

# IRRC

## F O R U M

A Periodic Record of Talks and Comments sponsored by the Information & Resource Center

## THE EAST GERMAN ECONOMY: BUSINESS OPPORTUNITIES AND RISKS

Rainer Veit

### A. Prospects and Problems of the East German Economy in the Years Ahead

#### Introduction

1. The political importance of what has happened since last November in East Germany has already been outlined: a dream come true, the German Question disappearing from the agenda of world politics, a decisive step towards the end of the Cold War.

In economic terms it is a challenge without parallel in the past: transforming a centrally planned economy into a modern market economy. Unlike the other East European countries, which are adopting a step-by-step approach, the change in East Germany was abrupt and severe. By introducing the D-Mark as the sole currency on July 1, the East German economy was plunged into unknown depths, namely international competition. An economy which was previously protected against competition by a non-convertible currency and government subsidies has had to compete against the rest of the world, especially West German companies, since July 1.

2. East Germany's present difficulties must be seen against this background. Production in industry and agriculture is declining sharply, unemployment is rising, traditional ties with East European trade partners are being loosened as they are mostly not able to pay for products from East Germany in hard currency.

However, these adjustment problems are no surprise. We both expected and predicted them. East German industry is over-dimensioned and must shrink appreciably; it currently accounts for 65% of GNP in East Germany compared with about 35% in West Germany. On the other hand, the service sector in East Germany is underdimensioned and underdeveloped with a share of 25% (West Germany: 56%). (Information on the structure of the East German economy and the shifts taking place in recent months is contained on pages 5-14 of our brochure "German economic and monetary union". It should serve as a guide to the East German economy.)

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## Introduction

On 28 September 1990 the Information & Resource Center organised a one-day seminar on "Penetrating the Eastern German Market Economy: Opportunities and Risks" in Singapore. The seminar was organised in cooperation with the Singapore Manufacturers' Association, Lufthansa German Airlines, the Deutsche Bank, and the Hanns-Seidel Foundation of Germany. Mr Rainer Veit, who was one of the speakers, gave 2 presentations which are both published here. He is the First Vice-President and International Economist of Deutsche Bank AG, Frankfurt.

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3. The decisive steps necessary to transform the previously centrally planned economy in East Germany into a market economy have been taken in recent months. These include the abolition of the former planning system, the introduction of private ownership of real estate and companies, including the privatisation of nationalised companies, the privatisation of the so-called Kombinate, (huge industrial conglomerates which consist of a large number of individual companies).

Although we expect initial adjustment problems in East Germany, we are surprised by the current very pronounced decline in production and employment in East Germany. Two factors are contributing to this:

- **First:** East German consumers now have a free choice of which things to buy for the first time in 45 years. The result of this is that they prefer West German and other imported goods, which they have seen on television and their previous rare visits to the West. They are avoiding their own products whenever they can, whether they can, whether they are cheaper than imported goods or not.

- **Second:** The competitiveness of East German companies is worse than expected. Roland Berger, a management consultancy company belonging to Deutsche Bank Group, examined 30 Kombinate. The results showed that without massive financial injections, not even one of these 30 Kombinate is competitive. This even applies to well-known companies such as Carl Zeiss Jena. Only heavy subsidies in the past enabled these companies to survive.

4. Where do the problems of East German companies lie? In which areas do they need help from experienced partners, including companies like ours and yours?

- Lack of experience in how to serve international customers, production techniques which lag far behind modern standards, total ab-

sence of office communication systems.

- Inefficient organisation, overdimensioned back-offices.

- Too great a depth of in-house production. Owing to the unreliability of deliveries, companies often manufactured their own primary products and spare parts as well.

- No management skills in sectors such as marketing, controlling, cost management. Do not forget that under the previous system profits or losses had nothing to do with competitiveness but were the result of centrally-fixed prices. Achieving a planned loss meant reaching the company's target.

- Equity was something unknown because government provided companies with the financial means they needed. Debts did not result from investments but were imposed on companies from above. Real estate was not an asset, since it belonged to the government.

I suppose this list of weak points in the East German company sectors explains why the present adjustment process is so difficult.

5. Apart from these problems, which have been inherited from the previous economic system, there are a few temporary problems to overcome.

First, I would like to mention the liquidity problems. Payment systems in East Germany do not yet exist in the form to which we are accustomed. Wages at most companies were paid in cash. Credit cards were unknown. This means that we have to build up payment systems from scratch. This will take time. Therefore payments from one town to another still take up to 3 or 4 weeks. We are, however, confident that these problems will be overcome in the next few months.

