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The Vietnamese Economy
Seven Years after the Global Financial Crisis

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Seven years after the Global Financial Crisis of 2008, concern with the Vietnamese economy has shifted from short-term issues of inflation and balance of payments to prospects for medium- to longer term economic development. After several tumultuous years, macroeconomic stabilization has been achieved, but growth is significantly below trend, and is heavily dependent on manufactured exports. State-led industrialization has, inter alia, resulted in a lack of "industrial deepening" as well as a low employment-output elasticity. Deep structural reforms, particularly in the financial sector, state-owned enterprises, and public finance and investment are necessary to lift Vietnam's longer term growth and to provide employment for its relatively young and growing population. Strong political leadership is needed to resist the influence of vested interests. Vietnam is indeed at the crossroads of taking action to join the ranks of the high-income industrialized economies of East Asia in the future or remaining mired in low middle-income status.

Keywords: Structural reforms, industrialization, employment, conglomerates, vested interests.

1. Start of the Global Financial Crisis

At the last ISEAS country-focused publication on Vietnam in April 2009 (*ASEAN Economic Bulletin* vol. 26, no. 1), the global economy was in crisis. Lehmann Brothers had crashed in September 2008, and there was concerted effort on the part of developed and developing countries to stimulate their economies and to keep open channels of world trade and finance. In that publication, the predominant concern was how to sustain the growth momentum in Vietnam in the face of deteriorating external conditions (Das and Shrestha 2009; Pincus 2009). At that time, Vietnam's medium-term prospects seemed brighter than for many other developing countries. It had just entered the "demographic window" when the proportion of working-age population exceeds the proportion of children and elderly people so that, for about the next thirty years, there would be an increase of labour supply in the country (Menon and Melendez-Nakamura 2009). Furthermore, given the generally positive social indicators,

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Vietnam could look forward to a growing workforce that is healthy and literate compared with other developing countries in the region and in the world. Indeed, during the initial phase of the Global Financial Crisis (GFC), Vietnam posted GDP growth of over 6 per cent, higher than most other countries in the region.

Admittedly, there were warning signs. The financial sector outside the banks was severely under-developed, and within the banking sector, large state-owned Economic Groups — which are conglomerates of large SOEs and their subsidiaries — had opened banks which, in the experience of other countries, would lead to imprudent inter-related lending within the conglomerates, and eventually to financial instability (Leung 2009). The challenges associated with surges in foreign direct investment (FDI) and the resultant infrastructure bottlenecks and inflationary pressures were identified (Tran 2009; Menon 2009). Furthermore, state-led industrialization was found to have had little positive impact on the growth of Vietnam's labour-intensive manufactured exports (Athukorala 2009). Nevertheless, the concern at that time was essentially short term and macroeconomic in nature; that is, Vietnam's ability to cope with the challenges generated initially by the euphoria associated with its entry into the World Trade Organization (WTO) in 2007, and then the expected fall in exports and FDI resulting from the GFC which hit in the third quarter of 2008.

