Central Institute for Economic Management

Lee Kuan Yew School of Public Policy
Asia Competitiveness Institute

National University of Singapore

Vietnam Competitiveness Report

2010

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All views and opinions expressed in this report remain the sole responsibility of the authors.

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FOREWORD

The year of 2010 marks an important milestone in the transition between the two decades of Vietnam's socio-economic development. The last ten years have witnessed the country's robust economic growth, improved living standards of the population, and most significantly, the deep integration into the global economy, turning Vietnam into an emerging attractive business location. Yet the economy is facing internally-rooted weaknesses and challenges, reflecting in its low competitiveness in different aspects. Moreover, rapid and complex changes in the external environment are affecting Vietnam's open economy in increasingly significant ways. All of these conditions and factors remind of and emphasize the crucial importance of redefining strategic directions and a growth model for Vietnam in the new stage of development, with competitiveness and sustainability being put at the heart.

In this context, the development and release of the Vietnam Competitiveness Report 2009 – 2010 are very meaningful in providing important and useful input for the Vietnamese Government and business leaders in their decision making. This is the first ever national report which provides comprehensive assessments of Vietnam's competitiveness in different aspects and at different levels, from both microeconomic and macroeconomic optics. The Report was developed independently and objectively by researchers and experts of the Asia Competitiveness Institute (Singapore) and the Central Institute for Economic Management (Vietnam), under the technical guidance of Prof Michael Porter of the Harvard Business School.

My hope is that this Report will lay an important stepping stone for Vietnam to conduct regular national competitiveness assessments and to implement rigorous action initiatives and programs at both the Government and the firm levels to upgrade the country's competitiveness and successfully achieve its ambitious development goals over the next decade.

Hoang Trung Hai
Deputy Prime Minister
Vietnam

FOREWORD

Over the last two decades, Vietnam has embarked on a remarkable journey. From being a closed and centrally controlled economy, the country has become a vibrant part of the global economy. This process has brought significant benefits to many Vietnamese citizens. Average prosperity has risen and poverty rates have fallen significantly.

Vietnam is now ready for the next chapter in its economic development. On this new path, the country will face new and complex choices in order to build the foundations of greater prosperity as well as to consolidate the achievements made so far.

The Vietnam Competitiveness Report (VCR) provides comparative data, analysis, and concrete proposals to help Vietnamese decision makers as they chart their country's future path. In my discussions with Vietnamese leaders, I have always been struck by their willingness to learn from outside perspectives. The Vietnam Competitiveness Report provides a comprehensive analysis that provides essential inputs towards an economic strategy that builds on international experience and addresses Vietnam's specific situation. The Report provides an in-depth analysis of the forces that have been driving Vietnam's growth thus far, and the key issues that the country now needs to address to continue and accelerate its development.

Vietnam is approaching an important transition point from economic growth based on tapping into the country's existing comparative advantages to growth based on upgrading its competitiveness building increasingly sophisticated competitive advantages. The Report identifies specific policy recommendations and an implementation structure to turn these recommendations into reality. Vietnam will benefit from studying the Report and taking action. While the country can be proud of what has been achieved, its performance is showing signs of fragility. Comparison with other countries reveals that Vietnam has not outperformed leading peers in the region. An action agenda informed by the ideas outlined in this report will be an important step towards exploiting the country's significantly greater potential.

Vietnam needs to start a discussion about how it wants to position itself in the global economy. What are the specific activities, clusters, and business environment strengths that it will be known for? And, Vietnam needs a more fundamental review of the institutional framework for economic policy making and implementation. The creation of the Vietnam Competitiveness Council, a recommendation in the Report that I strongly support, needs to be complemented by a new development agency such as a Vietnam Economic Development Board.

I am pleased to have been able to contribute to the Vietnam Competitiveness Report through conceptual guidance as well as in my role in ACI's International Advisory Board. The joint team from ACI and CIEM is to be congratulated on this important work. ACI's ambition is to provide government leaders with objective data and frameworks to make more informed policy decisions, whether or not they agree with every conclusion or recommendation. My hope is that this first Vietnam Competitiveness Report achieves this purpose and becomes a model for many other reports to follow.

Michael E. Porter
Bishop William Lawrence University Professor, Harvard Business School
Chair of the International Advisory Panel, Asia Competitiveness Institute

ABBREVIATIONS

ACAPR	Advisory Council for Administrative Procedures Reform
ACI	Asia Competitiveness Institute
AFTA	ASEAN Free Trade Area
AGRIBANK	Bank for Agriculture and Rural Development of Vietnam
AMCHAM	American Chamber of Commerce
ASEAN	Association of South East Asian Nations
BIDV	Bank for Investment and Development of Vietnam
BOD	Board of Directors
CBO	Congressional Budget Office
CCI	Country Competitiveness Index
CIEM	Central Institute for Economic Management
CIT	Corporate Income Tax
CMT	Cut, Make, Trim
CNC	Council of National Competitiveness
CPI	Consumer Price Index
CPIB	Corrupt Practices Investigation Bureau
EDB	Economic Development Board
EIU	Economist Intelligence Unit
EPZ	Economic Processing Zone
EU	European Union
EVN	Electricity of Vietnam
FDI	Foreign Direct Investment
FIE	Foreign Invested Enterprise
GC	General Corporation
GDP	Gross Domestic Product
GEPS	Government e-Procurement System
GRDI	Global Retail Development Index
GSO	General Statistics Office
HBS	Harvard Business School
HCMC	Ho Chi Minh City
HDI	Human Development Index
HSP	Hsinchu Science Park
ICAC	Independent Commission Against Corruption
ICOR	Incremental – Output Ratio
ICT	Information and Communication Technology
IFC	International Financial Corporation
ILO	International Labor Organization
IMF	International Monetary Fund
IPR	Intellectual Property Right
IT	Information Technology
ITRI	Industrial Technology Research Institute
IZ	Industrial Zone
JETRO	Japan External Trade Organization
JICA	Japan International Cooperation Agency
JSB	Joint Stock Bank
LND	Legal Normative Document
LND	Legal Normative Document
LPI	Logistics Performance Index
MNC	Multi-National Corporation
MND	Ministry of National Development
MOET	Ministry of Education and Training
MOF	Ministry of Finance
MOIC	Ministry of Information and Communication
MOLISA	Ministry of Labor, Invalids and Social Affairs
NA	National Assembly
NASC	National Assembly's Standing Committee

NICS	Newly Industrialized Countries
NISTPASS	National Institute for Science and Technology Policy and Strategy Studies
NOIP	National Office of Intellectual Property
ODA	Official Development Assistance
ODA	Official Development Assistance
OECD	Organization for Economic Cooperation and Development
OOG	Office of the Government
PCI	Provincial Competitiveness Index
PCNC	Presidential Council of National Competitiveness
PPP	Purchasing Power Parity
PPP	Public – Private Partnership
R&D	Research and Development
RCI	Regional Competitiveness Index
RIA	Regulatory Impact Assessment
ROE	Return on Equity
SBO	Senior Budget Officers
SBV	State Bank of Vietnam
SC	State Conglomerate
SCIC	State Capital Investment Corporation
SIPI	Social Infrastructure and Political Institutions
SME	Small and Medium Enterprise
SOCB	State-Owned Commercial Bank
SOE	State-Owned Enterprise
STAR	Support for Trade Acceleration Project
TFP	Total Factor Productivity
TI	Transparency International
TPI	Trade Performance Index
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Program
US	United States
USAID	U.S Agency for International Development
USD	United States Dollar
VAT	Value Added Tax
VCAD	Vietnam Competition Administration Department
VCCI	Vietnam Chamber of Commerce and Industry
VCR	Vietnam Competitiveness Report
VHLSS	Vietnam Household Living Standards Survey
VNCI	Vietnam Competitiveness Initiative
VND	Vietnam Dong
VNPT	Vietnam Post and Telecommunications Group
VSA	Vietnam Student Association
WB	World Bank
WBI	World Bank Institute
WDA	Workforce Development Agency
WDI	World Development Indicator
WEF	World Economic Forum
WTO	World Trade Organization

Executive Summary

EXECUTIVE SUMMARY

Background

The idea for an in-depth study of Vietnam's competitiveness emerged from a meeting between Prime Minister Nguyen Tan Dung and Professor Michael E. Porter in Hanoi in late 2008. Professor Porter had been impressed by the high growth and significant reduction in poverty in Vietnam, but was concerned that Vietnam's position in many international rankings of competitiveness had remained stagnant.

In 2009, Deputy Prime Minister Hoang Trung Hai asked Vietnam's Central Institute for Economic Management (CIEM) and the Singapore-based Asia Competitiveness Institute (ACI) to develop the first ever National Competitiveness Report for Vietnam. The Report contains a broad assessment of Vietnam's current competitiveness, an analysis of the key challenges and opportunities ahead, and a proposal for an economic strategy to enable Vietnam to reach a higher level of sustainable growth.

Main Findings of the Report

The Report is organized in four main chapters: Chapter 1 provides a background on the methodology; Chapter 2 looks at economic outcomes as indicators of revealed competitiveness; Chapter 3 provides the assessment of the competitiveness fundamentals that underpin the observed economic outcomes; Chapter 4 identifies the three most critical tasks Vietnam is currently facing based on this assessment, and makes concrete action recommendations on how to address them.

Economic outcomes

Vietnam has achieved impressive prosperity growth over the last two decades. Poverty rates have fallen significantly across the country. Inequality has overall remained low, despite some increase. Improvements in the quality of life have not only been driven by the improvements in income, but also the wide access to basic education and health care.

Vietnam is on the verge of becoming a low-middle income country but still falls behind more than 100 other countries globally. The prosperity differences within the country's regions are growing; the most prosperous regions around Ho Chi Minh City and Hanoi register the strongest growth, while other parts of the country are struggling to keep up.

The key driver of Vietnam's prosperity growth has been an improvement in labor productivity. However, despite the recent gains, Vietnam still remains behind many other countries on productivity. The labor productivity growth that has been achieved was the result of capital deepening associated with the structural change from agriculture to manufacturing. While this process has been effective and still has some room to continue, its potential is ultimately limited.

The analysis of economic activity indicators reveals that foreign direct investment inflows have been a central driver of structural change. Driven by foreign investors, exports have grown significantly. So have imports, driven by the supply needs of exporters and the growing local demand in Vietnam. However, value-added within the exporting sector remains low and productivity in other parts of the economy is far lagging.

Competitiveness fundamentals

Vietnam's growth has been driven by market opening that has enabled it to realize its existing comparative advantages, primarily the abundance of low cost labor. The competitiveness fundamentals are broadly in line with the growing but still relatively low level of prosperity reached so far.

Vietnam's social infrastructure and political institutions are generally solid. Basic education and health care are available across the country, providing an important basic prerequisite for economic growth. In terms of the rule of law, there are improvements in the letters of law, but effectiveness in implementation and the independence of the judicial system remain an issue. The political system is perceived as stable, but lacks the ability to take effective action. Corruption levels show few signs of falling.

Macroeconomic policy is a considerable weakness. Fiscal policy is hampered by the high structural deficits in the government sector. While the support of foreign donors is welcomed, this is no substitute for solid government finances. The persistent pressure on the exchange rate, high inflation, and the financial market overheating before the onslaught of the global financial crisis are indications of the problematic state of monetary policy.

Factor input conditions are improving but remain insufficient to support significantly higher levels of productivity. Significant investments have been made to upgrade the physical and utility infrastructure, but the impact of these investments is held back by low efficiency and the lack of prioritization. Public infrastructure investments are currently used to compensate regions with lower growth rather than to achieve the highest possible overall returns for the country.

Skill levels remain modest. While there has been a significant increase in the availability of training programs, the quality of education remains low and varied. The education system is not keeping pace with the rising demands of the Vietnamese economy. Government's efforts to manage the education sector through entry barriers for foreign providers and administrative oversight are a hindrance for extending supply and do not succeed in ensuring higher quality standards.

Despite improvements in recent years, the overall administrative environment is still cumbersome. This is undermining Vietnam's attractiveness as a business location. Several major reform initiatives, such as Project 30, are being carried out to improve the administrative practices. If they are fully implemented as planned, they will mark a significant improvement.

Financial markets remain relatively shallow and immature. Smaller private sector companies continue to have difficulties in getting access to capital. Equity markets suffer from high volatility and a lack of transparency, especially when it comes to the financial situation of state-owned enterprises.

The context for strategy and competitiveness is characterized not only by significant levels of formal market openness but also a dominant role of state-owned companies across many sectors of the economy. While foreign companies find an open environment in Vietnam, the domestic private sector struggles to achieve a more significant role in the economy. Competition remains focused on price and head-on rivalry, rather than on quality and features.

Clusters have emerged naturally as co-locations of companies conducting similar types of activities. However, the focus is on a narrow set of activities without the breadth of related and supporting industries, and active collaboration among companies remains limited.

Critical tasks facing Vietnam

Vietnam has achieved impressive growth based on its current model of FDI-driven sectoral change. With a significant share of the work force still active in agriculture, this model still has the potential to deliver years of growth. This positive outlook and the complacency it can easily foster is the most difficult challenge facing Vietnam. The three most critical tasks that Vietnam faces are, at their core, symptomatic of the growing fragilities of the current growth model. These fragilities are an important impetus to enter a new stage of development.

Macroeconomic imbalances

- Trade and current account balances; Vietnam is facing an increasing deficit in its trade balance. While widely perceived as a typical export-led economy, Vietnam is systematically importing more than it is exporting.
- Savings-investment imbalance; The external deficit has to be covered through capital inflows, from foreign investment, remittances, development aid, or through other sources. The increasing concerns about Vietnam's ability to finance its external deficit, fuelled by rising external debt and a significant drop in foreign reserves, create uncertainty about the country's future economic outlook.
- Inflation and exchange rate; Vietnam's inflation rate has in the last few years become increasingly volatile, with the rate of inflation ratcheting up. Large unsterilized capital inflows and rapid growth in domestic credit have created inflationary pressure. Under an exchange rate policy oriented towards stable nominal rates, this has led to increasing real exchange rates that had forced Vietnam into repeated devaluations.

At the minimum, these imbalances lead investors to require a higher risk premium to invest in Vietnam. Vietnam's macroeconomic imbalances could culminate in a crisis, when sentiments shift to deny Vietnam access to external financing. This would require a painful adjustment process with exchange rate adjustments, cuts in public expenditure, and possibly years of lost growth. The current policy response has recently received international praise, but falls short of a coherent strategy to address these challenges in a proactive and comprehensive way. Vietnam needs a more prudent macroeconomic policy approach that addresses the root causes of the emerging imbalances.

Microeconomic bottlenecks

- Skill and infrastructure shortages; Foreign investors are increasingly reporting skill shortages and infrastructure bottlenecks. These problems are locally concentrated in high-growth regions, especially the Ho Chi Minh City region.
- Profile and implementation rate of FDI; FDI is increasingly shifted to real estate and labor-intensive activities, with little evidence of positive spillovers. There is an increasing gap between announced and actual investments, partly because of the interest to "over-report" FDI attractions and problems in implementing FDI projects.
- Decreasing relation between investment and growth; the incremental capital to output ratio (ICOR) is often criticized in terms of its conceptual validity. But it is interesting to note that relative to its investment, Vietnam achieves lower GDP growth than China and India. State-owned enterprises account for the lion's share of capital investment, accentuating the low overall investment efficiency.

These emerging bottlenecks are signs of a gradually decreasing level of dynamism that the current growth model is able to generate. The policy response so far has been based on a largely accurate identification of the bottlenecks – all three main elements of the ten-year strategy are highly relevant. However, the impact of the steps taken in response has so far been clearly insufficient.

Competitiveness fundamentals

- Low value added exports; export-oriented manufacturing activities in Vietnam rely almost exclusively on imported supplies, while the only local content provided is the work of low- or semi-skilled Vietnamese employees. The only exceptions are exports of natural resources and agricultural products.

- Eroding cost competitiveness of Vietnam; while productivity has improved only marginally as infrastructure has been upgraded, costs have also gone up. Vietnam's cost position is gradually eroding relative to other countries that also provide a large pool of low cost labor.

