 year moving average)**



Source: World Development Indicators Online

Taken from Erixon (2005), p. 11.

(b) They further argue that aid dependency allows governments to avoid accountability to the public, which has corrupting influence even on the best intentioned governments.

(c) Not mentioned by these authors, but evident in Vietnam, is that aid dependency leads governments to give priority to projects that attract aid funding and to avoid those that they would have to finance themselves, even when the social return on such projects may be as high or higher than on those that donors are willing to finance.

2. *The negative effects of aid-induced losses on international competitiveness*

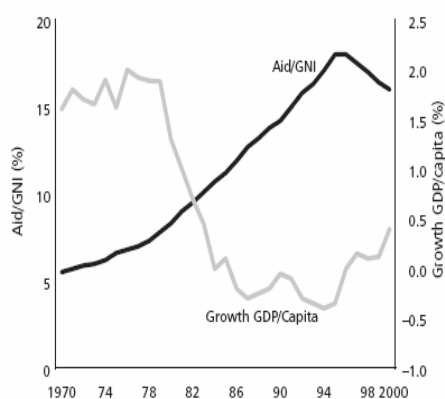
Rajan and Subramanian find that aid flows cause the nominal exchange rate to appreciate in countries with floating rates and can cause the prices of scarce resources to rise in countries with fixed exchange rates, both of which lead to real exchange rate appreciation and declining export competitiveness. This has a

deleterious effect on long-run growth because the export sector is a principal source of productivity growth in most developing countries.

### 3. The relation between aid and growth: the direction of causation

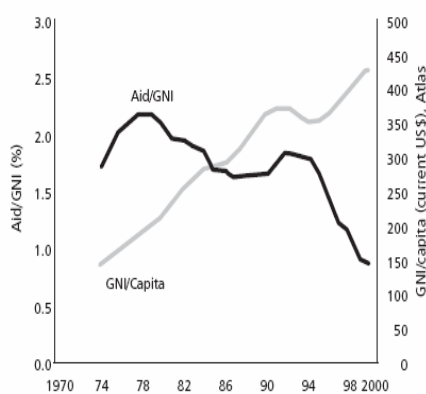
The relation between aid and growth in three major regions of the developing world is illustrated in Figures 2-4 below. The fact that it is negative everywhere does not, of course, imply that aid causes lower growth. The direction of causation could be the reverse, and indeed would be the reverse if aid were allocated on altruistic, humanitarian grounds. Countries with rising growth rates and income levels would get less and less aid, and those in economic decline would get more and more. The evidence suggests, however, that altruism is not the main determinant of aid flows. Indeed, Sachs and other advocates of higher levels of ODA make their case on grounds that increased aid will lead to growth, not on humanitarian grounds that more poverty should lead to more aid. I have no doubt that advocates of the MDG, including Jeff Sachs, are motivated by humanitarian concerns, but those are not the principal grounds on which they base their case.

Figure 2 Aid and growth in Africa (10-year moving average)



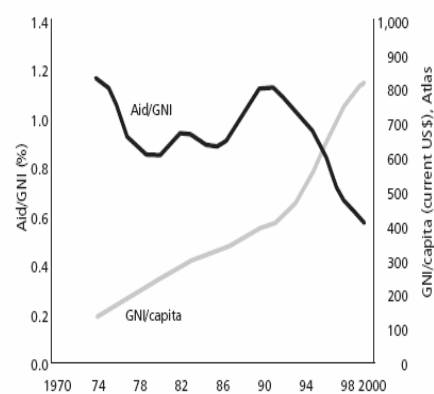
Source: World Development Indicators Online

Figure 3 Aid and GNI/capita in South Asia (5-year moving average)



Source: World Development Indicators Online

Figure 4 Aid and GNI/capita in East Asia and the Pacific (5-year moving average)



Source: World Development Indicators Online

Taken from Erixon, 2005.

#### **4. Aid, Economic Reform, and Growth: the experiences of China and Vietnam**

Economic reform inevitably faces political resistance and often is undertaken only when a major crisis threatens to topple the political status quo. The heavy costs of hyperinflation and the economic and political crises associated with it were necessary to force major structural adjustments and macroeconomic stabilization in Germany in the 1920s, Turkey in late 1970s, and Latin America in the 1980s and 1990s. Severe economic conditions at the end of the Great Cultural Revolution in China forced the Communist Party in 1978 to retreat from Marxist-Leninist ideology in favor of market-oriented economic reform in an effort to maintain the Party's power and regain popular support (Qian and Wu, 2000). When the growth effects of the early reforms in China began to wane in the late 1980s, China began to experience unprecedented social unrest, culminating in the 1989 Tiananmen incident. Fueled by the deteriorating economic situation and growing public cynicism about official corruption, the stage was set for a second round of reforms, even more dramatic than those in the early 1980s, that led the government in the early 1990s to abandon central planning and later in the decade to formally recognize the role of the private sector in China's constitution.