2. Developments to Date

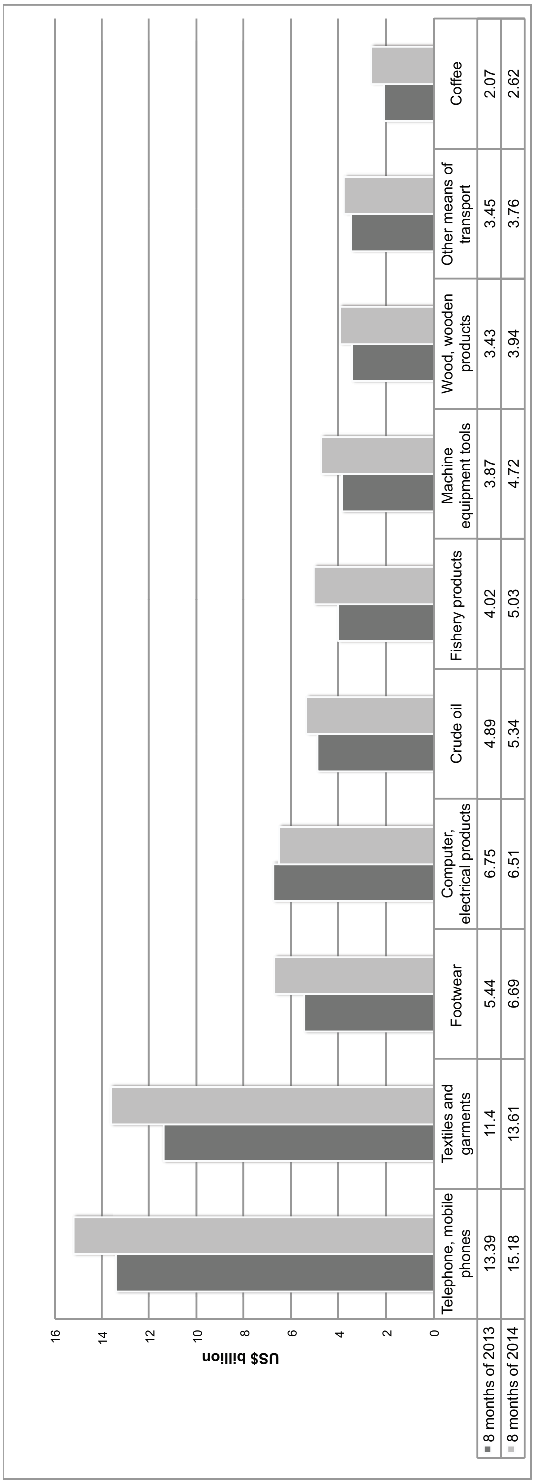
The failure of macroeconomic policy-makers in Vietnam to wind back the stimulus package in time, in addition to regulatory failures over the Economic Groups, resulted in the worst bout of macroeconomic volatility since *Doi Moi*. Stability did not return until 2012, leaving a legacy of bad debts which has plagued the economy and reduced domestic demand to this day (for a detailed discussion, see the next article in this issue by Sanjay Kalra).

Fortunately, export demand has been buoyant in recent years, boosted to a large extent by Vietnam's participation in the electronic parts and components trade. Export of mobile phones and parts in the first eight months of 2014 is valued at US$15.2 billion, surpassing even the export of garments valued at US$13.6 billion for the same period, and growth of some 10 per cent year-on-year indicates that this trend is continuing. See Figure 1.

Indeed, in the past seven years since the outbreak of the GFC, Vietnam has had an influx of FDI from multinationals in the electronic and related "hi-tech" industries which linked the country to the production networks of East Asia, and significantly transformed its export pattern (Bingham and Leung 2010; Athukorala and Tien 2012). Figure 2 shows that the export of electronics and related parts and components in 2013 has grown to over 34 per cent of Vietnam's export basket, compared with less than 4 per cent a decade earlier.

The foundations for this growth were laid in the structural reforms in the early part of the 2000s. As multinational enterprises are essential to participation in these production networks, regulatory changes which freed up the domestic private sector and which leveled the playing field to a certain extent between the foreign firms and domestic firms were important in encouraging the entry of multinationals such as Intel, Samsung and Nokia.[1] Furthermore, lowering the costs of communication, transport, electricity and other costs associated with doing business away from one's home-country (the so-called "service link" costs; see Kimura 2006 and Baldwin 2006) also added to Vietnam's attraction, in addition to low labour costs for foreign multinationals. In 2002, the charges for international phone calls, container transportation and electricity in Hanoi and Ho Chi Minh City (HCMC) were amongst the highest in East and Southeast Asian cities, even though the labour costs were (and still are) relatively low. However, by 2006, these costs of doing business in Vietnamese cities were lowered and became comparable with other Asian cities (see Figure 11.15 to 11.20 in Leung 2012).