- Low productivity of Vietnamese products versus imports; In a number of industries, foreign companies, for example from China, are able to out-compete local producers. While foreign companies generally face higher cost levels, they more than compensate for this with higher productivity levels. Higher foreign cost levels are more than compensated for by higher productivity levels abroad.

These observations are typical for an economy that is growing quickly based on the combination of domestic low cost labor and foreign capital. The current policy response is based on a widely shared view that Vietnam needs to move beyond the current economic growth model, which is based on low labor cost and intensive capital investment rather than on productivity and competitiveness. At the moment, Vietnam is trying to upgrade too many things at the same time, without a clear strategy that could align and sequence these activities towards a coherent new goal.

Main Recommendations of the Report

Vietnam's economic policy approach since 1986 has in many ways been an enormous success. Standards of living have gone up and many people in Vietnam have seen their livelihoods transformed. This is a source of well deserved pride. Changing the policy approach now is by no indication that the policies of the past were mistaken. It is a sign that Vietnam has changed: what worked well in the past is not necessarily what will work best in the future. Moving from one policy approach to another is not just a matter of refining current policies. It is driven by the need to adopt a new set of principles that can then guide the multitude of individual changes that are required. Three principles are particularly important and summarize the main transitions needed.

First, Vietnam's future growth has to move beyond providing access to and leveraging existing economic fundamentals. It needs to be based on a consistent upgrading of these fundamentals. This will require changes on both the macroeconomic and microeconomic conditions driving productivity. The current policy debate in Vietnam has not quite made the transition to this new vision. Much of the focus remains on short-term growth rates rather than on sustainable productivity growth and many macroeconomic policies to fuel short-term growth have no or negative impact on longer-term productivity.

Second, Vietnam's government needs to define a new role, in line with the demands of an emerging and dynamic market economy. This role is defined by the role that government needs to play to allow the market to function. Government needs to provide a transparent and effective regulatory environment in which companies can compete on equal terms and to have an effective approach towards providing public goods. In short, it needs an approach towards creating a business location with clear competitive advantages. The current policy debate in Vietnam is often focused on the size and the direct power of government, rather than on its ability to provide the functions needed.

Third, Vietnam needs to provide an environment where there is a more balanced mix of state-owned, private, and foreign companies competing in its economy. Competition between these groups needs to be on equal terms, enabling those that make the strongest contribution to Vietnamese prosperity to gain ground. The current policy debate in Vietnam too often gets hung up on political views about ownership. Market structure, i.e. the exposure to competition, is more critical than ownership per se in determining productivity levels. SOE governance needs to be transparent, the role of the government as an owner clearly separated from its role as a regulator, and SOEs need to be exposed to the same market rules and incentives as their foreign and local rivals.

Activities

Vietnam needs a more coherent and effective macroeconomic policy approach to address the risks posed by the imbalances that have built up in the economy. The following policy actions are examples of the necessary steps:

- Transparency of fiscal position of the government and SOEs; Vietnam should establish an effective and independent reporting body in charge of providing transparent and robust data, in line with international norms, on the state of the economy. SOEs need to be subject to stringent information disclosure requirements, especially on their economic efficiency, financial performance, and financial relations with the government.

- Strengthen budget discipline; Transparency and discipline in state budget management need to be enforced to minimize off-budget spending items and maintain a sustainable fiscal balance. The quality and effectiveness of public debt management need to be enhanced, and the transparency and independent monitoring of public investment needs to be enforced.

- Consistent and predictable monetary policy; Monetary policy collaboration among the National Assembly, the government, and the SBV needs to be clarified. Within this structure, SBV needs to send clear signals on its main monetary target, namely inflation, and the corresponding money supply and credit growth targets. Over time, the central bank's independence, competence, and capability need to be strengthened.

- Financial market regulation; Vietnam needs to develop a more robust regulatory framework in which the room for speculation is reduced while the financial system is gradually deepened. SBV needs to prudentially oversee the financial system to ensure the soundness of financial markets and institutions.

- Coordination of overall macroeconomic policy over time; The Central Committee for Financial and Monetary Policies can play an important coordinating role to enhance alignment of efforts across different ministries. Its operation and mandate should be upgraded and formalized to manage a medium- to long-term agenda rather than to seek ad-hoc solutions to immediate crises and problems.

Vietnam needs microeconomic policies that can effectively and quickly react to bottlenecks in the regions and clusters where they are most pressing. While a fundamental solution to these challenges requires broader-based changes in policies and institutions, there is a need to find effective answers more quickly in public private partnerships:

- Cluster-based action initiatives; the lack of dialogue between government agencies and companies is one of the most critical barriers towards removing the bottlenecks for growth. Pilot initiatives can be launched in clusters where there is sufficient critical mass for actions to affect a meaningful number of companies and the willingness of companies and public sector agencies to collaborate.

Vietnam needs an overall economic strategy that provides a coherent approach for upgrading competitiveness and moving the country to the next level of development and competitive advantages. This strategy is also dependent on how Vietnam intends to position itself in the global economy. To achieve this, Vietnam will need to change many of its policies as well as the way policies are designed and implemented. While, the task of repositioning Vietnam in the global economy is beyond the scope of this report, the following are key policy areas and policy processes where change is most critical.

Policies

- Education and workforce skills; skills are critical to enable the emergence of a higher value-added economy in Vietnam. The current approach has not delivered the required skills. A new approach towards education, in particular workforce skill development needs, will be required to strengthen the role of education as a central enabling condition for higher productivity.

- Physical infrastructure; Transportation, communication, and energy infrastructure are another critical condition for emergence of a higher value-added economy in Vietnam. The current approach has delivered a significant upgrading of physical infrastructure. While the costs of these investments have been high, their impact on competitiveness is limited and the demands of the economy have grown faster than capacity. A new approach for infrastructure investment needs to systematically evaluate public infrastructure projects by their contribution to competitiveness.

- SOE Governance; State-owned enterprises remain an important part of the Vietnamese economy and are likely to continue to do so. The current approach of SOE governance is not delivering the strong companies that are the objective of policy makers. A new approach needs to separate the roles of government as an owner from that as a regulator. Government needs to define a clear owner policy in terms of what it expects as returns from its SOEs. SOE need to be subject to the same competitive pressure as their foreign and local private sector rivals.

- FDI attraction; The attraction for foreign direct investment has been a critical driver of recent Vietnamese growth and will continue to be important. The current approach towards FDI attraction is reactive and oriented towards high announcements of FDI inflows. The value that this generates for Vietnam is insufficient. A new approach needs to focus on actual FDI, not announcement and more effective monitoring and follow up. Vietnam needs to separate FDI attraction from regulation and see FDI as a tool to strengthen Vietnam's competitiveness.

- Cluster development/Industrial policy; Higher competitiveness requires specialization in areas where the presence of related and supporting activities can support a level of productivity that any individual company finds hard to achieve. The current approach is based on creating national champions from SOEs, providing cheap credit to individual companies, and creating dedicated infrastructure. There are no effective strategies for specific sectors or industries. A new approach needs to focus on clusters and value chains, not individual companies or narrow industries. The objective needs to be improving productivity, not private profitability. Government efforts should enable companies in clusters to compete on a higher level, not shelter them from competition.

Institutional architecture

- Policy process; effective policies are more likely to emerge if a robust process of policy design and implementation is in place. Competitiveness requires an inherent ability to systematically upgrade and improve policies over time. The current policy design and implementation process in Vietnam have significant weaknesses. A new approach needs to provide data for fact-driven policy making and clear procedures to monitor the relevance and quality of policy. Planning efforts have to be consolidated and connected. There has to be an institutionalized impact assessment process and the coordination among different government agencies needs to be strengthened.
- Capacity; more effective policies require a more capable public sector. Well trained public officials and an effective organization and management structure are crucial to enable government to operate more effectively. The current approach in Vietnam reflects a very traditional public sector organization. The lack of a merit-based and transparent performance system and good governance principles have limited the performance of the public sector. A new approach needs to be based on an integrated efforts providing modern solution got leadership, training, incentives, and organizational structures.
- National – regional structure; Given Vietnam's size and geographic profile, the effective allocation of roles and responsibilities between national, regional, and local authorities is of particular importance. As companies always locate in specific regions within the country, the cumulative effect of government decisions at all levels at these specific places will directly impact the performance of these companies. The current structures in Vietnam have potential but currently suffer from significant weaknesses. A new approach needs to review the current mechanism of responsibility delegation, and strengthen oversight and quality control by the central government. Regions need to be motivated to collaborate and leverage on each other to develop their competitiveness and clusters rather than by competing with each other.

Implementation

The sequencing of activities in a competitiveness agenda is a crucial task and not just a technicality. First, governments cannot upgrade all dimensions of competitiveness in parallel. This overstretches their ability to achieve change and results in most cases in failure. This challenge is even more acute when, as is the case in Vietnam, an economy needs to transition from one set of competitive advantages and policies to the next level. Second, the impact of individual reforms often depends on other policy steps taken in parallel or even before. Without the right sequencing, results will take much longer to materialize. In the meantime, the political willingness to pursue reforms can wane if there are not positive results to point towards. Getting the sequence of reforms right is thus a critical dimension of a sustainable competitiveness agenda.

For Vietnam, we suggest an evolutionary reform process. Changes in competitiveness will initially be driven by narrow activities in well-defined pilot cases. Over time these new solutions will then be rolled-out nationally and across a broader set of policy areas. In the last stage, the institutional architecture of policy making will be upgraded. The only exception to this bottom-up approach is the set of activities needed to defuse the increasing risk of macroeconomic imbalances. Here an effective response will require changes at all levels – individual measures, changes in policy, reform of institutional structures – within a relatively small time frame.

Progress on implementing the competitiveness agenda requires the assignment of clear responsibilities. Such responsibilities can be defined at two levels. First, for each specific initiative there needs to be an institution or group in charge of driving the process. Second, there needs to be an overarching structure that can manage the portfolio of activities, ensuring that the most critical efforts are being undertaken and mobilizing new efforts at the appropriate time. For Vietnam, we suggest creating a Vietnamese Competitiveness Council to assume this role, leveraging the experience many other countries have made with similar structures. The Council would coordinate the government agencies and public-private project groups that are engaged in the specific activities launched in the context of the competitiveness agenda. It would manage the overall project portfolio and monitor progress on individual activities. The Council would report to the Party, the government, and the public on the progress of the competitiveness agenda. To perform these tasks, the Council would have direct link to the political leaders, be comprised of leading government and business leaders, including executives of foreign-owned companies, and have a dedicated secretariat with appropriate resources.

Conclusion

Vietnam's growth since the mid-1980s has been driven by transition and structural change. Transition has transformed the governance of the economy from plan to market, opening up Vietnam for integration with the global economy. Structural change has transformed the composition of the economy, moving millions from subsistence agriculture into capital-intensive manufacturing and services. Both of these changes have enabled underlying competitiveness, essentially the presence of low cost labor, to be revealed. Growth has been fueled by these macroeconomic, "systemic" changes. More recently, the policy response mainly focuses on intensifying investment, especially in SOEs and infrastructure, to generate growth rather than on upgrading productivity and efficiency.

However, the economic logic behind this growth model ultimately has limited potential. The highest level of prosperity that Vietnam can reach given this approach is defined by the level of productivity unskilled workers can reach in manufacturing. If Vietnam is not able to move beyond this model, it will be stuck at lower middle income level, with poorer economies threatening its position. Furthermore, the over-reliance on externally-financed investment as a driver of growth is generating dangerous macro-imbalances which may ignite crises.

It is widely acknowledged that Vietnam needs to move beyond the current economic growth model which is based on low labor cost and intensive capital investment towards productivity and competitiveness as the core of growth. Vietnam's future growth has to move beyond providing access to and leveraging existing economic fundamentals. It needs to be based on a consistent upgrading of these fundamentals and creating new advantages. This will require changes on both macroeconomic and microeconomic conditions driving productivity. This new vision is a critical perquisite for Vietnam to move up sustainably to the next stage of development.

Chapter 1

Introduction

INTRODUCTION

Why this report?

Background

Vietnam has been one of the most impressive growth stories in the global economy over the last few decades. Following the economic reforms during the second half of the 1980s, GDP per capita has grown at an annual rate of almost 6%. Millions of Vietnamese have been lifted out of poverty. The Asian financial crisis and the current global economic downturn did not affect Vietnam as much as many other countries. International donors view Vietnam as one of their clear success cases, where foreign aid is generally well utilized and has a visible impact. Private investors also see Vietnam as an increasingly attractive destination.

While much has been achieved, there is an acute awareness that Vietnam still has ways to go. The level of prosperity is still low, even compared to many Asian peers. Domestic macroeconomic instability has been a reminder of the fragility of growth. Poverty remains entrenched among specific social groups and low-growth regions of the country, and becomes much harder to address by general economic growth. The achievements thus far have raised both ambitions and expectations, forcing the country to look for ways in which growth can be sustained at the level of development that Vietnam has now reached. In many respects, Vietnam is now facing a more complex set of choices then it did when it decided to open up to the global economy two decades ago.

Over the next few months, Vietnam faces a number of key milestones that will have a significant impact on the country's medium-term outlook. One of them is the official launch of Vietnam's 10-year strategy, currently under discussion in the Party, the Government, and the National Assembly. It sets important markers on the policy issues that the government aims to address and outlines a broad vision for where its leaders see Vietnam at the end of this decade. Another one is the Party Congress in early 2011 which will also set important directions for the course ahead.

Against this background, the idea for an in-depth study of Vietnam's competitiveness emerged in a meeting between Prime Minister Nguyen Tan Dung and Professor Michael E. Porter, Harvard Business School, in Hanoi in late 2008. Professor Porter was impressed by the high growth and the significant reduction in poverty over the last two decades. But he also pointed out that Vietnam's stagnant position in many international rankings of competitiveness was a cause for concern. The ensuing discussions triggered the decision to develop the Vietnam Competitiveness Report. In 2009, Deputy Prime Minister Hai asked Vietnam's Central Institute for Economic Management (CIEM) and the Singapore-based Asia Competitiveness Institute (ACI) to develop the first ever National Competitiveness Report for Vietnam. Professor Michael E. Porter has remained engaged in this process through his role as the co-chair of ACI's International Advisory Panel. His team at the Institute for Strategy and Competitiveness has provided technical guidance throughout.

Ambitions/ Objectives of the Report

The Vietnam Competitiveness Report aims to contribute in three key dimensions to the debate about the choices Vietnamese leaders are facing:

- a broad set of **data** on different aspects of Vietnam's economic performance, activity, and competitiveness;
- a **conceptual framework** for interpreting this data and the underlying relationships between its different dimensions; and
- **concrete proposals** on policy priorities and specific action initiatives.

Each of these dimensions is important in its own right. Many if not all of the choices that Vietnam is facing today cannot be addressed by ideology or generic theory alone. They require an in-depth analysis of where Vietnam stands today. This is why providing policy makers with data to pursue fact-driven policy choices is increasingly critical.

Competitiveness has so many aspects and dimensions, that the picture from the data alone is often hard to translate into clear policy implications. This is why using the conceptual framework developed by Prof. Porter - embedded in academic research but not driven by strong ideological priors - is an important tool helping decision makers to deal with this complexity.

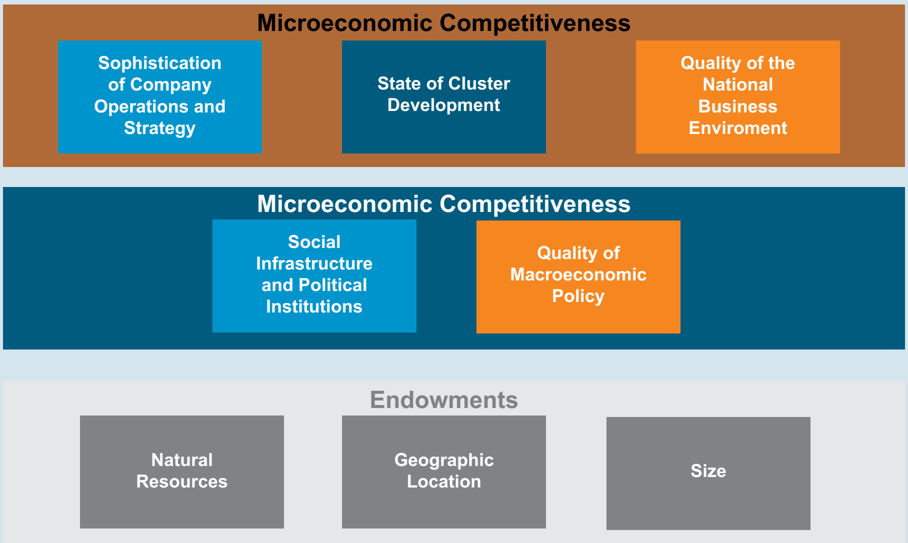
Policy decisions are what ultimately matters. These decisions have to be developed by the relevant authorities in Vietnam, taking into account its legacy and context. This report contributes to the effectiveness of the decision making process by presenting action proposals that decision makers can build upon.