Vietnam is yet another case in point. The first fifteen years after the war ended in 1975 were a period severe deprivation in Vietnam. The growth statistics (based on socialist national income accounting methods and entirely unreliable) paint a bleak picture, but the reality was far worse. During the 1980s millions of Vietnamese risked everything, including the lives of their children, to escape the country. By the end of the 1980s, according to the World Bank, at least 80 percent of the population lived in extreme poverty and that is probably an underestimate. My own Vietnamese family probably would not have been counted in the 80 percent estimate, but family photos from that period show everyone as nothing but skin and bone.

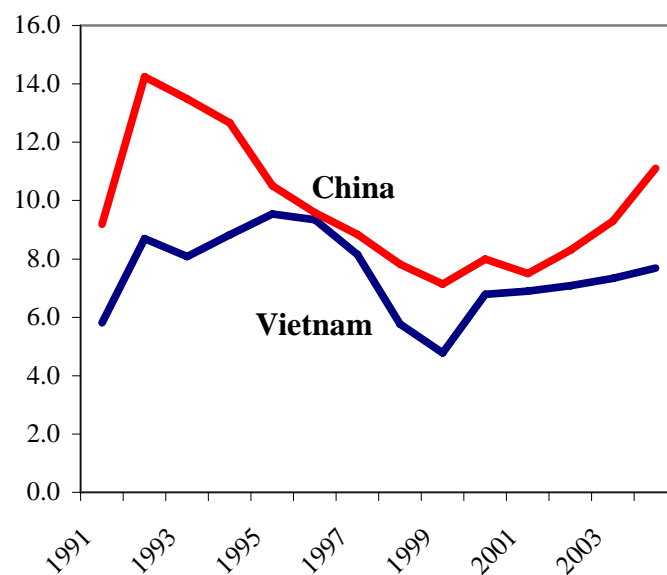
In the 1980s, efforts were made to repair Vietnam's socialist centrally planned economy, but none of the measures taken had a lasting effect. In addition, the 1980s witnessed a deterioration in macroeconomic stability, as inflation soared. With a major crisis looming, the Communist Party at its 6th Congress in December 1986 announced a change of course. Under the banner "*doi moi*" (renovation) the country would henceforth begin a gradual transformation from a centrally-planned to a "socialist market economy." Gradualism didn't work, however, and just two years later the economic situation had deteriorated further, with inflation reaching 400 percent in 1988/89. If that were not enough, the Soviet Union announced that its aid to Vietnam, which in the 1980s ran at about 10 percent of GDP, would be curtailed. With the U.S. economic embargo in place, Vietnam had no access to World Bank and IMF loans and received only a small amount bilateral aid, mainly from Sweden.

All alone in the world, with its back to the wall, Vietnam launched a sweeping set of structural adjustment and macroeconomic stabilization measures in 1989/90.

- To raise efficiency, the government eliminated the system of dual pricing and state procurement, giving farmers in particular an enormous boost in incentives. In addition, the exchange rate was unified and devalued, leading to a dramatic increase in exports.
- To stabilize the economy, government spending was cut by 6 percentage points of GDP, subsidies to SOEs were eliminated, real wages of public sector worker were reduced, and a half million military personnel were demobilized. As a result the fiscal deficit was eliminated, the growth of credit was declined and in short order the inflation rate came down from triple to single digits. Vietnam carried out, perhaps more successfully than any other country ever has, the orthodox IMF stabilization package, but without the assistance or financial resources of the IMF.

The rest, as they say, is history. After reforms taken in the early 1990s, both China and Vietnam experienced rapid growth, though China grew significantly faster, real GDP growth averaging almost 10 percent per year versus Vietnam's 7.5 percent. The gap between China and Vietnam in terms of per capita income growth is even greater because of China's lower population growth rate (per capita income growing at about 8 to 9 percent growth in China versus about 5 percent in Vietnam).