This will contribute to reducing the liquidity problems of East German companies. Since July, the authorities have been generously granting liquidity credits to East German companies, whether they were competitive or not. In future, the authorities will start to differentiate between companies which are currently in trouble but have a good chance of survival and companies which are more or less already bankrupt but kept alive artificially by liquidity credits which they cannot repay. Separating the losers from the winners in the way I described will be a crucial task.

6. The last problems I would like to mention here is the property problem. After the Second World War the communist regime in East Germany nationalised nearly all ex-

isting companies and a considerable proportion of real estate. Now, 40 years later, real estate and nationalised companies are to be given back to their previous owners or their inheritors. This is more difficult than it sounds. The previous owners have to prove their ownership, which in many cases is not easy. Inheritors are often not even aware that their parents used to own property in the East. The result is that restoring previous property rights takes time. In the meantime companies, houses and industrial real estate cannot be bought by investors. To solve this problem the German government, after unification on October 3, will have to look for a pragmatic solution, such as is offered by the unification treaty, namely that private real estate which is needed urgently for infrastructural purposes or to create new jobs will not be given back to its previous owners, but can be sold to investors or used in some other way. The owners of this real estate will, however, get financial compensation. This means that real estate which is needed to improve the infrastructure or to build new production facilities will soon be available to private investors without them having to find out beforehand who the owner is and whether he is willing to sell. Such a pragmatic approach to a crucial problem should help considerably.

7. The decisive point, however, is not the present difficulties but the question of how long the trough in East Germany will last and what will follow afterwards? Will the expectations of markets come true, which in the first few months after the opening of East Germany's borders caused West German stock prices to rise dramatically? And how much will this all cost?

To start with the latter point, it will cost a lot. Estimates of capital requirements in East Germany have continuously been revised upwards. Our latest estimate is DM 60 bn this year and nearly DM 100 bn next year. The bulk of this amount is made up of payments for people who have lost their job or are on short-time work. In addition, the West German government has to bridge the gap between expenditure and revenue in the newly-established health-insurance and pension schemes in East Germany. A considerable proportion of government deficits will, however, benefit private investors in East Germany in the form of tax credits, investment premiums, cheap credits etc. We will discuss this later on. West Germany is providing East Germany with billions of D-Marks in 1990 and 1991 to improve the in

frastructure, which is in pretty poor shape. Last but not least West Germany will have to pay DM 13 bn in the period 1991/1994 for the retreat of Soviet troops from East Germany in the years to come.

8. Since monetary union was offered to East Berlin in February of this year, international financial markets have been wondering whether West Germany can afford these high amounts. Our answer is that we can. Private capital formation is DM200 bn this year. The self-financing potential of our domestic bond market is DM 280 bn for 1990. On the basis of the above figure, unification will cost West Germany DM 1000 per capita this year and DM 1500 next year. We believe this is an acceptable price for unification.

9. Therefore, we do not expect German interest rates to go up much further. With yields of 9% nominally and 6% in real terms, risk premiums are already pretty high by German standards. The rise in government deficits in Germany (West and East Germany this year: 1990 at least DM 100 bn, next year 130 bn) is not the result of a lasting deterioration in German government finances but stems from a massive amount of jump-start financing to East Germans to help them overcome their present temporary adjustment problems and enter a growth path, which most likely will be steep. Then public deficits will start declining possibly considerably.

10. This brings me to the important question of when this upturns will start and what its growth potential will be.

The present downward trend of the East German economy will certainly continue into next year. The necessary adjustment in industry and agriculture will take time. We do, however, see a good chance of the East German economy passing its trough in the course of next year. Here we are trusting in a strong expansion in the service sector, the retail sector and especially in the building industry. These sectors have already started to pick up, as 150 000 newly-established small companies in East Germany show, from pubs and ice-cream parlours to service stations and gas stations for cars, consultancy firms etc.

In the course of 1991, the growth impulses from the service sector and the housing industry will become stronger than the dampening effects from industry and agriculture. The economy will then leave its downward trend and enter a growth path.

11. This growth path will be

steep between 1992 and 1995. We estimate an annual GNP increase in this period of between 7% and 10%. This strong expansion will stem from three main factors:

- firstly, the pent-up demand of East German consumers. At the moment they are only sparsely equipped with consumer durables. Only 50 % of them have a colour television compared with 94 % in West Germany. Only one in six households in East Germany has its own telephone. There are many products to which we have been accustomed for years which they have never even seen, such as microwave ovens, CD players etc. In other areas, prices in the past were ridiculously high; personal computers comparable to the very simple Commodore 64 used to cost 12 000 ostmarks. East German consumers will try to copy our Western standard of living as quickly as possible.