Not everyone will agree with all the recommendations in this report. But many, we hope, will find the analysis a useful stimulus for their own thinking. And the data, we hope, can become a widely accepted foundation for the policy debate in Vietnam.

Positioning of the Report versus other reports and studies

The Vietnam Competitiveness Report intends to complement and build on existing work, not to replace it. It has a number of characteristics that distinguish it from existing reports and plans. The ambition of the report is both more comprehensive and more focused: It is more comprehensive in providing a view across many policy areas and combining analysis with action recommendations. Yet,

DETERMINANTS OF COMPETITIVENESS



Source: Professor Michael E. Porter and Dr. Christian H.M. Ketels

it is also more focused in its primary aim of identifying which areas are most critical for Vietnam, and in suggesting a specific sequencing of actions across the various areas in which upgrading ultimately needs to take place.

The report compares Vietnam's performance with other countries on many indictors. But it does not focus on ranking Vietnam overall against other countries, as other global rankings and indices have done. Instead, it provides an in-depth analysis of the root causes of economic performance, based on Vietnam's competitiveness fundamentals. The report provides an overall look at the national economy. The analysis of individual regions or sectors is beyond the scope of this report and could be conducted in the future.

The Vietnam Competitiveness Report serves as a complimentary source of policy input to elaborate and support the broad vision and orientation set forth in key policy documents such as the ten year strategy, the five year development plan and the Party Congress Resolution.

Finally, the institutional authorship of the Report gives it a unique blend: It is not influenced by strong institutional interests; the combination of CIEM and ACI was explicitly chosen to minimize such bias. And the combination of a domestic and a foreign partner marries local insights with international experience.

Methodology

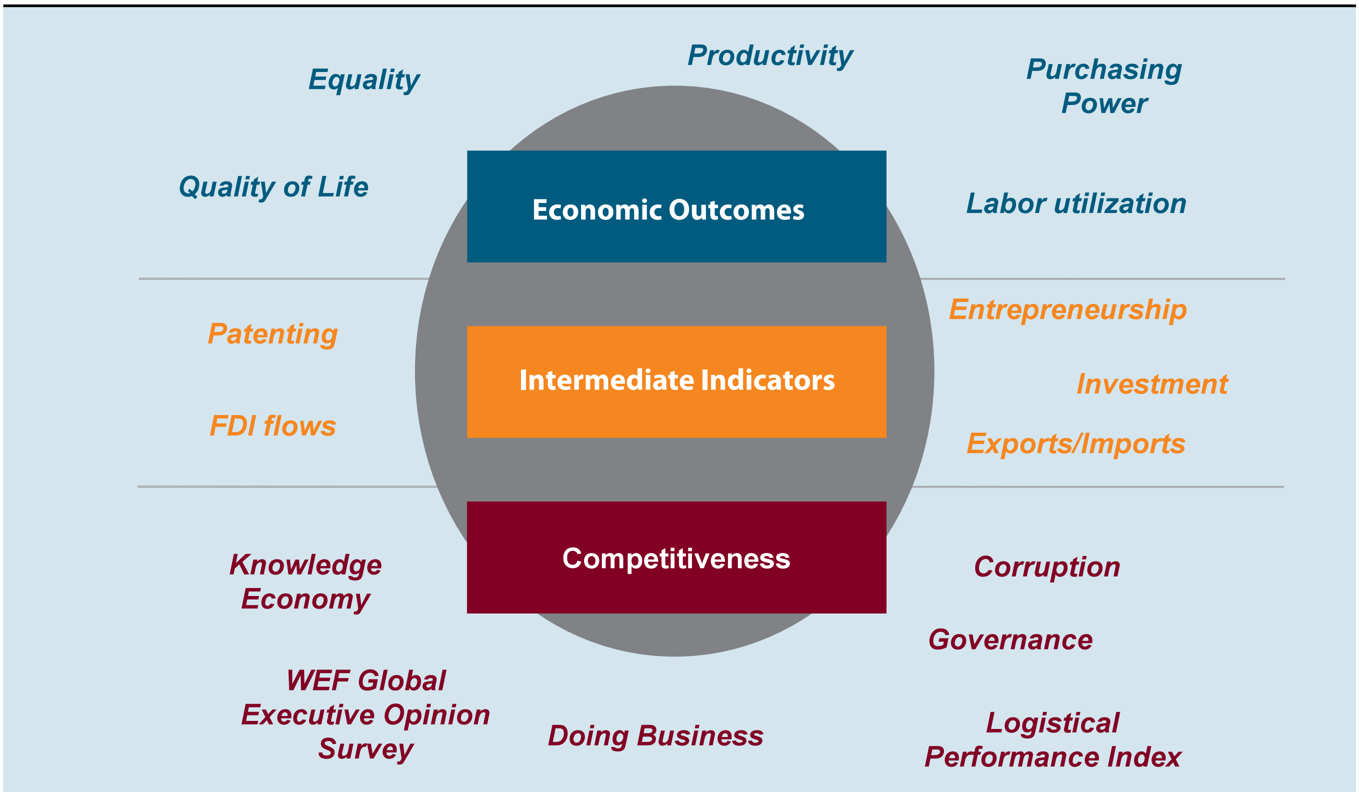
The Report's analysis is grounded in the competitiveness framework developed by Professor Michael E. Porter over the last two decades. This framework is flexible in capturing the role of many different types of factors that influence competitiveness. It recognizes their interdependence and makes no prior assumptions about the critical role of any individual factor.

The central tenet of the competitiveness framework is the notion that productivity – the ability to create valuable goods and services through the use of a country's human, capital, and natural resources – is the ultimate driver of sustained prosperity. Productivity depends both on the value of the goods and services produced and on the efficiency with which they are being provided. High competitiveness, then, is ultimately reflected in high productivity.

Productivity is the result of a large number of factors that are shaped by the collective action of all participants in an economy. One set of factors, organized under the heading of macroeconomic competitiveness, set the overall context in which companies operate. These factors include the quality of social infrastructure and political institutions as well as of macroeconomic policy. They do not affect productivity directly but create the opportunity space in which productivity-enhancing actions can be taken.

The other set of factors, called microeconomic competitiveness, capture the way companies operate and the external dimensions that have a direct impact on the results of their activities. These factors include the sophistication of companies, the strength of clusters, and the quality of the business environment. All of them have a direct impact on productivity.

Endowments are another important set of factors to consider. They do not affect productivity, but can provide direct benefits to prosperity. They also set in an important way the overall context in which a country's economy and its global positioning develop.



The competitiveness diagnostics applied in this report use a broad set of data. The data are organized in a number of key categories that provided different perspectives on Vietnam's competitiveness position:

- The first group of indicators provides an assessment of the economic performance of the country. This includes an analysis of the standard of living of Vietnamese citizens, given the fundamentals of their economy. Relevant variables include average prosperity levels, income inequality, regional development, and other measures of progress. It also examines the main elements of prosperity growth: labor productivity and labor mobilization. Indicators of structural change and demographics are also included.

- The second group of indicators includes intermediate indicators of economic activity. The factors in this category are signs of and contributors to competitiveness but not ultimate goals of economic policy. They include measures of foreign and domestic investment, international trade, innovation, and entrepreneurship.

- The third group of indicators tracks Vietnam's position on the broad range of macro- and microeconomic competitiveness fundamentals that ultimately explain the economic outcomes discussed in the previous sections. The indicators covered range from assessments of governance quality, the provision of primary public services, the state of public finances, the sophistication of companies, the dynamism of clusters, the quality of physical infrastructure and, the intensity of local competition, and many more.

The combination of these three groups of indicators provides important insights for policy makers that are often lost in more narrow assessments. The economic performance indicators capture the ultimate objectives of policy; failure on this dimension signals failure overall. Their decomposition provides initial insights into critical policy issues. The economic activity indicators then deepen the understanding of how competitiveness fundamental are translated into ultimate economic benefits. Again, the particular patterns of these indicators provide important direction to where policy must focus. The competitiveness fundamentals, then, capture the root causes of outcomes at higher levels. This is where policy needs to intervene, targeting those areas that the analysis of economic outcomes have revealed as critical, not just those in which a country happens to be weak.

The Vietnam Competitiveness Report draws on a broad range of data sources including many international assessments and databases. Many Vietnamese and foreign institutions have provided access to their analysis and reports; we appreciate their willingness to share this material with us. Through CIEM, we have also had access to a large number of Vietnamese government statistics.

Over the last year, CIEM and ACI organized a range of interviews and workshops to obtain inputs and to discuss preliminary findings of the analysis. These meetings have included Vietnamese government officials, Vietnamese business leaders, foreign investors, researchers, experts and representatives of foreign aid organizations. An advisory group of experienced Vietnamese officials and experts has provided regular input and feed-back. In June 2010, a preliminary version of the report was discussed with more than 300 attendees at a workshop organized alongside the WEF East Asia Summit in Ho Chi Minh-City. We are grateful to all our partners for their openness in sharing insights and opinions with us.

The remainder of the report is organized in three chapters.

Chapter 2 looks at economic outcomes as indicators of revealed competitiveness. The chapter first describes different dimensions of Vietnam's prosperity. While GDP per capita is a central benchmark, this section widens the view beyond GDP per capita to better capture the quality of life across different parts of Vietnam's society. It then decomposes Vietnam's overall prosperity performance into labor productivity and labor mobilization. The impact of structural changes in the economy is a particular focus of this analysis. The second part of the chapter then looks at indicators of economic activity that as signals and contributors of competitiveness tend to foreshadow future prosperity. They are important analytical tools but not appropriate policy objectives. Targeting them directly, as many countries have done, often leads to better performance on the indicator but no improvement in either prosperity or competitiveness. The economic outcome indicators addressed include measures of investment (domestic, inward FDI), global integration (FDI, exports, imports), innovation, and entrepreneurship. Key observations from the analysis of outcome indicators are summarized at the end of each major section.

Chapter 3 provides the assessment of the competitiveness fundamentals that underpin the observed economic outcomes. The first part of the chapter reviews Vietnam's endowments in terms of geographical location, natural resources, and other given factors. The second part is devoted to the main elements of macroeconomic competitiveness, i.e. the strength of social infrastructure and political institutions (SIPI) and the quality of macroeconomic policy. SIPI includes basic human capacity, the rule of law, and the effectiveness of the political system. Macroeconomic policy indicators include fiscal and monetary policy as well as external and internal balances. The third part covers the three dimensions of microeconomic competitiveness, i.e. company sophistication, cluster strength, and business environment quality. The diamond, a concept first introduced by Professor Michael Porter in 1990 is used to organize the analyses of the business environment by four broad dimensions - factor input conditions, the context for strategy and rivalry, demand conditions, and supporting and related industries. Key observations from the analysis of competitiveness indicators are summarized at the end of each major section.

Chapter 4 turns from the analysis to the recommendations. The first part of this chapter synthesizes the main findings from the previous two chapters to identify three critical tasks Vietnam is facing. The second part outlines an action agenda to address these tasks in turn. It sets out a number of general principles that should guide Vietnamese economic policy in this transition. It then provides specific action recommendations in each of the priority policy areas. The third and final part of the chapter turns to implementation, an area which has received insufficient attention in the past. It suggests an approach of sequencing actions over time, to enhance the momentum for change based on initial success and learning. And it outlines and organizational architecture for managing the competitiveness action agenda, with a Vietnamese Competitiveness Council at its center.

Chapter 2

Vietnam's Economic Performance

VIETNAM'S ECONOMIC PERFORMANCE

Chapters 2 and 3 examine the competitiveness of the Vietnamese economy in three levels, providing a comprehensive assessment of outcomes, drivers or intermediate indicators and underlying causes. Understanding these is critical to the formulation of a national economic strategy and a comprehensive supporting policy package. Chapter 2 focuses on the first two layers. It begins with an examination of indicators of economic well-being and the quality of life of the Vietnamese people. This if followed by an exploration of the intermediate indicators or drivers of prosperity such as trade and investment. The third layer of competitiveness, or underlying causes, is discussed in Chapter 3.

Economic Outcomes

Ultimately, the goal of economic development is a sustained increase in prosperity or the standard of living. Indeed, many economic plans, including the ten-year strategy for Vietnam, which is currently under discussion, also refers to specific goals in terms of the standard of living. Comparing these metrics across countries as is done below, provides a realistic competitiveness benchmark or a relative assessment of how competitive an economy is.

While the standard of living is a central element of the assessment, it is not a very informative tool to guide policy making. It only describes the combined impact of all the determinants of competitiveness on the quality of life of the average Vietnamese. Policy-relevant insights can be obtained from assessing both economic and non-economic measures of well-being and from decomposing the standard of living into various components such as the mobilization of resources, in particular labour, and how efficiently or productively these resources have been employed in order to achieve a higher standard of living.

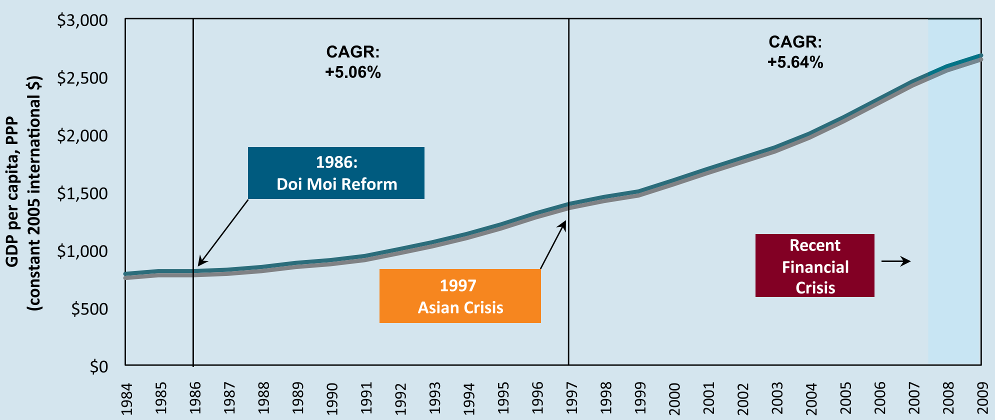
Standard of Living

Income: GDP per capita

- *GDP per capita has grown quickly and steadily over the last two decades, yet it is at a low absolute level*

Vietnam's average income — real GDP per capita — has grown rapidly since the country launched the Doi Moi Reform, growing at an average annual rate of 5.06 percent between 1986 and 1997 (pre-Asian Financial crisis) and at the higher rate of 5.64 percent between 1997 and 2009 (Figure 2.1). Vietnam stood out as one of the fastest growing economies in the world during this period allowing it to reach the lower middle-income group in 2008 when its per capita income exceeded USD 1,000. And it continues to make significant progress since, despite the recent financial crisis.

FIGURE 2.1:
GROWTH PATTERNS OF VIETNAM'S GDP PER CAPITA 1984-2009



Source: World Development Indicators.

FIGURE 2.2:
COMPARISON OF GDP PER CAPITA GROWTH, 1990-2009

Note: GDP per capita growth (CAGR) for Cambodia is for the period 1993 - 2009.

Source: World Development Indicators.

While Vietnam's economic growth over the past two decades has been impressive in relative terms, the per capita GDP (measured using purchasing power parity) of the country remains low compared to other countries. In 2009, Vietnam ranked 113th in the world and it is still among the poorest countries in East Asia (Table 2.1). In addition, Vietnam's prosperity level lags significantly behind traditional tiger economies such as South Korea and even China's per-capita GDP is more than twice that of Vietnam's (Table 2.1 and Figure 2.3).