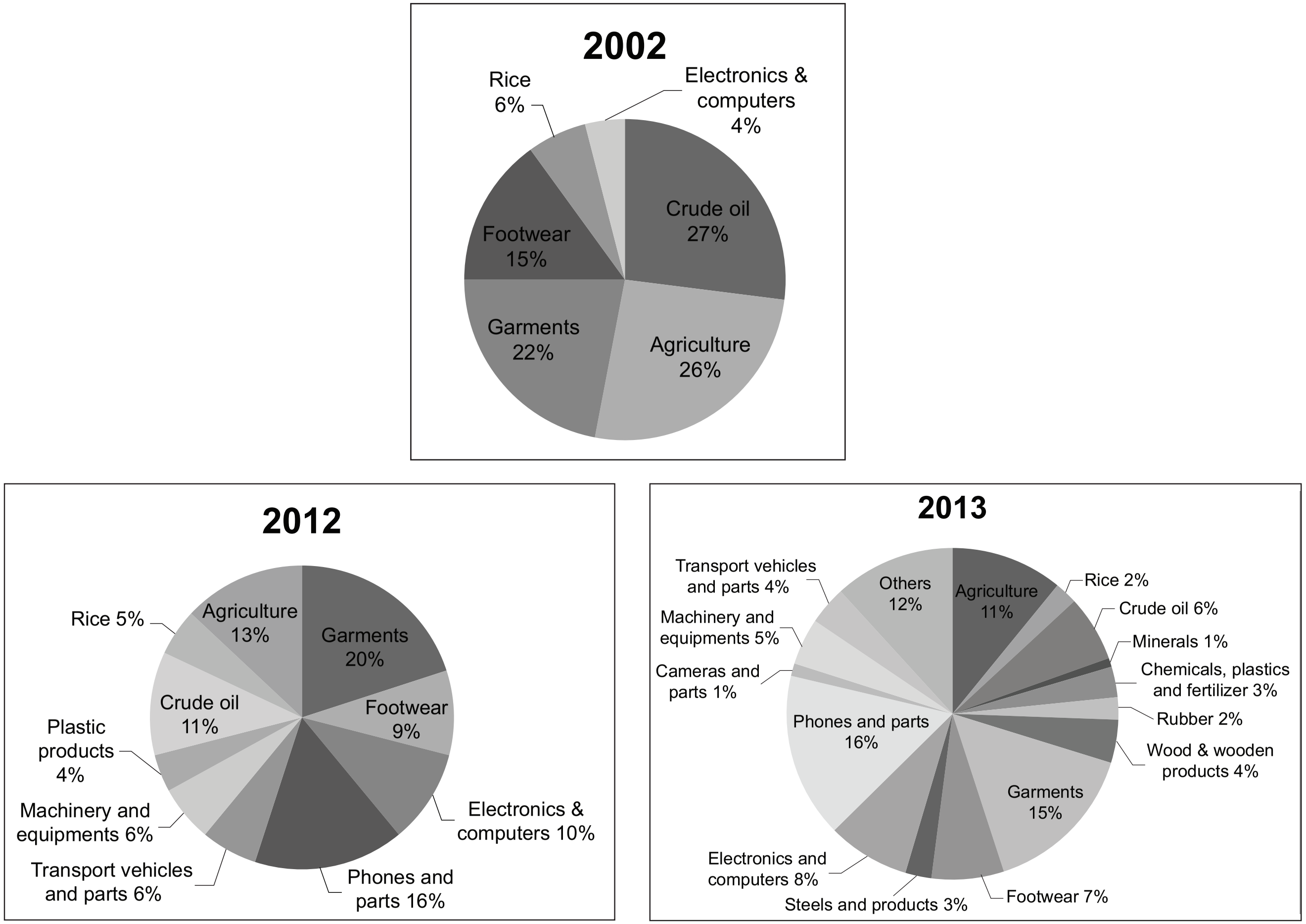
FIGURE 1
Changes in Vietnam's Exports (2014 vs. 2013)



	Telephone, mobile phones	Textiles and garments	Footwear	Computer, electrical products	Crude oil	Fishery products	Machine equipment tools	Wood, wooden products	Other means of transport	Coffee
8 months of 2013	13.39	11.4	5.44	6.75	4.89	4.02	3.87	3.43	3.45	2.07
8 months of 2014	15.18	13.61	6.69	6.51	5.34	5.03	4.72	3.94	3.76	2.62

SOURCE: General Statistics Office (GSO), Vietnam.

FIGURE 2
Changes in Vietnam's Exports Basket



SOURCE: General Department of Customs.

3. Medium-term Prospects

Having attracted the multinationals, however, it is crucial that Vietnamese firms are able to link up with, and provide supporting services to, foreign-invested firms if Vietnamese workers are to benefit from jobs that have prospects of security and increasing standards of living. The concern, therefore, in this volume is more with prospects for *medium-term economic development*, addressing questions such as how to raise and then maintain Vietnam's productivity and growth rates for long periods into the future (see especially articles by Pincus, Vu and Pham in this issue).

The lack of "industrial deepening" is apparent in Vietnam and poses a serious barrier to long-term growth. Despite being the fastest-growing exporter of mobile phones and parts in recent years, very few Vietnamese firms are suppliers to Samsung and other multinationals in this sector. For instance, screws and plastic casings for mobile phones still have to be imported as they are not produced by domestic firms. In Vietnam's second largest exporting industry, namely garments, the lack of supply of both quantity and quality textiles is identified as one of the major constraints to future development, as reliance on imported fabrics from China does not give garment producers the flexibility to respond quickly to changes in international fashions (World Bank "Trade Facilitation Report" 2013). During 2014, this dependence on imported textiles also exposed the industry to political risks as political tensions rose between China and Vietnam over issues in the South China Sea. Yet, the state sector has been significant in the production of textiles in Vietnam (see Table 1). Removing state firms from activities that are purely in the private domain will help in developing backward linkages in the garment industry, and reduce reliance on the import of textiles and fabrics.