12. The second growth factor will be the high investment requirements for East Germany's infrastructure. You will have the opportunity of seeing the present state of East German telecommunications, the traffic system etc. for yourself during your visit there. The capital requirement for infrastructure projects over the next 8 to 10 years in East Germany is estimated at DM 500 bn. The emphasis will be on telecommunication services, traffic systems, the construction of sewage and effluent treatment plants and sewerage systems as well as the treatment of contaminated ground.

13. The strongest impulses for growth and employment in East Germany will come, however, from modernisation in industry and in the housing sector. It is estimated that the East German companies will have to invest more than DM 2 bn in both sectors during the 90s. We are confident that about half of the investment capital needed in industry will come from investors outside East Germany, whereas the amounts needed to build new houses and restore existing ones will be financed by domestic investors.

14. Taking the enormous pent-up investment requirements in industry, housing and the service sector into account, we do not exclude the possibility that growth rates in East Germany after its economic upturn will even exceed our forecast appreciably, in the first few years at least. Prior to July 1, productivity in East German industry was estimated to be 40 % of the West German level. Capacity utilization in East German industry was at that time 38 % compared with 90 % in

West Germany. If East Germany only succeeded in halving the productivity gap with West Germany between 1992 and 1995, so that at the end of this period it was achieving 70 % of West German figures, this would mean annual growth in East German productivity of nearly 20 % p.a.

This high productivity potential is also the main reason why we do not believe that the upswing in East Germany will be endangered by wage costs. Companies in Eastern Europe will be able to pay substantially higher wages once the economic upturn has started. The problem will be in the interim period 1990/91, when people will already be demanding higher wages in anticipation of future productivity growth.

15. You may be asking whether there are any previous examples of the steep upswing we are expecting in East Germany for the medium term. The answer is that there are. During the 50's, West Germany achieved average economic growth of 7 1/2 %, and Japan 8% p.a. Both countries at that time had to build up new production facilities to replace those which had been devastated or destroyed during the War. Both countries had the chance to apply the most modern technology, soon outperforming other countries in competitive terms. Although the situation in East Germany is certainly different in some respects, why should the same thing not happen again?

Let me stop there. I have tried to make a few remarks on the current difficulties in East Germany and its long-term growth potential. What this means from an investor's point of view will be the subject of my second presentation after the coffee break.

## B. East Germany As A Place To Invest: - Remarks From An Investor's Point Of View

1. How should we evaluate East Germany's growth prospects as well as the risks involved from an investor's point of view? The answers to this may well differ from those given from the viewpoint of an economist. The adjustment problems in East Germany and the costs related to this are a

major concern with respect to interest rates and public finances. From an investor's point of view they do, however, also have a positive impact. The greater the problems, the greater the willingness of government will be to grant additional tax incentives for private investment in East Germany.

I would like to concentrate on these questions:

- What is the attractiveness of East Germany from an investor's point of view, and what are the problems here?

- What about investment promotion in East Germany?

- Finally: what could be an appropriate investment strategy for a South-East Asian investor?

I do not intend to cover technical questions, for example whom to contact about business in East Germany. The reason for this is very simple: I am no expert here, whereas our colleagues who have been active in East Germany since spring can provide you with precise information. Therefore our Regional Head Office here in Singapore will transmit any question you might have in this respect to our people on the spot, who will hopefully be able to provide you as soon as possible with a reliable answer.

2. First question: What is the attractiveness of East Germany from an investor's point of view? I have already mentioned two important points, which I would like to repeat

- the pent-up demand of consumers,

- the huge need for investment in industry and housing.

There are additional factors which will benefit foreign investors

- East Germany has a sufficiently-trained and highly-motivated labour force. What they are still lacking is the ability to think in terms of a market economy. But they are learning quickly. The proportion of graduates from universities is comparable to West Germany and substantially higher than in other East European countries.

- Despite this year's wage increases, between 20 and 30 % of wage costs in East Germany per hour are still about 50 % lower than in West Germany. This gap will shrink in the years to come, but very likely not disappear in the first half of the nineties. Assuming the high productivity potential already mentioned, unit labour costs could well remain rather stable despite steeply-rising nominal wages.

- The East German economy has strong ties with the Comecon countries. The East Germans know Comecon markets better than we

do, they speak their languages. To prevent a total breakdown of trade relations with Eastern Europe after July 1, the West German government will spend more than DM 1 bn to subsidize export and import contracts between East German companies and partners in Comecon.