Non-income Measures of Economic well-being

Poverty Reduction

- *Significant successes in poverty reduction, however risk of re-impoverishment remains high*

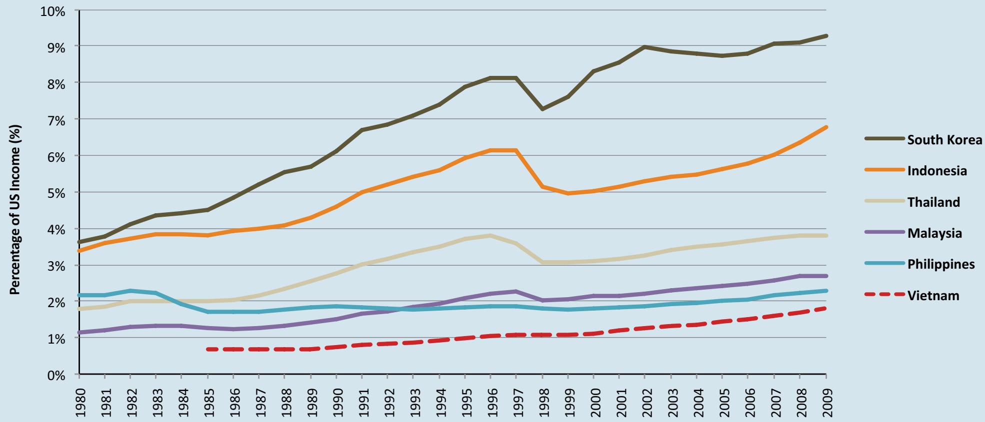
Vietnam is recognized as one of the early achievers of the Millennium Development Goals on poverty reduction. . Its poverty rate fell dramatically from 58.1 percent in 1993 to 14.5 percent in 2008 (GSO 2006)[1]. The country managed to significantly reduce poverty rate in both urban and rural areas as shown in Figure 2.4. In 2009, despite the slowdown in economic growth, the proportion of poor households continued to decline. This is estimated to remain at 11 percent by the Government's poverty standards[2] . However, it is worthwhile noting that while the country's successes in poverty reduction are significant, "these results are not really stable, the rate of re-impoverishment remains high" as candidly pointed out by Prime Minister Nguyen Tan Dung in his article written on the occasion of the New Year 2010 (Press Center 2010).

TABLE 2.1:
COMPARISON OF PER CAPITA INCOME IN 2009

Economy	USD	PPP$	Group Rank ($PPP)	World Rank by ($PPP)
Singapore	36,537	50,705	1	4
Japan	39,727	32,443	2	20
South Korea	17,078	27,168	3	26
Malaysia	6,975	13,982	4	49
Thailand	3,894	8,004	5	80
China	3,744	6,838	6	83
Indonesia	2,349	4,205	7	106
Philippines	1,745	3,546	8	110
Vietnam	1,052	2,957	9	113
Lao	940	2,259	10	125
Cambodia	677	1,913	11	131

Source: World Development Indicators.

FIGURE 2.3:
CATCHING-UP ON ECONOMIC DEVELOPMENT– VIETNAM VS. EAST ASIAN COUNTRIES



Source: World Bank Development Indicators; calculations by ACI.

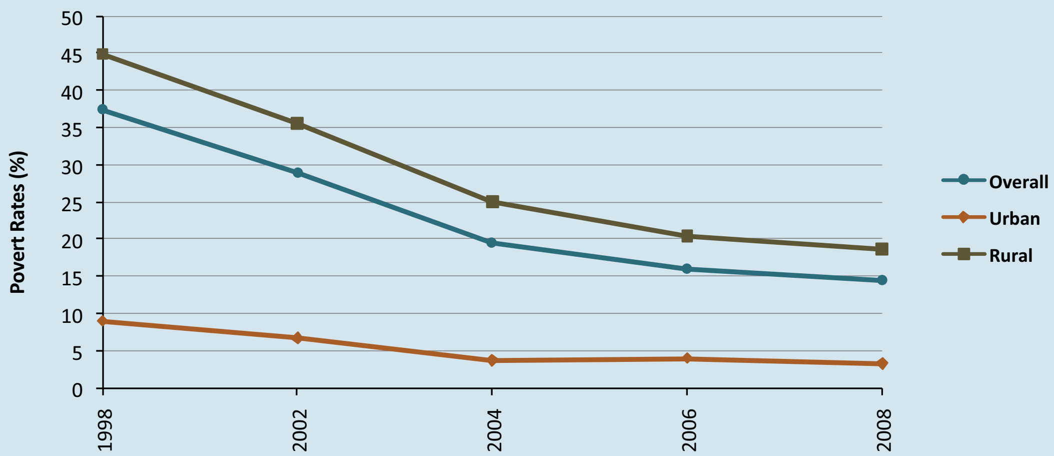
The risk of re-impoverishment is high for three groups. The first group includes poor households who rely solely on agricultural production and live in the coastal region of the Red River Delta or Mekong Delta. These areas are also more susceptible to natural disasters, floods and epidemics. The second group includes poor, mostly minority households living in the Northern mountainous region, the Central Highlands, islands, or places with difficult access to production sources or social services. The third group includes the urban poor with low education levels or professional skills. Income disparity among economic regions demonstrates that growth policies which aim at creating low value-added jobs will help reduce poverty, but will not bridge the income gap between rich and poor areas. Thus, policies need to target productivity improvement in poorer regions in order to improve their standard of living in a sustainable way.

Income Inequality

- *Overall, inequality is widening in the wake of economic growth, but remains lower than that of peer countries*

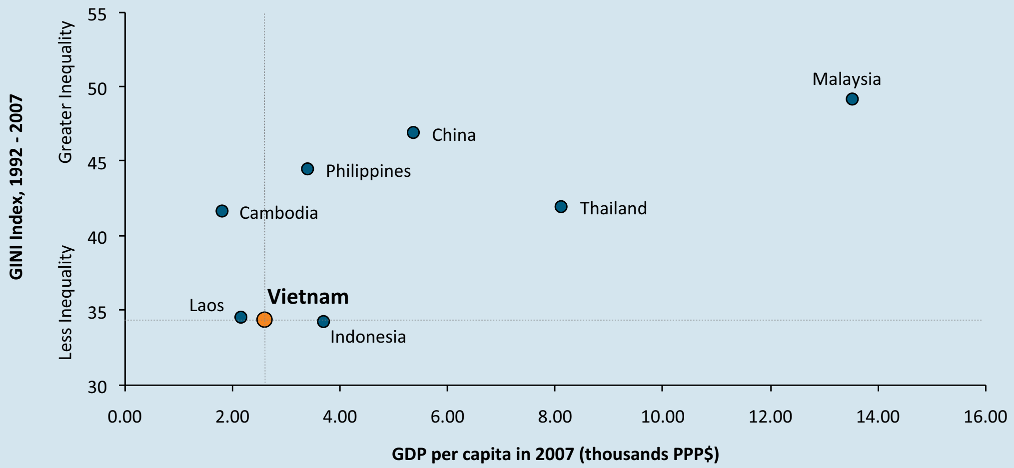
Income inequality has been widening and this is an expected result of Vietnam's high economic growth. However, the country's level of income inequality is still low relative to countries such as China, Thailand, Philippines, Malaysia, and Cambodia (Figure 2.5).

FIGURE 2.4:
POVERTY REDUCTION, 1998-2006



Source: VHLSS, GSO

FIGURE 2.5:
GINI COEFFICIENT AND GDP PER CAPITA



Note: The Gini index ranges from 0 (absolute equality) and 100 (absolute inequality). Gini index in the latest period from 1992-2007.

Source: Human Development Report 2009, UNDP.

Quality of Life

The broader concept of "quality of life" is an important measurement of a country's competitiveness. The Human Development Index (HDI) represents an attempt to measure such a quality. In addition, other indicators include environmental quality, population characteristics, quality and access to health care services, education, and gender equality.

Human Development Index (HDI)

- *Moderate position on HDI ranking, lower scores than those of most Asian peer countries*

The HDI is compiled based on a set of indicators organized into three components: income, health, and education. Vietnam scored well in the health component, which is proxied by life expectancy, compared to its Asian peers (Table 2.2). However, Vietnam needs to do more to improve the education component where it continues to lag behind many of its Asian peers. For instance, the mean years of schooling is 5.5 and the expected years of schooling is 10.4 (an improvement of 4.9) for Vietnam, while these figures, respectively, are 5.7 and 12.7 (an improvement of 7) for Indonesia. In order to improve the HDI, it is essential for Vietnam not only to catch-up in GDP per capita, but also in terms of other indicators, especially education.

TABLE 2.2:
HUMAN DEVELOPMENT INDICATOR AND ITS COMPONENTS IN 2010

	HDI rank	Human Development Index (HDI) value	Life expectancy at birth (years)	Mean years of schooling (years)	Expected years of schooling (years)	Gross national income (GNI) per capita (PPP 2008 $)	GNI per capita rank minus HDI rank	Non-income HDI value
South Korea	12	0.877	79.8	11.6	16.8	29,518	16	0.918
Singapore	27	0.846	80.7	8.8	14.4	48,893	–19	0.831
Malaysia	57	0.744	74.7	9.5	12.5	13,927	–3	0.775
China	89	0.663	73.5	7.5	11.4	7,258	–4	0.707
Sri Lanka	91	0.658	74.4	8.2	12	4,886	10	0.738
Thailand	92	0.654	69.3	6.6	13.5	8,001	–11	0.683
Philippines	97	0.638	72.3	8.7	11.5	4,002	12	0.726
Indonesia	108	0.6	71.5	5.7	12.7	3,957	2	0.663
Viet Nam	**113**	**0.572**	**74.9**	**5.5**	**10.4**	**2,995**	7	**0.646**
India	119	0.519	64.4	4.4	10.3	3,337	–6	0.549
Lao PDR	122	0.497	65.9	4.6	9.2	2,321	3	0.548
Cambodia	124	0.494	62.2	5.8	9.8	1,868	12	0.566
Bangladesh	129	0.469	66.9	4.8	8.1	1,587	12	0.543

Source: United Nations, 2010.

BOX 2.1:
POLLUTION IN THE DELTAS OF DONG NAI RIVER, CAU RIVER AND NHUE RIVER

The mining and mineral exploitation industry alone accounts for 55 percent of industrial waste. Twenty-five percent stems from metal production, 7 percent from paper production and food industry accounts for 4 percent. In the Nhue river valley (including the Hanoi region), 56 percent of total sewage is from households, 24 percent is industrial wastewater and 4 percent is sewage from trade villages. In the Dong Nai river valley (including HCMC, Dong Nai, Binh Duong), about 480,000 metric tons of waste water are released daily, with industrial and processing zones accounting for 24.6 percent of that total.

Source: World Bank, 2006.

Environmental Quality

- *Industrial pollution has resulted in a serious degradation of environmental quality*

Over the period 1998-2007, the emission of CO2 from energy consumption increased by 9.6 percent annually (UN Environment Programme). Air pollution is mainly caused by industries, transportation and other civil industries.

Water pollution is getting worse, especially in large industrial centers, industrial zones in the deltas of Dong Nai river, Cau river and Nhue river. Pollution causing agents include growing industrial production, rapid urbanization and high construction density[3].

The Elements of Prosperity

Prosperity decomposition is an arithmetic exercise which decomposes the sources of economic growth which include mobilization of factors of production and productivity. Since the different components of GDP per capita are driven by policy choices in different areas, the decomposition provides useful insights into which dimensions of competitiveness may need further analysis.

The Sources of Growth

Total factor productivity (TFP)[4] - an important measure of efficient use of capital and labor inputs- has tended to decline significantly since 2000 and capital deepening has become the main driver of growth.

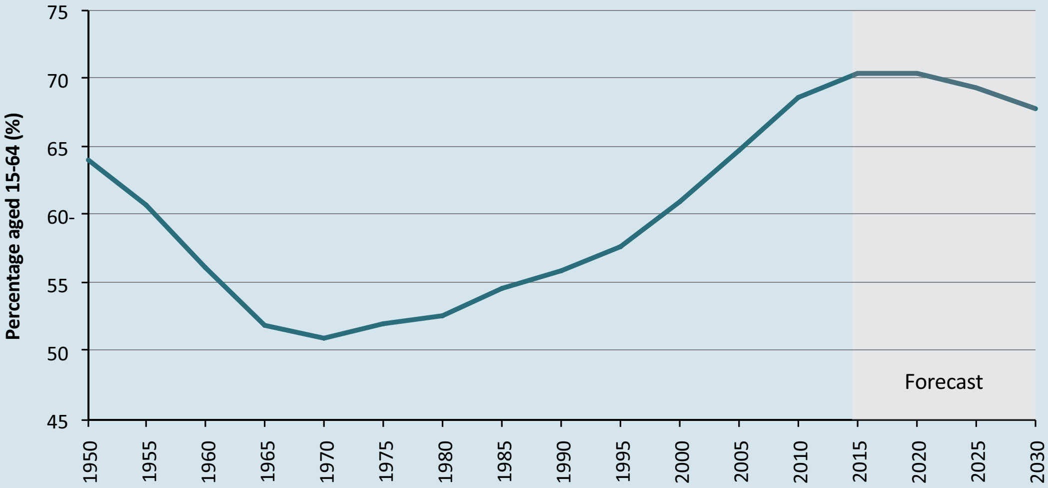
GDP growth rate of a country can be decomposed into three sources: growth in capital input, growth in labor, and growth in TFP. Over the period 1990-2000, 34% of GDP growth in Vietnam was accounted for by growth in capital input, 22% by growth in labour input and 44% by growth in total factor productivity (TFP). However, during the period 2000-2008, the contribution of capital increased significantly to 53%, while that of TFP declined sharply to 26% (Table 2.3). In comparison, in most of Vietnam's ASEAN peers such as Indonesia, Malaysia, Thailand and the Philippines, the contribution of TFP to economic growth increased quite substantially during the more recent period 2000-2008. Furthermore, in China, more than 50% of economic growth over the entire period 1990-2008, more than 50% of growth was accounted for by TFP growth. Clearly, Vietnam stands out in its reliance on capital accumulation and this suggests that the real return on capital is likely to be low in Vietnam and also calls into question the sustainability of the present growth trajectory.

TABLE 2.3:
SOURCES OF GDP GROWTH, 1990-2008

Country	Period 1990-2000				Period 2000-2008			
	GDP	Sources of Growth			GDP	Sources of Growth		
	Growth	Capital	Labor	TFP	Growth	Capital	Labor	TFP
	Contribution in percentage points per annum (ppa)							
Vietnam	**7.3**	**2.5**	**1.6**	**3.2**	**7.3**	**3.9**	**1.4**	**1.9**
China	9.9	3.6	0.7	5.5	9.7	4.1	0.6	5
India	5.3	2.1	1.2	2	7.3	3.1	1.6	2.7
Cambodia	7.3	2.8	2.5	2	9	4.2	3.5	1.3
Indonesia	4.1	2.5	1.1	0.5	5.1	1.4	1.1	2.5
Malaysia	6.9	3.7	2.1	1.1	5.4	1.6	1.1	2.7
Philippines	3	1.3	1.4	0.3	4.7	1	1.9	1.8
Thailand	4.4	2.7	0.3	1.4	4.7	0.8	1.4	2.5
	Contribution share							
Vietnam	**100%**	**34%**	**22%**	**44%**	**100%**	**53%**	**19%**	**26%**
China	100%	36%	7%	56%	100%	42%	6%	52%
India	100%	40%	23%	38%	100%	42%	22%	37%
Cambodia	100%	38%	34%	27%	100%	47%	39%	14%
Indonesia	100%	61%	27%	12%	100%	27%	22%	49%
Malaysia	100%	54%	30%	16%	100%	30%	20%	50%
Philippines	100%	43%	47%	10%	100%	21%	40%	38%

Source: Data from WDI; calculations by ACI.

FIGURE 2.6:
VIETNAM'S WORKING-AGE POPULATION



Source: UN Population Database Revision 2008.

Labor Mobilization

Labor mobilization measures the share of population engaged in generating value in the economy. As an aggregate, it captures the impact of two factors. First, the demographic profile determines the working age population. Changes in the ratio of the working to non-working population can have a significant impact on growth rates over time. Second, the employment intensity—labor force participation—depends on the effectiveness of labor markets in providing job opportunities.