Figure 5: Real GDP Growth in China and Vietnam: 1991-2004 (percentages)

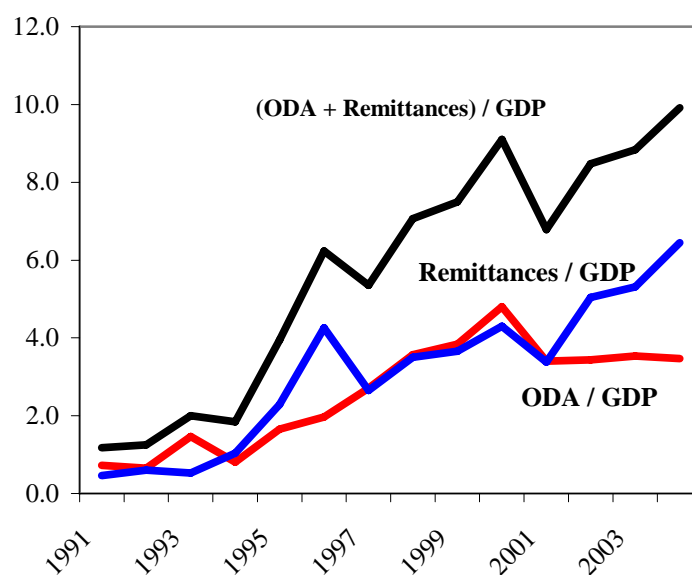


Sources: Vietnam: Government Statistical Office; China: China Statistical Yearbook.

In neither China or Vietnam, nor any other country that I know of, did aid play the role that Sachs and others propose that it play in Africa—breaking the trap of poverty and lifting countries onto the bottom rung of the development ladder. In the post-reform period, ODA to China has averaged only about 0.4 percent of GDP per annum, so whatever its contribution to China's superlative growth record it must have been relatively minor. In Vietnam, on the other hand, ODA as a percent of GDP averaged 2.6 percent per annum after it was resumed in the early 1990s. As a share of infrastructure investment, however, ODA accounts for almost half of total spending. Since infrastructure investment likely has a high

social rate of return and strong growth effects, the one-third share of ODA devoted to building roads and bridges has probably had a positive effect on growth, assuming that ODA-financed infrastructure investment in Vietnam would not have been otherwise undertaken by the government on its own, as it was in China and on a scale proportionately much greater than in Vietnam.

**Figure 6: ODA and Remittance Flows to Vietnam as percentages of GDP: 1991-2004**



Source: IMF (2005).

Even more significant than ODA has been the rapidly growing flow of remittances from the three million overseas-Vietnamese (*Viet Kieu*). Like ODA, remittances constitute an addition to resources and foreign exchange available for investment, but unlike ODA, remittances flow directly to people and not into the black hole of the government's coffers. It is likely, therefore, that remittances have made a more significant contribution to poverty reduction in Vietnam than ODA, since remittances are often received by lower-income households and used to improve their housing conditions, nutritional intake, health care, and

education, in addition to financing small businesses and creating employment (IMF, 2005, p. 40).

The experiences of China and Vietnam, and those of a lot of other developing countries, demonstrate that policy matters. Economic reforms that create and strengthen market institutions and incentives lead to higher growth, lower levels of poverty and rising prosperity. Since saving rates tend to rise with per capita income, economic reform can launch a country onto a virtuous circle, in which growth drives saving and investment and saving and investment drive growth.

What makes governments overcome political resistance and undertake wholesale economic reforms of the kind that China and Vietnam made in the early 1990s? History suggests that economic and political crises have often forced governments to undertake economic reforms that they might otherwise have avoided if the crises they faced could have been forestalled by, for example, an inflow of foreign aid. Would the Communist Party in Vietnam have abandoned the socialist centrally planned economy, so deeply rooted in its ideology, if foreign donors had been prepared to step in and bail the country out when the Soviet Union stepped out and cut off aid in 1990? Who knows? I rather doubt they would have, since the momentum of economic reform in Vietnam weakened after aid resumed following the normalization of relations with the United States (and with it the World Bank and IMF) in 1994. That is why I wrote in the Sachs review that “one cannot but wonder how many other countries (like Vietnam) might benefit more, in the long-run, from being cut off from aid than from a substantial increase in it.” I further noted, however, that the innocent victims of extreme poverty in Africa have no hope in the long-run, which is why aid flows for humanitarian purposes should be increased, even if the case for increasing aid to break an alleged poverty trap and launch self-sustaining growth is unconvincing.

Why is humanitarianism not sufficient justification for aid by those who advocate it? Why must the champions of aid base their argument on a premise for which there is at best weak empirical support and no historical precedent? Why isn't helping desperate people survive enough? If aid were directed toward humanitarian instead of growth objectives the resources required would probably not exceed the amount demanded to meet the UN's Millennium Development Goals, since much of the donor infrastructure would be redundant, as would the legions of aid experts and consultants that absorb hefty share of aid budgets everywhere.

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