Ongoing negotiations related to the Trans Pacific Partnership (TPP) agreement should help in this regard. As part of the substantial economic benefit summarized by Vo Tri Thanh in article number six of this issue, implementation of the TPP (which includes Japan and the United States but excludes China) would mean not only significantly increased access of Vietnam's garment export on a tariff-free basis to a very much larger market, but the rules of origin would provide an incentive for businesses to invest in

TABLE 1
Share of SOEs in Revenue and Output by Sector

Sector	*Share of total revenue (%)*	*Share of total output (%)*
Telecommunications	91	—
Insurance	88	—
Water transport	57	—
Construction	26	—
Fertilizer	—	99
Coal	—	97
Electricity, gas, etc.	—	94
Water supply	—	90
Cement	—	51
Beer	—	41
Refined sugar	—	37
Textiles	—	21
Steel	—	21

Source: Lim (2014), p. 56.

Vietnam's upstream textiles sector. Competition rules associated with the TPP would also limit the scope of state-owned enterprises (SOEs) in upstream industries and tip the balance in favour of small and medium-sized firms (SMEs). No doubt, these considerations would have led to the decision to sell the conglomerate Vinatex, together with its 120-plus subsidiaries in September 2014 (see section 5 on state-led industrialization below in this paper).

Case studies of the garment, footwear and electronics industries have all found that lack of finance is a constraint to SMEs and start-ups, leading to a lack of development in the supporting industries in these sectors. This seems to be a worldwide phenomenon in developing countries, and government-funded development banks have been used to address this issue (for example, in some Latin American countries notably Brazil and in South Africa).[2] In the case of Vietnam, simply removing the regulation (allegedly for prudential reasons) that banks are to lend only to firms with a proven past history of operations would open the way for funding start-ups. This is not to say that bank managers necessarily have the skills or the risk preference for lending to start-ups and SMEs, particularly when they can make more profitable and secure loans to SOEs. But building a strong and commercially-oriented banking sector with greater competition amongst banks would encourage bank lending to all productive enterprises, including SMEs.

Furthermore, appropriate skill levels are a definite "must" in industrial development. However, skills are not synonymous with education. Vietnam has a large number of universities producing graduates of varying qualities who could well experience a skills mismatch with the requirements of industry.[3] Ongoing reforms of government expenditures and finances would, hopefully, result in additional public resources available for investment in skills development. However, that is a long-term goal and may not, in the end, produce the required types of skills at the appropriate levels.

Some governments (for example, India) have therefore chosen to play a coordinating role, bringing together multinational corporations, the domestic private sector, and training institutions in an attempt to align current and future industry needs with skills development. A relatively high quality of public administration is needed to be successful in this coordination role. At the very least, all stakeholders must be confident that the government officials and bureaucracies involved would be corruption-free, and committed to the stated objectives of the exercise. As this type of operation could be quite long-lasting, periodic project evaluation is necessary to avoid "capture" by particular interest groups. The outcomes of the Indian experiment could provide useful lessons for Vietnam.

It is clear that in the medium-term, reliance simply on low-cost labour and regulated prices of state-owned utilities in telecommunication, shipping, ports handling and other logistics costs would not be sufficient to stay competitive in modern-day manufacturing. Continued structural reforms in SOEs, the banking sector, and in public finance and investment are necessary to enable Vietnam's private firms to flourish and move up the value chain in manufacturing.

Indeed, as pointed out by Jonathan Pincus in article number three of this issue, just as in the case of rice, coffee, garments, footwear and other labour-intensive exports from Vietnam, the failure to improve quality and to move up the value chain is a self-limiting growth model (the so-called "vent for surplus" model) which stops well short of enabling Vietnam to become a high-income country through successful industrialization in the footsteps of the Asian Tigers of Taiwan, the Republic of Korea and, of course, Japan in an earlier era. Furthermore, Vu Minh Khuong in article number four of this issue points out that whilst total factor productivity growth (TFP) in Vietnam was robust in the decade 1990 to 2000, TFP dropped significantly in the following decade (2000 to 2010), despite a substantial increase in capital investment. It is obvious that wasteful investment spending on the part of SOEs and the government was responsible for the fall in productivity in the last decade. The need, therefore, for deeper regulatory, institutional, and other structural reforms *à la* China currently, is important and pressing for Vietnam to lift and then sustain high rates of growth into the medium-term future.