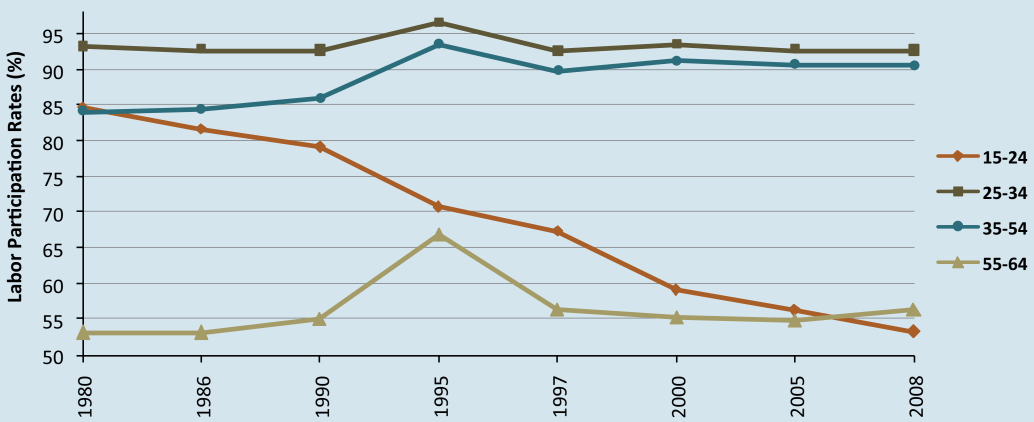
Demographic Trends

- *A young population with a high share of people in working age is an advantage, but initial signs of population aging and rising population density are posing challenges*

Vietnam has a large and young population, with 90 percent below or within working age. At the end of 2009, its population was estimated at 86.06 million; of which, 29.6 percent live in cities and 70.4 percent in rural parts[5]. It is the third most populous country in South East Asia and the 13th most populous country in the world.

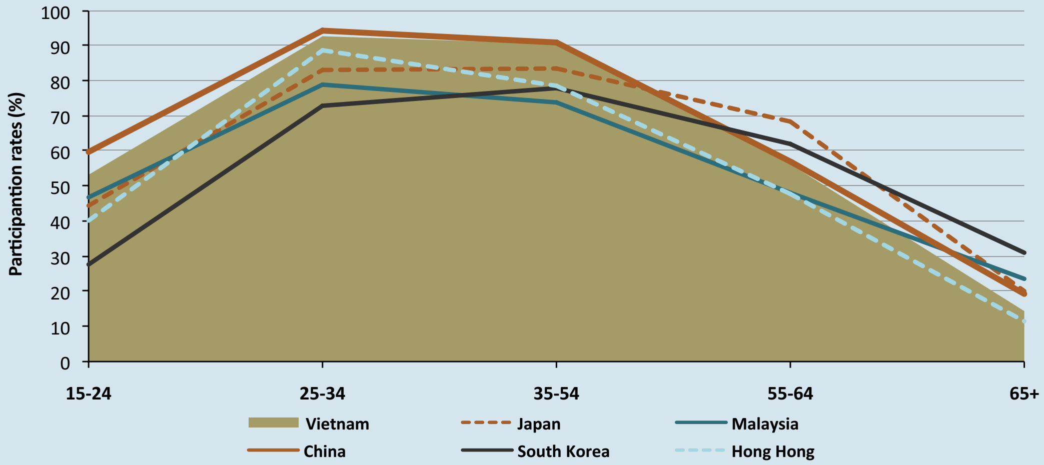
The share of the population below the working age (0 – 14 years old) has declined from 34.3 percent (1999) to 26.5 percent in 2009 (UN Population Database). Meanwhile, the share of the working age population (15 – 64 years old) has increased from 60.18 to 67.18 percent over the last decade. The senior citizens group (above 64) has increased slightly from 5.51 percent to 6.30 percent. Vietnam has entered the period of a "golden population structure" with a total workforce about double the size of the non-working population. This "golden" structure can be maintained for about 15 to 30 years, or up to 40 years at a maximum, depending on future birth rates. Vietnam needs to take advantage of this low dependency ratio and demographic bonus to develop a high quality labor force for boosting economic growth.

FIGURE 2.7:
LABOR FORCE PARTICIPATION RATES BY AGE GROUPS, 1980-2008



Source: International Labour Organization

FIGURE 2.8: AGE-SPECIFIC LABOR FORCE PARTICIPATION RATES IN 2008, VIETNAM AND OTHER ASIAN COUNTRIES



Source: International Labour Organization

There are however some initial signals of an ageing population. The ageing rate of Vietnam has increased by 11 percent (from 24.5 to 35.9 percent) over the past 10 years. The current ageing rate is higher than the average rate for the ASEAN region (30 percent). An aging population will pose serious challenges for the social security system given the country's current low level of development.

Vietnam is among the most densely populated countries in the world—with the average population density of 254 people/km2 in 2007. This density is 1.86 times higher than that of China (136 people/km2), 10 times higher than that of developed countries and 6 to 7 times higher than the world's average density. High population density affects the quality of the living environment, especially in urban areas. This implies that land-intensive industries are no longer an advantage for Vietnam and Vietnam needs to use its land resources most efficiently.

Labor Force Participation

- *The labor participation rate is high but declining, as younger people can afford to stay longer in school*

Vietnam's labor force comprises 43.8 million people (April 2009), equivalent to 51.1 percent of the total population. As illustrated in Figure 2.7, the labor participation rate has decreased over time, primarily as a result of declining participation by the 15-24 age-group. However, although in 2008 this rate decreased by 2.5 percentage points compared to that in 1998, it still remained high at 77.4 percent, equal to the rate for many high-income countries such as Japan, Denmark, etc.

The lower participation rate of working-age population could be explained by the fact that younger people stay longer in school. Thanks to improvements in living standards. The participation rate for 15-24 year old age group has declined continuously since 1980.

In 2008, the structure of labor force participation by age-group for Vietnam resembled that of China, where 92.8 percent of the 25-34 year old age-group participated in the labour force. For the 15-24 age-group, the participation rate of high-income countries such as South Korea was lower than that of Vietnam; however, the rates for 55-64 and 65 and above age group were higher. The evidence from these and other countries implies that Vietnam needs to take full advantage of its golden population structure before the greying of the population emerges over the next two decades.

TABLE 2.4: COMPARISON OF EMPLOYMENT GROWTH RATES

Country	Employment growth (%)
Vietnam 1991 – 2007	**2.4**
Korea 1969-1988	3.2
Malaysia 1977-1996	3.5
Thailand 1976-1995	3.0
Taiwan 1963-1982	3.4
Indonesia 1977-1996	2.9
Philippines 1961- 1980	3.3

Source: Fulbright Economics Teaching Program, The Structural Roots of Macroeconomic Instability, September 2008.

Employment Growth

- *Employment growth lags behind GDP growth; a high share of self-employed and informal employment suggests that unemployment and underemployment figures may be underestimated*

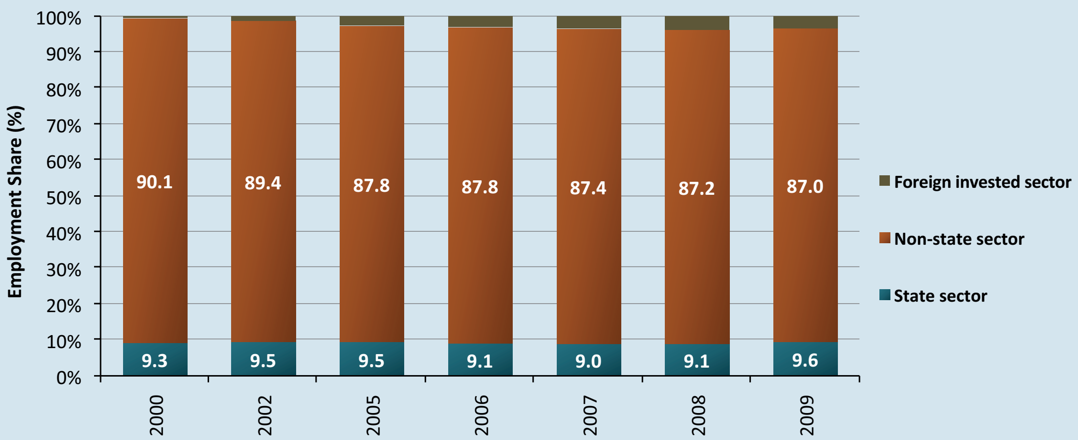
The growth in labor demand is relatively low compared to the Vietnam's high income and export growth. Compared to other countries in the period of their own rapid growth, Vietnam's performance on job creation is not as impressive. Vietnam's high labor participation rate (43.9% in 1991) as compared to peer countries (e.g. 29.4% for Korea in 1960 and 34.2% for Malaysia in 1977) may provide a partial explanation. However, Thailand started the take-off period in 1976 also with relatively high labor participation rate (42.6%) but still recorded the average job growth at 3.0% over two decades.

The sectoral distribution of investment explains much of the lackluster performance of the economy in creating jobs. Some 37 percent of total investment flows into the capital-intensive state sector, which accounts for only 10 percent of jobs. In contrast, the private domestic ("non-state") sector employs 87 percent of all workers, but its share in total investment is only 28 percent. Redressing that imbalance needs to be part of any strategy for accelerating job creation.

The serious challenge for facing Vietnam's economy is to create sufficient jobs in rapidly growing sectors that can absorb its large young labor force, without being trapped in low-productivity, labor-intensive industries.

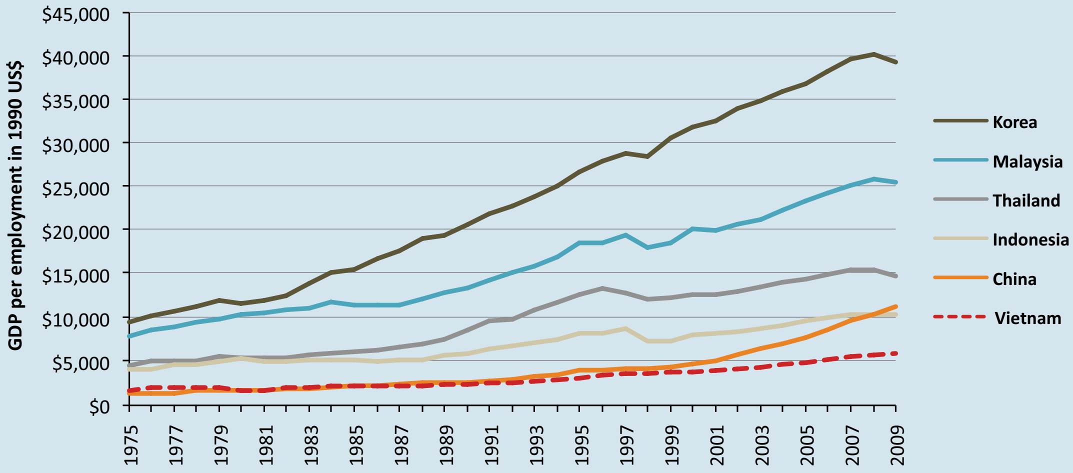
Salaried employees in the formal sector account for only 23 percent of the total number of workers (ILO's Employment Trends Report 2009). The remaining 77 percent are self-employed or unpaid family workers. Small, and mostly informal, family farms and enterprises comprise an unusually large proportion of employment in Vietnam. Therefore, the official unemployment statistics may underestimate the level of underemployment or unemployment of the self-employed workers (including people working in agriculture) and those who work outside of formal economy.

FIGURE 2.9: EMPLOYMENT STRUCTURE BY OWNERSHIP, 2000-2009



Source: General Statistics Office of Vietnam

FIGURE 2.10: PRODUCTIVITY GROWTH – VIETNAM VS. OTHER ASIAN COUNTRIES, 1975-2009



Source: The Conference Board,Total Economy Database 2010.

Labor Productivity

Labor productivity growth is ultimately the key for sustained prosperity gains as it is intimately linked to wages and the standard of living. Labor productivity—defined here as GDP per worker has three dimensions:

- First, higher labor productivity can be the result of better skilled employees, an increase in complementary factors of production such as capital, or better use of technology.
- Second, higher average labor productivity can be the result of either sectoral change — a growing share of labor in sectors with higher productivity levels, or within-sector growth — higher labor productivity within sectors as a result of innovation.
- Third, higher average labor productivity can be the result of changes in the composition of companies in the economy (foreign vs. local, private vs. government-owned) that have different levels of productivity or of productivity growth.

Overall Labor Productivity

- *Despite relatively high growth rate in overall labor productivity, the absolute level remains much lower compared to most countries in the region*

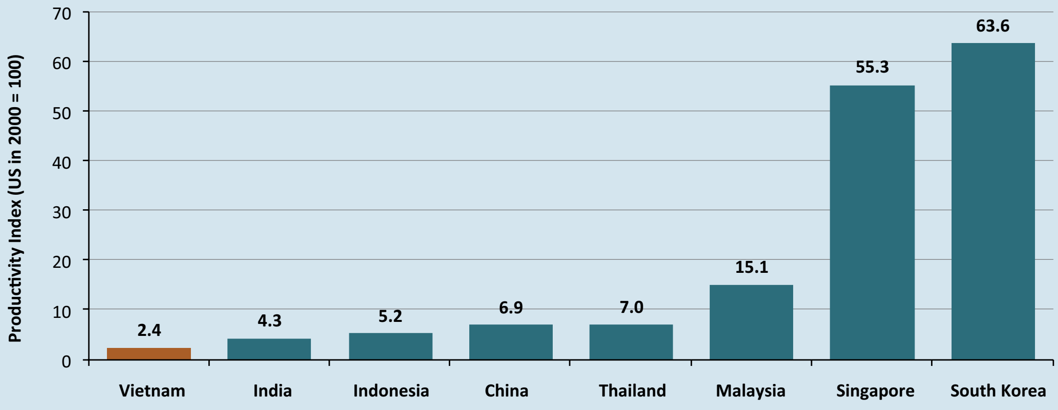
Labor productivity has continuously improved since 1986, with a relatively high rate of improvement compared to peers. Vietnam's average labor productivity growth during the period 1986 to 2009 was 4.67 percent; higher than that of other ASEAN countries (3.73 percent) but significantly lower than that of China (7.26 percent). However, the subsequent sections examine whether this growth was generated by a shift towards capital-intensive production or by improvements in skills and technological progress.

In absolute terms, Vietnam remains a low productivity country compared to the rest of Southeast Asia. In 2009, Vietnam's productivity was equivalent to only 14.9 percent of that of Singapore, 9 percent of that of the U.S., 40 percent of that of Thailand and 52.6 percent of that of China.

The comparisons look even worse for the manufacturing sector, which is expected to be the key driver of Vietnam's productivity growth. Taking the level of manufacturing sector productivity of the US in 2000[6] as 100, the relative productivity of the manufacturing sector in the same year was only 2.4 for Vietnam; whereas it was 4.3 for India, 5.2 for Indonesia, 6.9 for China, 7 for Thailand, 15.1 for Malaysia, 55.3 for Singapore, and 63.6 for South Korea (Figure 2.11).

The low growth rate of productivity within sectors raises a serious concern. The experience of NICs in Asia has shown that sectoral productivity growth should be the key driver of overall productivity growth. In South Korea for example, sectoral productivity growth accounted for 83 percent of overall productivity growth during the high growth period 1963-1973 while sectoral structural shift accounted for only 17 percent. The figures were 69 percent and 31 percent during 1973-1985 and 89 percent and 11 percent during 1985-1996, respectively (Van Art and Timmer, 2003). Similarly, 85 percent of Singapore's productivity growth during 1970-2005 was from sectoral productivity growth (ACI, 2009).