3. The greatest incentive for a potential investor in East Germany is, however, the prospect of East Germany becoming a powerhouse of Europe, possibly the Nr. 1 growth area in the single European market of the nineties. In three or four years' time East Germany will have the best equipment, the most sophisticated technology and markets expanding faster than anywhere else in Europe. Although the idea seems pretty premature for the time being, in the latter part of this decade West European growth will increasingly lag behind the more dynamic newly-industrialized countries of the present Comecon area. We might then be looking at them with the same mixture of envy and admiration with which Europeans have been following the impressive upswing in Singapore and other countries in South-East Asia in recent years.

4. Some of the problems and difficulties for private investors in East Germany have already been mentioned this morning, for example the poor condition of infrastructure and the lack of experience, even among managers, to think in terms of a market economy. Another problem which often puzzles potential investors is the considerable pollution; it is really shocking in some areas. The problem, however, does not lie with private investors, as the cost of cleaning up the environment does not have to be borne by them. Another obstacle is bureaucracy, left over from the old planning system. The impression of East Germany as a paradise for investors would be completely wrong. It is a pretty difficult market with a lot of traps. Owing to its market potential and its geographical position it is, nevertheless, a tempting prospect.

5. We are often asked whether the "East German cake" has not already been distributed among German companies. The answer is definitely "no". It is true that 95 % of joint ventures with East German companies have West German partners. But the bulk of these joint ventures are only promises, declarations of intent with little substance. Only a few spectacular investments in the banking, insurance and energy sectors in East Germany have so far taken place.

In addition, the West German ministry of economics and the

Treuhandanstalt, the organisation in East Berlin which has been entrusted with the privatisation of 8000 East German state-owned companies and which is run by Mr. Rohwedder, the head of the Hoesch steel group, are both looking demonstratively for non-discriminating potential foreign investors.

When the West German airline Lufthansa was planning a 26 % stake in the East German airline Interflug, the Treuhandanstalt officially intervened and blocked the deal. At the moment the Treuhandanstalt is negotiating with British Airways about a possible participation of this British company.

Other joint ventures have already been signed with non-German investors.

- Asea Brown Boveri has signed joint ventures with a power plant and industrial plant in East Germany. Sales in East Germany by the mid-1990s are estimated at \$ 1.2 bn.

- MEI Japan and Nissan Opto have invested \$ 50 mn in a joint venture for fax machines with Robotron.

- Lafarge Coppee has bought a cement factory in East Germany, thus investing FF 1 bn; another FF 1 bn investment in East Germany is planned for the coming year.

- Coca Cola is planning a \$ 140 mn investment in bottling and distribution.

- ICI is to produce nylon fibre in Thuringia, and L'air Liquide is to start industrial gas production in East Germany.

- Rupert Murdoch, the international press tycoon, has started printing and publishing together with a West German company in East Germany.

This list is, of course, not comprehensive. It does not include, for example, the Japanese investors who have spotted potential in the hotel sector and elsewhere. It shows, however, that there are not only good profit-making opportunities in the underdeveloped service sector in East Germany, but also in at least some industrial sectors.

6. Second question: What about investment promotion in East Germany? In your documentation you will find an overview of present investment promotion schemes in East Germany. Let me mention the most important points.

- The whole of East Germany will become a regional support area on October 3. Alongside an already existing 12 % investment premium for investments made in East Germany between July 1, 1990 and June 30, 1991, and an 8 % premium

until June 30, 1992, investment in East Germany will be promoted by as much as 33 %. This is more than in any other support region in Germany. This 33 % is, however, only available for investments made in East Germany before June 1992. After this, investment support will be reduced to 23 %.

- With regard to support for medium-sized enterprises, two measures currently being implemented will be continued: first, the special programme to promote the equity capital base of the self-employed and, second, the loans made under the European Recovery Programme (ERP). The latter funds are available for the purposes of founding new businesses, modernizing existing ones and to finance environmental protection measures. The volume of this so-called ERP programme will be increased from currently DM 6 bn to DM 7.5 bn for 1990, and from DM 1.5 bn to DM 6 bn for 1991.

- By virtue of the unification of the two Germanys, the Eastern part of the country will become eligible for all the economic support programmes currently available in West Germany, including any EC-sponsored programmes. East Germany will also have access to funds from the European Investment Bank both for the purpose of improving the region's infrastructure and for investments in its industrial sector.

- Another aspect of crucial importance to potential investors is that through December 1991, any buyer of an existing plant can apply for a waiver of responsibility for any environment damage caused by that enterprise prior to July 1, 1990.