In addition to industrial development, there is a further reason for the reform of state finances. Figure 7 in Sanjay Kalra's paper shows that fiscal balances as a percentage of GDP have been in deficit since 2007 and have been rising in recent years. The fiscal deficit is estimated to be around 6 per cent of GDP again in 2014, resulting in a projected level of public debt equal to about 55 per cent of GDP (IMF Staff Report 2014).

Admittedly, the bulk of Vietnam's foreign debts are long-term concessional aid funds and, hence, quite stable. However, since the development of the domestic bond market about six years ago, 94 per cent of domestic bond issuance has quite short maturities — less than seven years. Worryingly, agencies other than the Ministry of Finance are allowed to issue bonds with maturities exceeding only one year. As Pincus points out in his paper, fragmentation of the state and the apparent inability of the central government to impose discipline over provincial governments working with some large SOEs is proving to be a hurdle for *effective* implementation of SOE reforms. Vu's paper also argues that decentralization in Vietnam, with some 90 million people and 63 provinces, has led to duplication of infrastructure and wasteful government spending. Such fragmentation could also have serious macroeconomic consequences. In a world of rapid and sudden movements in international capital, fickle investors can attack a currency quite relentlessly. Vietnam has improved its levels of international reserves and stabilized its exchange rates in recent times, enhancing its external buffer against sudden changes in investor sentiments. Its domestic buffer (in the form of sound government finances and sustainable levels of public debt) also needs strengthening in the medium-term (see Kalra's paper).

4. Structural Reforms

It is important to note that the deep structural reforms proposed are very different from earlier industrial policies of "picking winners". Without significantly better public administration in Vietnam, targeted programmes (for example, in the form of special loans from "development banks" or specifically targeted skills training, and so on) could well add to the already substantial rent-seeking activities of the state-owned conglomerates discussed later in this paper. Indeed, a more market-oriented and commercial banking sector, a much more productive state sector, and more efficient public finance and investments would help promote industries in which Vietnam has a comparative advantage. This, as argued by James Riedel (article seven of this issue) and substantiated empirically by the study by Thi Thu Tra Pham (article five of this issue), still lies in cheap labour, and that pursuing industrialization in labour-intensive exports could still bring rapid economic growth through improved productivity at the firm level. Furthermore, Vo Tri Thanh's paper emphasizes the very large growth potential from the conclusion of various regional trade agreements such as the ASEAN Economic Community, the Regional Comprehensive Economic Partnership (RCEP) agreement (ASEAN plus China, Japan, Australia, New Zealand and India), and particularly the TPP. Indeed, Pincus himself admits that the "vent for surplus" model could still have quite a way to go for Vietnam.

5. State-led Industrialization

Unfortunately, it seems that the leadership had chosen to pursue a solution of state-led industrialization rather than to rely on Vietnam's own private sector. After more than twenty years since the start of SOE reforms in Vietnam, the state sector still plays a dominant role in industry, particularly in upstream service activities such as telecommunications, transport and electricity which crucially determine the cost base for many downstream industries such as garments, footwear and electronics (see Table 1).

It is now becoming obvious that the formation of large Economic Groups in 2006 is having a deleterious impact on the economy. In theory, these conglomerates were supposed to emulate the *chaebol* of South Korea. However, the *chaebol* were privately owned and not state-owned, and they were under very strict conditions to develop brand names (such as Samsung) to compete in the *international* market. Instead, conglomerates in Vietnam were given monopoly power to exploit the *domestic* market. The paucity of regulation meant that the conglomerates quickly focused on short-term profits in areas such as real estate and finance rather than concentrating on their core activities of shipbuilding, ports management, electricity generation and supply, and other areas of heavy industry. The burst of the asset bubbles in 2008–09 has therefore left the Vietnamese economy with a legacy of bad debts and corporate failures, reducing economic growth to between 5 and 6 per cent per annum instead of an average of 7.5 per cent per annum in the decade prior to 2008 (for detailed analyses, see articles by Kalra, Pincus and Riedel in this issue). The government has now acknowledged that over half of the bad debts in the banking sector resulted from the activities of the conglomerates.