FIGURE 2.11: MANUFACTURING SECTOR PRODUCTIVITY IN 2000 – VIETNAM VS. SELECTED ASIAN COUNTRIES



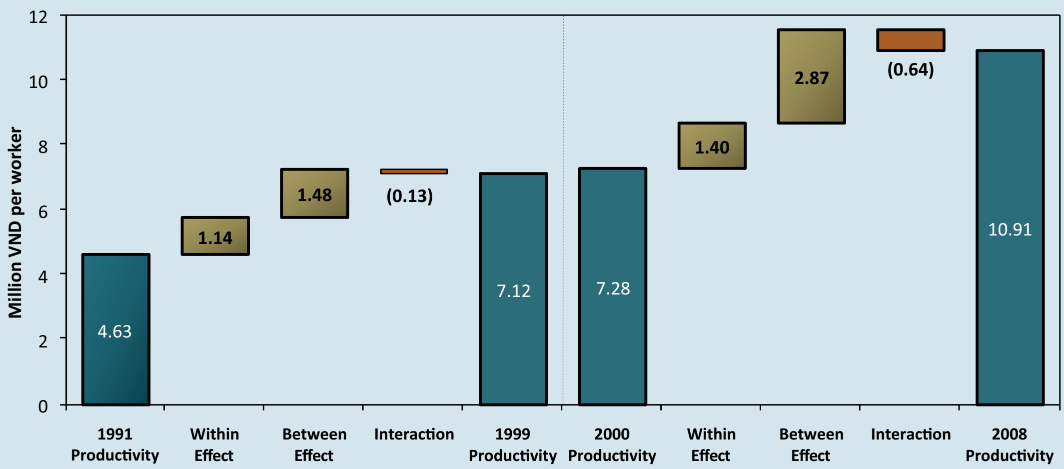
Sources: UNIDO; China Statistical Yearbook.

The Impact of Sectoral Shifts on Labor Productivity

- *The growth in labor productivity is largely due to the shift from agriculture to manufacturing and services; however, within-sector productivity growth remains feeble*

During 1996-2008, labor productivity increased at an average annual rate of 4.8 percent, from a low base. Much of this is accounted for by shifts in the sectoral structure, even while sectoral productivity growth has been lower. Compared with the period 1991-1999, the contribution of structural shift to overall productivity growth in 2000-2008 was even higher. Figure 2.12 below shows that structural shift contributed more than two thirds of the overall productivity growth over the 2000 - 2008 period, while sectoral productivity growth only accounted for one third of the overall growth. This was largely the result of labor moving from low productivity sectors to higher ones (static structural shift). Sectors which managed to increase both their productivity and their share in the total workforce (dynamic structural shift) were too few in number and had little impact to overall productivity growth. In other words, the structural shift over the last two decades has been mostly horizontal, with agriculture shrinking while industries and services expanding in terms of both sectoral contribution to GDP and sectoral share in the total workforce.

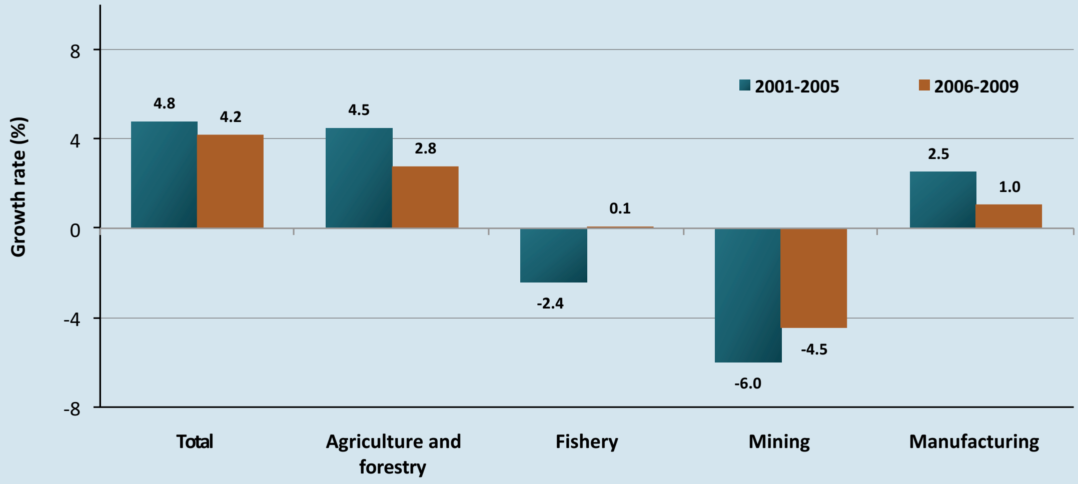
FIGURE 2.12: DECOMPOSITION OF LABOR PRODUCTIVITY, 1991-1999 AND 2000-2008



Note: Productivity is measured by GDP per worker at 1994 prices.

Source: General Statistics Office of Vietnam; calculations by ACI and CIEM.

FIGURE 2.13:
GROWTH RATE OF OVERALL AND SECTORAL LABOR PRODUCTIVITY



Source: General Statistics Office of Vietnam.

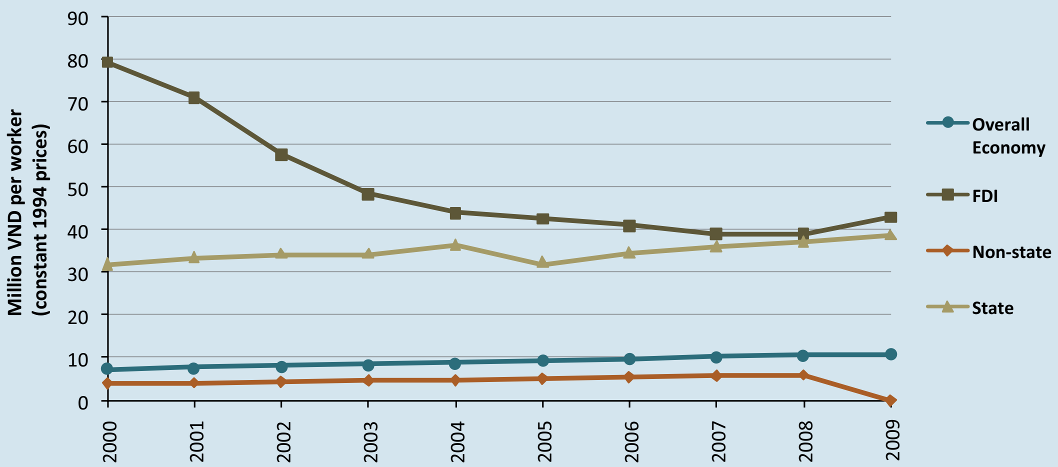
Figure 2.13 shows that the agricultural and forestry sector registers the highest rate of growth of labour productivity, yet the focus of both government and foreign investors is on the manufacturing sector where labour productivity growth has been much lower in comparison. In recent years, the processing industry has created many new jobs, and has contributed significantly to the shift in labor structure and sectoral structure. These achievements are due primarily to the expansion of production volume and the absorption of low-skilled workers, not from a shift to higher value-added products.

Labor Productivity by Ownership

- *Labor productivity varies among economic segments: it is much higher in the FDI sector, but declining sharply as FDI shifts toward more labor-intensive activities; labor productivity in the state sector is high because of capital-intensive production processes; it lags in the private sector*

In 2000, the average labor productivity in the FDI sector was more than double the productivity of the state sector, 20 times higher than that of the non-state sector and 10 times higher than that of the overall economy. But the gap has been narrowing, primarily because FDI has basically shifted toward more labor-intensive activities in the post-integration stage. Many FDI enterprises in processing industry use outdated technology, and also fail to comply with the current legislation on environmental standards, causing much pollution. This sector's productivity has witnessed a sharp decline during 2000 – 2007. By 2008, the sector's productivity was only 7 times higher than that of the non-state sector and was equivalent to 90 percent of the state sector, yet still 4 times higher than that of the overall economy. Labor productivity in the non-state sector lags, because it comprises a large proportion of informal and smallholder businesses with low capital-labor ratios and limited access to technology.

FIGURE 2.14:
LABOR PRODUCTIVITY BY OWNERSHIP



Note: Data for 2009 are preliminary.

Source: General Statistics Office of Vietnam.

Assessment
Continuous growth has raised Vietnam's income per capita to over USD 1,000 since 2008 and improved other measures of living standards. However, despite these achievements, the growth process has encountered three serious problems that threaten national competitiveness. First, labor productivity has progressed continuously for the past 20 years. However, opting for capital-intensive production processes has raised labor productivity, but at the expense of capital productivity, with limited impact on growth and Vietnam remains an economy with low labor productivity. Second, the income gap between the richest and the poorest group has widened. Third, environmental quality is degrading, especially in key economic regions that are also the leading engine of national growth. Vietnam is also undergoing rapid urbanization, imposing serious pressures on urban infrastructure and on the creation of non-agriculture jobs.

Vietnam' sources of growth resemble those of other Southeast Asian countries; physical capital still plays a major role, while the contribution of technological advances is low and unstable. Vietnam has high labor mobilization rate and will continue to benefit from its golden population structure in the following decades. However, the fact that labor quality is low and has not seen much improvement, especially in the case of young workers, has been a bottleneck for labor productivity growth.

Moreover, the low contribution of sectoral productivity growth to overall productivity growth is a serious concern. Growth was mainly driven by structural shifts from agriculture to manufacturing and services. The process is still ongoing, but will ultimately be limited by the low productivity of the manufacturing sector. Experiences from developed countries show that in the long run, it is productivity growth within sectors rather than structural shifts that drives overall productivity growth. Thus, future policies need to target sectoral productivity growth in order to increase national competitiveness.

Intermediate Indicators of Economic Performance

Indicators like investment, trade, and innovation represent 'leading indicators' of future prosperity. Investment increases the capital stock and is often a sign of other improvements in the productive capacity of an economy. Competition through trade improves efficiency, exposes local companies to external rivalry and new ideas, and thus enhances productivity. Innovation leads to new products, new services, or new ways of production and marketing.

From the perspective of a competitiveness analysis, these indicators play a dual role. They reflect underlying competitiveness, but they also contribute to competitiveness. If there is more investment, more trade, or more innovation, the underlying competitiveness of a location tends to grow over time.

Intermediate indicators are too often misunderstood as policy objectives rather than as diagnostic instruments. Investment is a typical example: if it occurs naturally as part of the market process, it is a sign of and contributor to competitiveness. But if it is the result of government intervention, for example because of subsidies paid to investors, investment can undermine prosperity. A competitiveness assessment therefore needs to view these intermediate indicators as part of an overall diagnostic, not as an ultimate objective. This perspective also increases the value of looking at other indicators, for example the nature of investors or the productivity of their investments, to get a clearer sense on whether the intermediate indicator is a good indicator of (and contributor to) underlying competitiveness.

Investment
Investments, whether from domestic or foreign sources, are a sign that there is confidence in the future economic attractiveness of a location. Investments have a direct impact in terms of the capital deepening they represent. Quite often, new machinery and equipment lead to parallel improvements in organization and activities. And investment tends to increase the returns to skills, creating incentives for upgrading in other dimensions of competitiveness. Foreign investments have additional benefits in contributing additional capital, technology, and linkages to foreign markets.

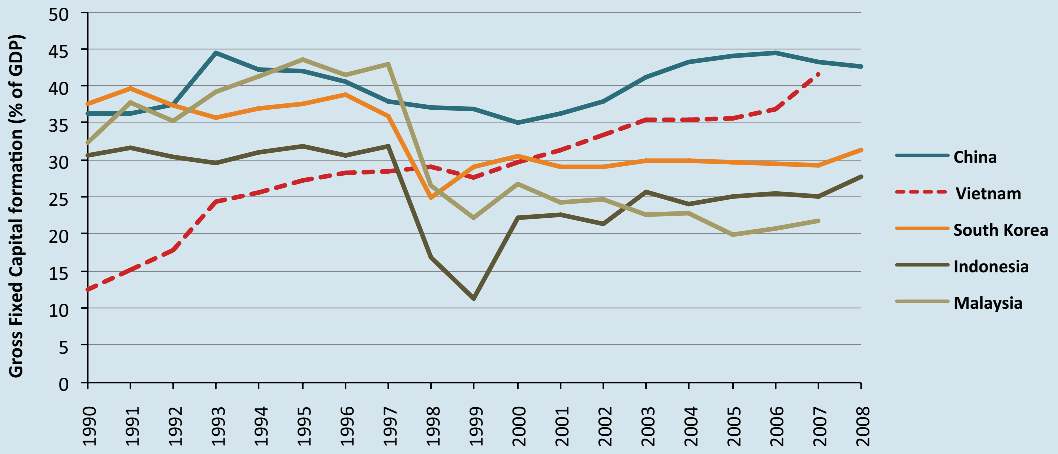
Overall Investment Performance:

Investment Rate
- *The investment rate is high and growing*

Economic growth is accompanied by acceleration in investment. For Vietnam, the ratio of Investment to GDP increased from 18.1 percent in 1990 up to 46.5 percent in 2007. Inflation-restraint measures by the government brought the ratio back down to 41.3 percent in 2008.

This ratio was much higher than that for some NICs over the period 1960-1980, or for China and some fast-developing countries during the last few decades. For instance, from 1961-1980, the ratio of investment to GDP of South Korea reached an average of 23.3 percent, and Taiwan 26.2 percent, while their GDP grew by 7.9 percent and 9.7 percent, respectively. During 1981-1995 (before the Asian financial crisis), Thailand's GDP had an annual average increase of 8.1 percent, with 33.3 percent of investment to GDP. In 2001-2006, Vietnam registered an annual investment ratio of 37.2 percent, close to the 38.8 percent of China; however, annual GDP growth rate of China was 9.7 percent compared to 7.6 percent for Vietnam (Reidel, 2009).

FIGURE 2.15:
INVESTMENT PATTERNS, 1990-2008



Source: World Development Indicators

Investment Efficiency

- *Investment efficiency is low and declining*

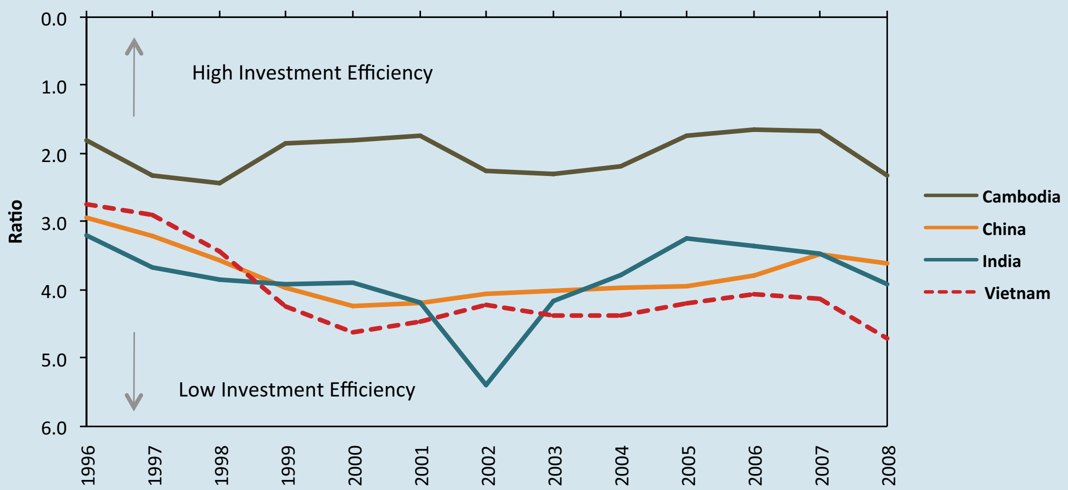
The incremental-capital output ratio (ICOR) which relates (net) investment in one year to subsequent gains in GDP may not be a solid analytical tool but nevertheless gives an interesting perspective: Vietnam's investment rate is high relative to growth. And the rate appears to be on the increase. Vietnam's ICOR averaged 4.8 during 2000-2008 and 5.4 for the period 2006-2008. At that level, it is much higher than that of NICs during the transition period from 1961-1980 such as Taiwan (2.7), South Korea (3) or some countries in the region like Thailand (4.1 from 1981-1995) and China (4 from 2001-2006). Incremental Capital-Output Ratio, Vietnam and selected Asian countries.