With regard to the old debts of state-owned companies, the unification treaty will provide temporary relief during the current difficult adjustment phase. Payments on interest and principal for loans taken out prior to June 30 will be suspended until DM-based opening balance sheets have prepared for these companies. This task must be completed no later than the end of next February. Based on these opening balance sheets, decisions will be made by a case-by-case approach as to whether or not old debts should be forgiven, either in full or at least in part, or whether a company should receive financial support for a restructuring programme. An across-the-board write-off of all corporate debts is not likely.

What is the necessary procedure to qualify for financial support in East Germany? A company applying for investment promotion must

submit a reorganization programme which is based on a M-based opening balance sheet and a detailed business plan. The proposals must include information on how the intended measures will help restructure product output, renew the capital base and streamline the entire operation so that it will be competitive in the marketplace. The documents submitted by the formerly state-owned enterprises will be evaluated by the Treuhandanstalt.

7. The last - and possibly most important - question is what would be an appropriate strategy for the East German market? The answer to this depends, of course, on what you are looking for.

Most foreign investors, whether from West Germany or elsewhere, have so far been approaching the East German market cautiously. Before starting production there, the prime intention was usually to serve the market with products. The priority here was therefore to construct service networks and sales organisations in East Germany. This is in line with past experience, which shows that it is usually best to supply a market first before actually starting production there. This second phase has, however, already started, as the above examples show.

To recommend certain sectors of the East German industry for private investors is tricky as we still know too little about them. The best prospects seem, however, to lie with the following industrial sectors

- petrochemical industry
- scientific equipment making
- machine tool industry
- curtain and lace production
- manufacturing of sporting guns
- fine ceramics
- china
- shipbuilding
- polygraphic industry (print machines)

In the service sector, however, the situation is different. Most products here are still underdeveloped or in a pretty poor condition. This applies to a broad range of services in banking, insurance business, sectors such as publishing and tourism. The attractiveness of this part of the East German economy is therefore greater than in industry, agriculture or the energy sector. I mentioned already that some services to which we have been accustomed for some time do not yet even exist in East Germany, for example consulting, catering, leasing, and software companies.

8. Even in these cases, the East German market must be examined thoroughly. The supply of new or better services must take place parallel to the demand for such ser-

vices. It would make no sense to provide the East Germans with products or services which they will neither want to nor be able to pay for. To give just one example: East Germany's hotel sector does not need luxury suites or golf courses. What is urgently required is middle-class hotels with a bath or shower in each apartment - which is still the exception today - and with a pleasant, friendly restaurant downstairs. Most hotels in East Germany are not very pleasant or friendly, are rather impersonal and expensive, and staying there is often boring. Once shops and offices are closed there is little to do in the evenings - no cable TV in hotel rooms, no bars or discos to go to, no cinemas to watch a movie. I am pretty sure that you will find plenty of niches for doing business in East Germany.

9. Besides tourism, financial services and consulting, I could imagine that there are two closely interrelated sectors of the East German economy which will expand rapidly, as they provide people with services which they have lacked in the past.

The first sector consists of services for private households such as laundrettes, tailors, shoe-repair services, garages and carwashers as well as all sorts of craft services.

The first sector consists of services for private households such as laundrettes, tailors, shoe-repair services, garages and carwashers as well as all sorts of craft services.

The second sector has to do with housing. As result of the immense pent-up demand for renovation, rents still being frozen and about a quarter of the labour force having to stay at home for at least a few months during the present adjustment phase, the bulk of modernisation and renovation in housing will be carried out by the owners or tenants of houses and apartments. Therefore DIY stores and other supermarkets selling building materials in East Germany can look forward to profitable times here. In addition, producers of building such as carpets, plastic window-frames, wallpaper and paint will benefit from the forthcoming boom in renovation. It might, however, be already too late to enter such markets, as these market segments have been explored for months by West European companies. Production facilities for plastic window-frames, for example, are springing up everywhere.

10. Whether a South-East Asian investor should approach the East German market with a fully-owned subsidiary there, via joint ventures

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or indirectly by taking, for example, a stake in a West European company doing business in East Germany depends on the specific circumstances in each individual case. I'd therefore like to refrain from making any recommendations.

Ladies and gentlemen, the single European market is only two years

away. If you are thinking of getting a foothold in this dynamic market, East Germany might be a good place to start.

"East Germany stands as one of the world's most promising markets for foreign investment during the 90s. It will undergo one of the most rapid economic expansions in modern history. The next 6 to 12 months are a window of oppor-

tunity for investors to lay the base for participation in one of the world's most promising growth markets in the 90s." These are not my own words, but quotations from a brandnew study compiled by Salmon Brothers. Unlike me this well known American investment house can certainly not be suspected of speaking pro domo. So if you don't believe me, just believe them.

## Information & Resource Center

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