State-led industrialization has a further negative impact on the Vietnamese economy; namely, output growth that does not generate a great deal of employment growth. SOEs in capital-intensive heavy industries do not generate much employment directly, as they add only around 9 per cent to employment growth (Lim 2014). However, they consume a large proportion (some 38 per cent currently) of capital investment and most of the bank credit, thereby depriving the domestic private sector of capital. Yet it is the domestic private sector (the SMEs) that is the employment generator. Hence, SOEs indirectly are negative as far as employment generation is concerned. Indeed, David Lim (2014) estimates the employment-output elasticity for Vietnam to be only between 0.25 to 0.36 — below the average for Southeast Asian countries of 0.39 and 0.42 (ADB 2006).[4] Hence, even if the target 8 per cent per annum growth were to be attained, this would add only between 0.86 million to 1.25 million jobs per annum, below the 1.6 million new jobs needed to keep the growing labour force employed (Lim 2014). Furthermore, as we have seen earlier, output growth in recent years has been between 5 and 6 per cent, and is unlikely to exceed this range without significant structural reforms. The growing pressure on employment and the implications for the legitimacy of the one-party rule must be forefront in the minds of policy-makers in Vietnam.

In recent months, there does seem to be some move (albeit cautiously) to ramp up SOE reforms. In April 2014, the government listed 127 national projects calling for foreign investment before 2020. Foreign ownership is to be increased from 49 per cent to 60 per cent.[5] The enterprises within the state-owned Economic Groups are permitted to sell non-core assets (which are considered state assets) at a book loss, and the Prime Minister has announced 432 SOEs to be equitized by 2015. Judging by the relative lack of interest in the Vinatex initial public offering (IPO) in September 2014, and despite prospects of regional trade agreement outcomes being favourable to Vietnam's garment exports, there is some doubt that this more rapid pace of privatization is actually achievable.[6]

6. Political Economy of Structural Reforms

Structural reforms are notoriously subject to influence by vested interests, and Vietnam is no exception. Reports becoming available regarding investigations into the failed activities of Vinashin (the state shipbuilding conglomerate) and Vinalines (the state shipping and ports authority conglomerate) reveal gross mismanagement and malfeasance (see Pincus, this issue and Harvard Asia Programs 2008 for examples of malpractice in conglomerates). Increasingly, therefore, questions are being raised about the political will of the government to make the needed structural reforms in such a way that benefit the economy rather than powerful insiders.

Pincus' paper points out the fragmentation of state authority, and argues that a concerted change in personnel management within the Communist Party of Vietnam is needed in order for SOE reforms to be truly effective in benefiting the economy. At the same time, Riedel's article stresses that the development of economic institutions can bring a country such as Vietnam quite a long way

— in fact, to middle-income status. Beyond that, sound, market-friendly and non-extractive political institutions are needed for continued development into a high-income economy.

Vietnam therefore does appear to be at crossroads. The government can decide on the next "*Doi Moi*" of deeper institutional and structural reforms, and conditions associated with the various regional trade agreements — in particular, the TPP — do give the government support in this regard. Or the government can carry on "business as usual". However, once the "contradiction" between protecting the state sector to the benefit of powerful vested interests and the need to provide jobs and raise the living standards of the growing population is understood, the choice seems eminently clear. It is hoped that this country focus issue adds to such understanding.

NOTES

1. The Enterprises Law 2001 and 2006 helped free up the domestic private sector whilst the Unified Investment Law 2006, and the various agreements associated with Vietnam's entry into the WTO in 2007, helped level the playing field for foreign firms. However, the large SOEs were, and still are to some extent, protected.
2. On average, the share of bank loans for working capital to SMEs in Vietnam appears to be relatively higher than in Argentina, Brazil, Chile, Colombia, Mexico, Indonesia, Cameroon, and Bostwana, although the share of bank loans for fixed assets (that is, long-term lending) is very much lower in Vietnam than in these other countries (OECD 2013, Figures 6.5 and 6.6).
3. It is well known that in 2009, only 40 out of some 2,000 graduate applicants passed Intel's qualifying test to work in its first microchip plant.
4. Admittedly, with high proportions of employment in the informal sector, the employment-output elasticity is a less than ideal measure. However, it is still meaningful to compare Vietnam with Indonesia where the employment-output elasticity in manufacturing is estimated to be between 0.3 and 0.5 (communication with Dr Christopher Manning, Australian National University, November 2014).
5. Still not passed by the National Assembly at the time of writing.
6. Vinatex, with some 120 subsidiaries, failed to sell all its shares at the IPO, and 51 per cent is still held by the state. Vietnam Airlines had a partial sale in November in which no bids came from foreign investors and the shares were bought by two Vietnamese banks.

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