Investment of the State Sector

- *The state sector accounts for a high share of investment, but efficiency is low*

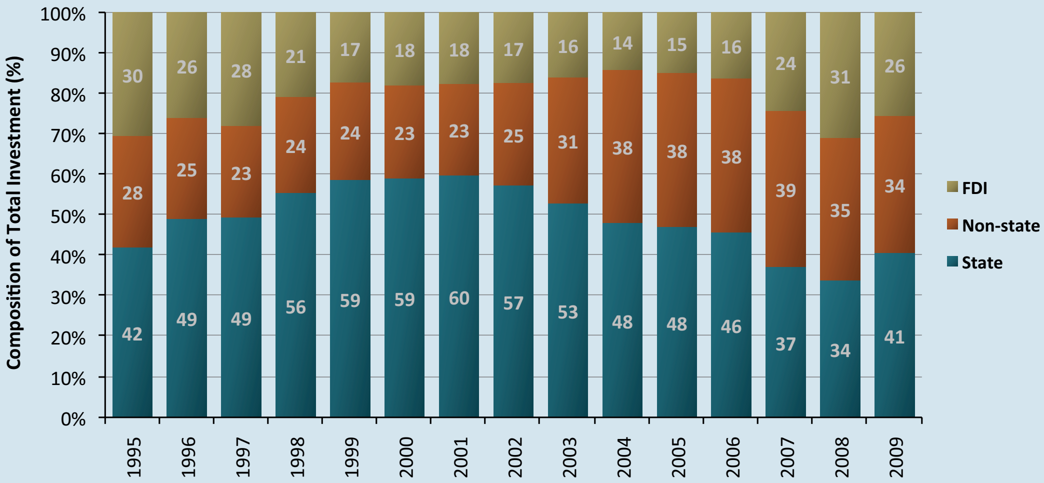
Despite the fact that the private and FDI sector's investments have expanded at a very high rate, 18 percent and 44 percent respectively, in the last two decades, the state sector still accounted for the lion's share of total investment. The efficiency of these investments therefore plays a key role in determining the growth rate and macroeconomic stability in Vietnam.

FIGURE 2.16:
INCREMENTAL CAPITAL-OUTPUT RATIO – VIETNAM AND SELECTED ASIAN ECONOMIES



Source: World Development Indicators and Economist Intelligence Unit 2010; calculations by ACI.

FIGURE 2.17: COMPOSITION OF TOTAL INVESTMENT BY OWNERSHIP, 1995-2009



Source: General Statistics Office of Vietnam.

State investment comes from four sources—state budget, SOEs, state credit, and "the other."[7] The first two sources account for about three quarters of total public investment. State investment is declining[8] since 1996 as a result of the continuing equitization process. Even so, it still accounts for high percentage in total social investment, at an average of 49.3 percent from 1995-2008.

Investments in the state sector have been less efficient than in both the non-state and FDI sectors. For instance, according to some estimates, the ICOR of the state sector is 1.5 times higher than that of the whole economy, regardless of the ICOR calculation methods, whether by using gross capital formation or accumulative assets (Bùi Trinh 2010). Given its importance in terms of total investment, the low efficiency of state investment, especially of SOEs, drags down overall performance and undermines competitiveness gains in Vietnam.

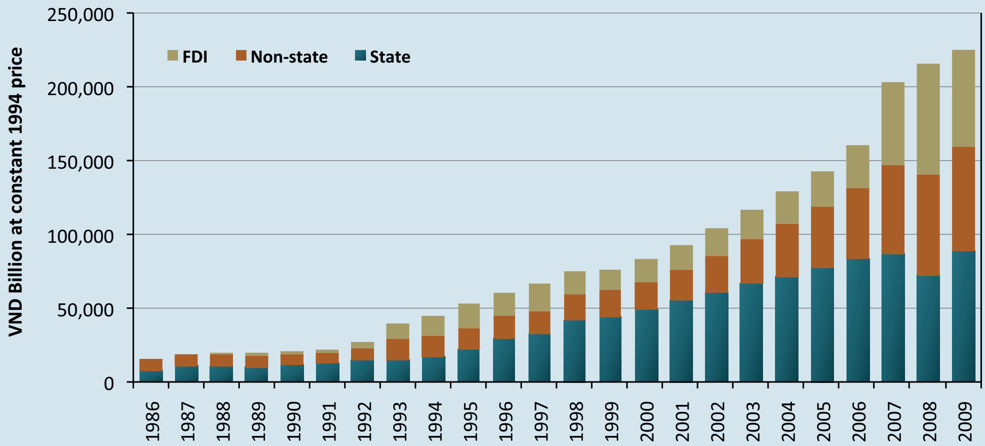
Foreign Direct Investment

Overall FDI Performance

- *Robust FDI inflows result in a high share of FDI to GDP*

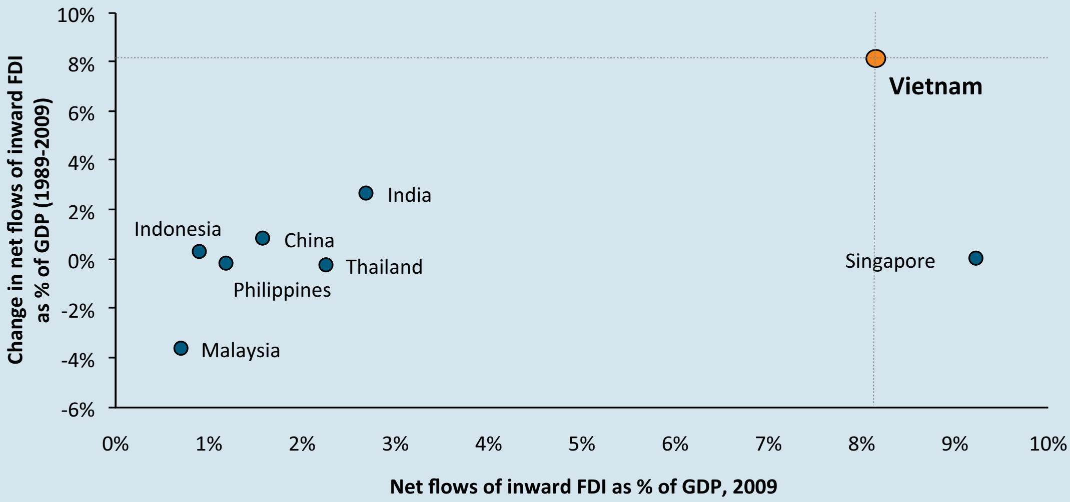
In Vietnam, FDI represents an important source of capital. According to data published by UNCTAD, the share of FDI in total gross fixed capital formation in Vietnam increased from 12 percent in 2006 to 25.5 percent in 2007 and 24.1 percent in 2008. The FDI stock relative to GDP increased from 25.5 percent in 1990 to 66.1 percent in 2000. By 2008, the total registered FDI amounted to USD 164 billion with almost 11,000 projects, but the FDI stock had dropped to 53.8 percent of GDP.

FIGURE 2.18: GROSS FIXED CAPITAL FORMATION BY OWNERSHIP, 1986-2009



Source: General Statistics Office of Vietnam.

FIGURE 2.19: OPENNESS TO FOREIGN INVESTMENT



Source: Economist Intelligence Unit 2010; calculations by ACI.

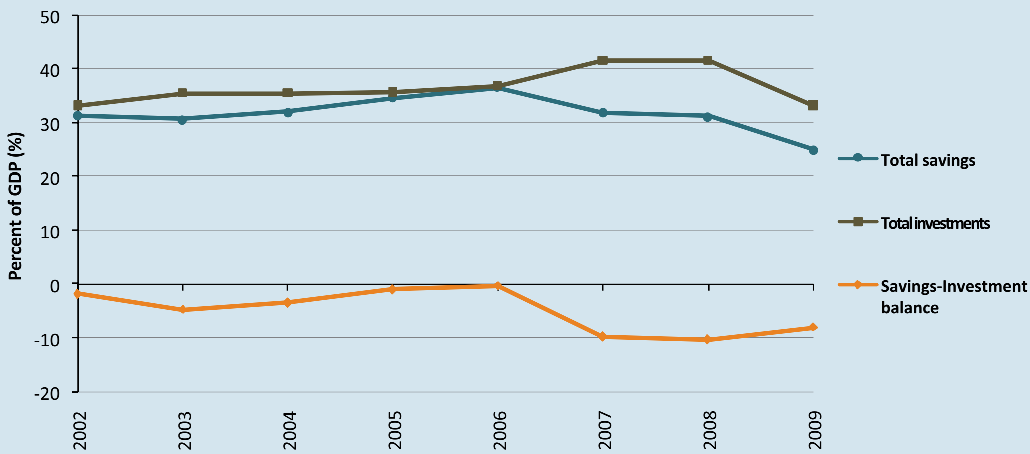
Domestic savings have not been sufficient to finance investment. The economy therefore depends increasingly on foreign resources and FDI has increasingly become an important source to compensate the saving and investment gap that has widened in the past three years.

FDI Implementation Rate

- *A widening gap between announced and realized FDI*

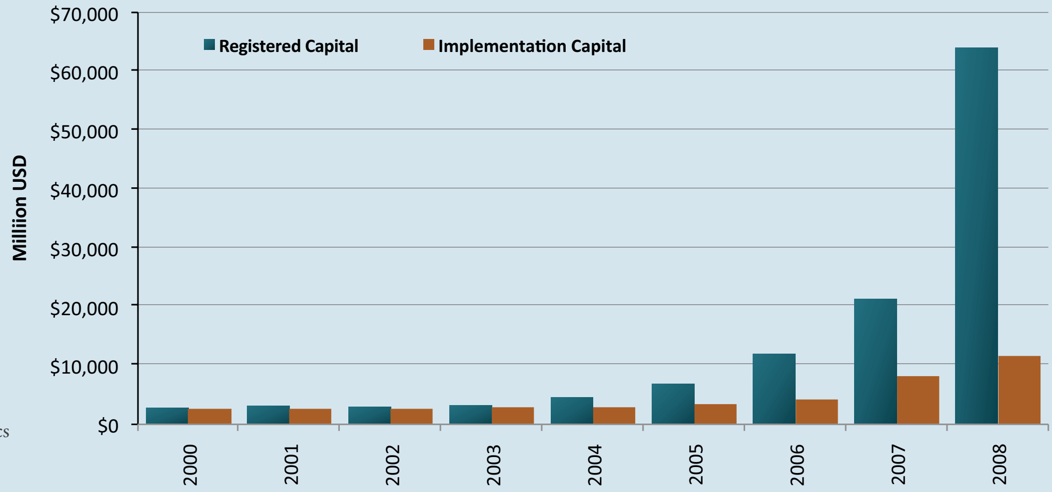
While the announced foreign direct investment projects continue to be strong, there is an increasing gap between announcements of foreign investment projects and actual investments made. The disbursement rate, actual vs. announced, was highest during 1997 – 2004 (73.5 percent) but has dropped dramatically to 40.1 percent during 2006 – 2008. Part of the growing gap might be explained by the FDI attraction race at the regional level that provides an incentive to "over-report" FDI commitments. But part of it is likely to be driven by increasing problems in implementing FDI projects in line with initial plans, or speculative behaviors of some investors who register projects to "reserve a seat" and resell their licenses for profit.

FIGURE 2.20: THE SAVINGS-INVESTMENT GAP, 2002-2009



Source: General Statistics Office of Vietnam.

FIGURE 2.21:
ANNOUNCED VS. REALIZED FDI, 2000-2008



Source: General Statistics Office of Vietnam.

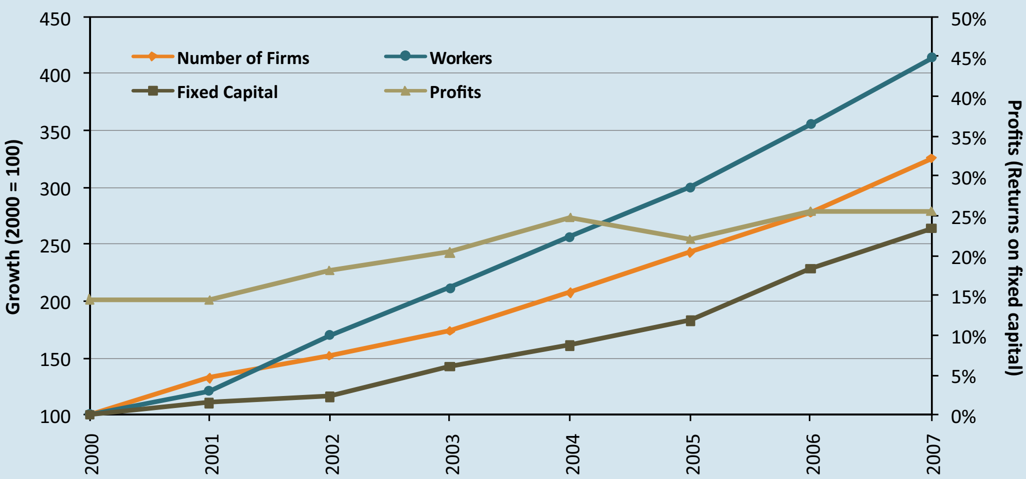
Targets of FDI

- *FDI is increasingly shifting to real estate and labor-intensive industries*

In the early years, FDI inflows were concentrated in import substitution and non-tradable industries (such as oil, construction, transportation, or communications) to serve the temporarily protected domestic market (STAR 2003). However, over the last five years, FDI inflows have shifted to more export-oriented and labor-intensive industries and to the real estate sector. Figure 2.22 shows that the number of workers in the FDI sector grew faster than the number of firms and fixed capital, reflecting a rapid shift towards labor-intensive industries. This trend is a response to the removal of industrial protection measures and also to the prevailing low-wage labor advantages. In 2009, the number of FDI projects investing in real estate and leasing business accounted for 21 percent of the total projects and the amount of invested capital was equivalent to 33 percent of total registered capital (GSO 2009).

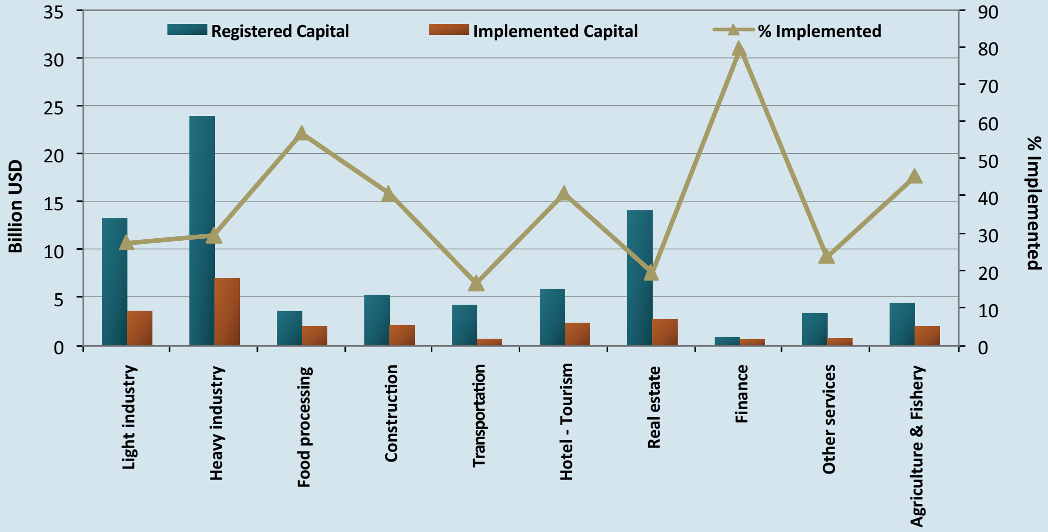
Although the manufacturing sector still accounts for the largest share in total registered capital, actual disbursement level in this sector have been especially low, representing only 30 percent of the total implemented capital during 1988-2007. This may reflect more difficulties and lower returns in investing in the manufacturing sector compared to the services and real estate sectors. It therefore requires reconsideration in policy and provision of incentives to encourage more FDI into the sectors that can boost up productivity and create more spillover values for the economy.

FIGURE 2.22:
PERFORMANCE OF THE FOREIGN INVESTED SECTOR



Source: General Statistics Office of Vietnam.

FIGURE 2.23:
CUMULATIVE FDI DISBURSEMENT RATIOS BY SECTOR, 1988-2007



Source: FIA's Report on Vietnam's 20-year FDI Development.

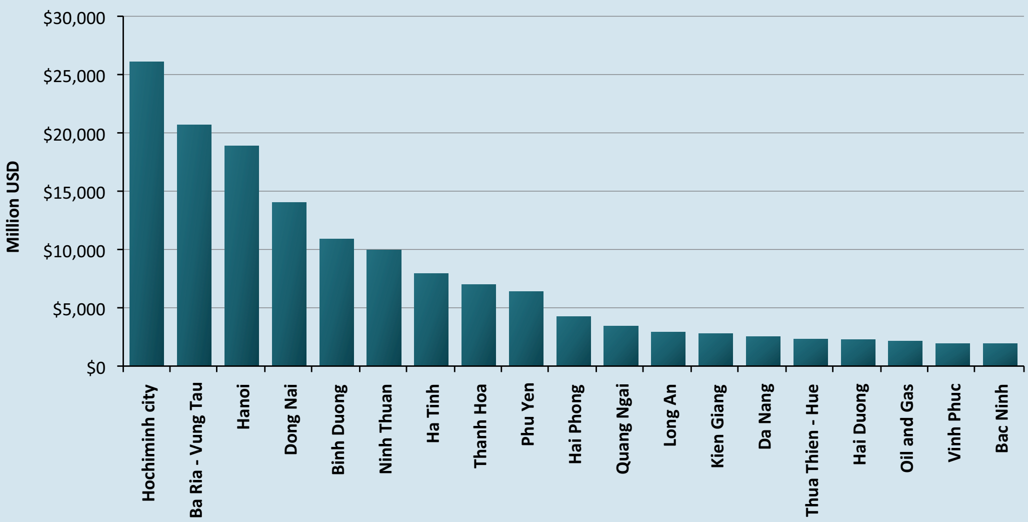
Policy decisions by the government of Vietnam in relation to the sectoral composition of FDI may also have an impact. There has been a call for a re-thinking of priorities for FDI. Investments in real estate projects have been criticized for various reasons, ranging from loss of land for agriculture to land price bubbles and increasing asset inequality between urban and rural areas. There is widespread discussion about focusing on projects with high domestic value-added or a high technological component. For instance, Ho Chi Minh City is now reluctant to grant FDI licenses to low-skilled labor-intensive projects. At the same time, the relocation of FDI manufacturing projects from China to Vietnam would continue. For instance, at present many South Korean businesses are seeking more competitive locations to replace some of their Chinese operations, and ASEAN countries are favoured because of their location and culture. Thus, Vietnam could be among the countries to benefit the most from this trend.

Regional FDI concentration

- *FDI is highly concentrated in a few geographic centers, but is moving slowly to the next layer of provinces*

In 2009, the top provinces attracting FDI in Vietnam are Baria-Vung Tau (USD 6.73 billion out of the total USD 21.48 billion), Quang Nam (USD 4.174 billion) and Binh Duong (USD 2.502 billion). Ho Chi Minh City and Hanoi were ranked 7th and 8th, respectively. There were 537 projects licensed in the three major economic centers of the country, accounting for 64 percent of the total new licenses granted countrywide. Cumulatively by the end of 2008, Ho Chi Minh City, Ba Ria Vung Tau and Hanoi were the top three destinations for FDI.

FIGURE 2.24:
TOP DESTINATIONS FOR FDI (CUMULATIVE) AS OF DECEMBER 31, 2008



Note: FDI data are cumulative and cover the periods when Vietnam started to attract FDI until December 31, 2008.

Source: FIA.

BOX 2.2:
TECHNOLOGY LEVEL OF FIES IN HCM CITY

As of December 31, 2008, HCM city has three export processing zones and twelve industrial zones with a total of 1,143 active projects, whose registered capital stood at USD 4.36 billion and with approximately 250,000 employees. However, there are only three qualified high-tech enterprises: Nidec Tosok, Mtex, and Renesas. In 2005, exports of high-tech products from these three enterprises alone made up almost 22 percent of total export turnover of all operating industrial zones (IZs), amounting to USD 300 million. Overall, the technological content of industrial products remains low.

According to the recent 2008 survey conducted by HCM city's Department of Science and Technology, out of a total of 429 enterprises operating in industrial and export processing zones (EPZs), only one percent of all enterprises attained a high-technology level, 4 percent nearly high-technology, 8 percent slightly above average, 36 percent average and up to 51 percent, a below-average technology level. The technology level is measured in terms of sophistication in the following factors: machinery and equipment; information technology; human resources; and business operation methodologies. Tan Thuan EPZ is fully utilized, mostly by FIEs. However, a sizable number of its enterprises still have low technology levels.

Source: CIEM

Impact of FDI

- *FDI has limited spillover effects and few linkages with the local economy*

The increasing volume of FDI has been characterized by a relatively low technological content. Policies to attract high-tech investments from FDI have been strengthened since 2005 with the adoption of the Investment Law and the Law on Technology Transfer in 2006. The government also paid more attention to attract FDI with high technological content via the establishment of high-tech industrial parks such as Hoa Lac High-Tech Zone[9]. However, there are only 28 licensed investment projects in these parks at present, some of which are foreign invested, with registered capital totaling less than USD 1 billion and still in the "warm-up" phase. Low labor skills, low technological capability of domestic enterprises and weak forward and backward linkages between foreign-invested enterprises (FIEs) and domestic enterprises have hindered effective technology transfer (Tue Anh N.T. 2009).

According to the 2009 Provincial Competitiveness Index (PCI) Survey, among nearly 10,000 local private enterprises surveyed, only 6.9 percent reported FIEs as their main clients. Of the remainder, 15 percent cited SOEs and 58 percent mentioned other local private companies as their main clients.

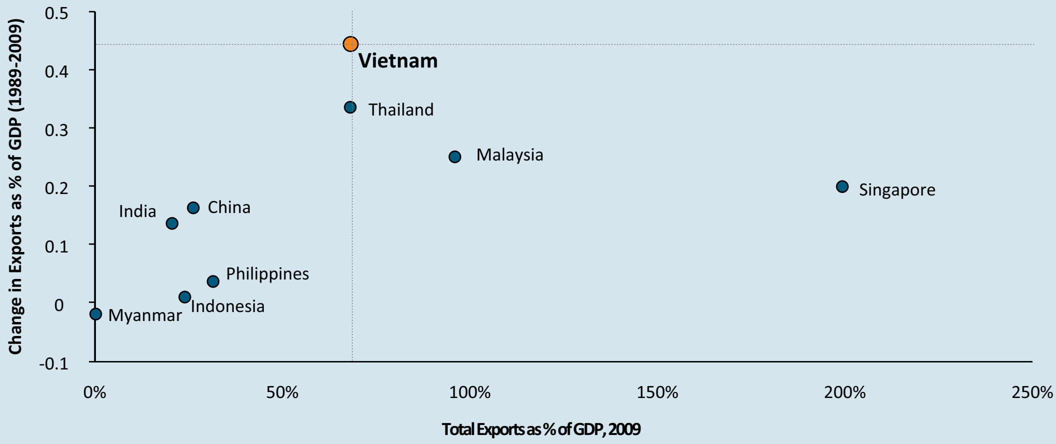
A recent CIEM survey of 100 percent foreign-invested companies in the garment and electronics industries in Hung Yen, Hai Duong, Vung Tau, Binh Duong and Dong Nai provinces revealed that the companies carry out only the simplest activities in their production line in Vietnam, while design and other more sophisticated details are decided by the parent company overseas. The parent company also supplies inputs and handles distribution and sales of final products. This is a typical model of a simple processing industry competing primarily on price, which requires cheap labor, high consumption of electric power, and good transportation and logistical infrastructure. With this model, it is very difficult to generate positive technology spillovers from the FDI sector. Recent policy measures and efforts to create a more enabling and less costly environment for enterprises, particularly for FDI, are important but not necessarily sufficient to generate FDI spillovers and contribute to productivity upgrading.

What Attracts FDI?

According to a recent JETRO's annual survey of Japanese-affiliated firms operating in Asia, political stability (61.1 percent of respondents), low wage labor (38.9 percent) and market size (38 percent) are Vietnam's strengths as an investment location.

In summary, FDI has increased in terms of volume, but the lack of incentives to increase quality, efficiency and competitiveness of industries in particular and the economy in general, has limited its contribution to upgrading competitiveness. Better incentives are needed to encourage high technology-intensive activities, accelerated technology transfer, introduction of technologies with less environmental pollution and a continuous skills transfer

FIGURE 2.25:
LEVEL AND GROWTH OF EXPORTS



Source: Economist Intelligence Unit 2010.

Trade[10]

Trade contributes to prosperity in many ways and it enables specialization where an economy has comparative or competitive advantages. As a two-way street, trade exposes local producers to competition and it also offers access to knowledge in global markets.

Exports

Export Patterns

- *The level of exports to GDP is high, but Vietnam accounts for a relatively small share of the global market*

Available trade data vividly demonstrate the rapid integration of Vietnam into the world economy, especially after the conclusion of the Bilateral Trade Agreement with the US in 2001. Exports of goods and services soared more than four times between 2000 – 2008, from USD 17.2 billion to USD 69.8 billion in 2008, before contracting to USD 62.8 billion in 2009 in the aftermath of the global financial crisis. With this level, Vietnam's ratio of exports to GDP in 2009 was almost 68 percent, only behind Singapore and Malaysia, and at par with Thailand and higher than most of other countries in the region.

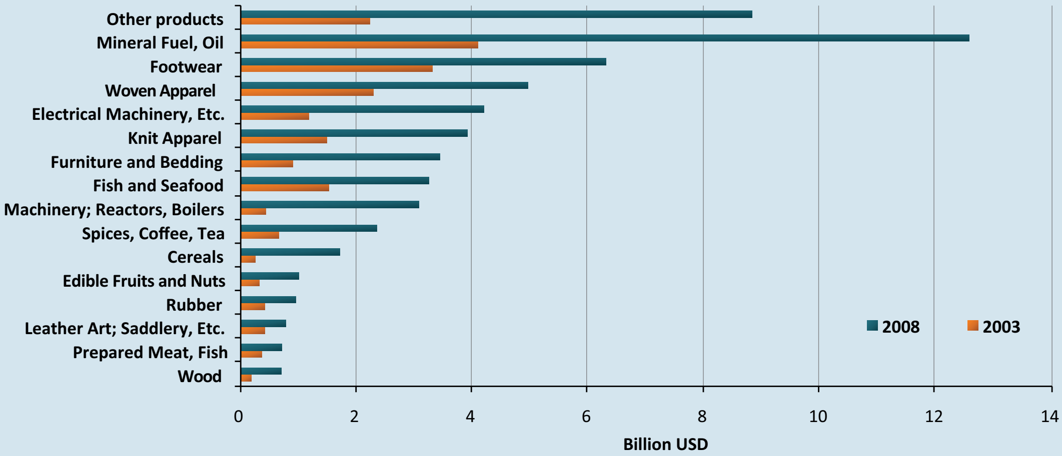
Table 2.5 below shows additional performance indicators of trade. Vietnam's export growth lags only behind that of China, but its global market share is relatively small. This is in part a reflection of the size of the economy.

TABLE 2.5:
TRADE PERFORMANCE INDEX (TPI) IN 2006

Country	Global market share (%)	Growth of export value (%)	Growth of export volume (%)	Number of big exports with turnover of USD 100,000
China	8.1	31	21	4,644
Malaysia	1.3	14	2	3,397
Thailand	1.1	18	8	3,281
Indonesia	0.8	15	2	2,941
Vietnam	**0.4**	**26**	**9**	**2,107**

Source: Trade Performance HS: Exports and Imports of all industries (2006), Trade Competitiveness Map, International Trade Centre (ITC).

FIGURE 2.26:
COMPOSITION OF VIETNAM'S EXPORTS BY MAJOR PRODUCT CATEGORY 2003 AND 2008



Note: Export products are classified according to the Harmonized System (HS).

Source: Global Trade Atlas.

Composition of Exports

- *Strong specialization in labor-intensive low-tech and agribusiness products*

Besides crude oil which accounts for a share of roughly one-fifth of all exports, key export products remain largely labor-intensive or agricultural activities, such as footwear, apparel (both woven and knit), and electrical machinery.

For the 15 top product categories shown in Figure 2.26, the relative increase between 2003 and 2009 varies considerably. The slower-growing product groups include footwear (average annual rate of increase of 13.8 percent), woven apparel (16.7 percent), fish and seafood (16.4 percent), rubber (18 percent), leather art & saddlery (13.2 percent), and prepared meat & fish (14.1 percent). The fast-growing product groups include electrical machinery (29 percent), furniture and bedding (30.7 percent), machinery, reactors and boilers (47.6 percent) and cereals (46.5 percent). As a group, the top 15 product categories increased by 22.9 percent per year, another indicator of Vietnam's growing export diversification. Exports in all other product categories (not shown in Figure 2.26) increased by 31.7 percent per year during the period 2003 to 2008.

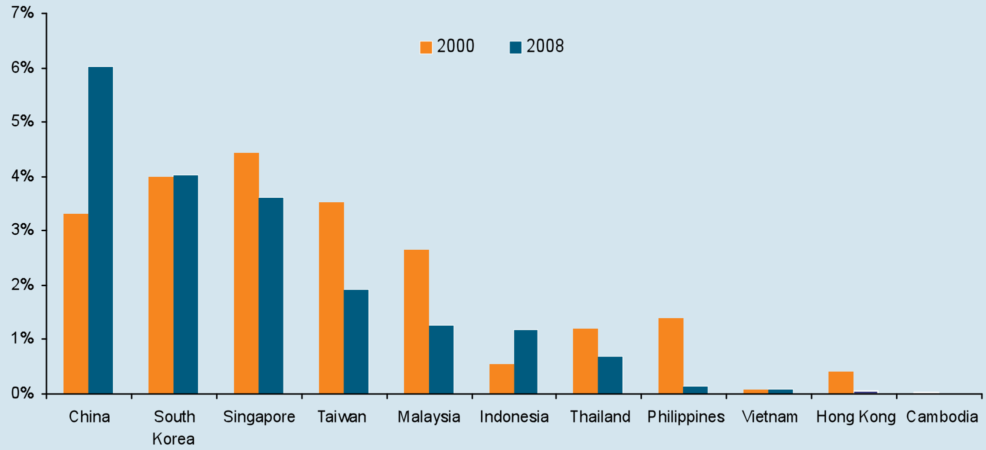
TABLE 2.6:
MANUFACTURED EXPORTS, 2000-2008

Country	Value of manufactured exports (billion USD)			World market share			Annual growth rate		
	2000	2005	2008	2000	2005	2008	2000-2005	2005-2008	2000-2008
Cambodia	1.1	3	4.6	0.02%	0.03%	0.03%	22.2%	15.4%	19.6%
China	228.4	722.6	1,370.1	3.79%	7.44%	9.51%	25.9%	23.8%	25.1%
Hong Kong	22.1	16.5	10.7	0.37%	0.17%	0.07%	-5.7%	-13.6%	-8.7%
Indonesia	42.9	55	82.4	0.71%	0.57%	0.57%	5.1%	14.4%	8.5%
South Korea	166.5	277.7	409.4	2.76%	2.86%	2.84%	10.8%	13.8%	11.9%
Malaysia	87.5	120.4	140.1	1.45%	1.24%	0.97%	6.6%	5.2%	6.1%
Philippines	36.6	39.4	45.2	0.61%	0.41%	0.31%	1.5%	4.6%	2.7%
Singapore	129.6	215.4	303.7	2.15%	2.22%	2.11%	10.7%	12.1%	11.2%
Taiwan	144.5	183.1	223.9	2.39%	1.89%	1.55%	4.9%	6.9%	5.6%
Thailand	58.7	95.9	149.1	0.97%	0.99%	1.04%	10.3%	15.9%	12.4%
Vietnam	**6.8**	**17.5**	**41.2**	**0.11%**	**0.18%**	**0.29%**	**21%**	**33%**	**25.4%**

Note: Mirror data is used for Vietnam and Cambodia in 2008.

Source: UN Comtrade.

FIGURE 2.27:
MARKET SHARES IN WORLD'S 20 MOST DYNAMIC MANUFACTURED EXPORTS, 2000 AND 2008



Note: Most dynamic manufactured exports are products of which total global trade values are above USD 20 billion between 2000 and 2008.

Source: UN Comtrade.

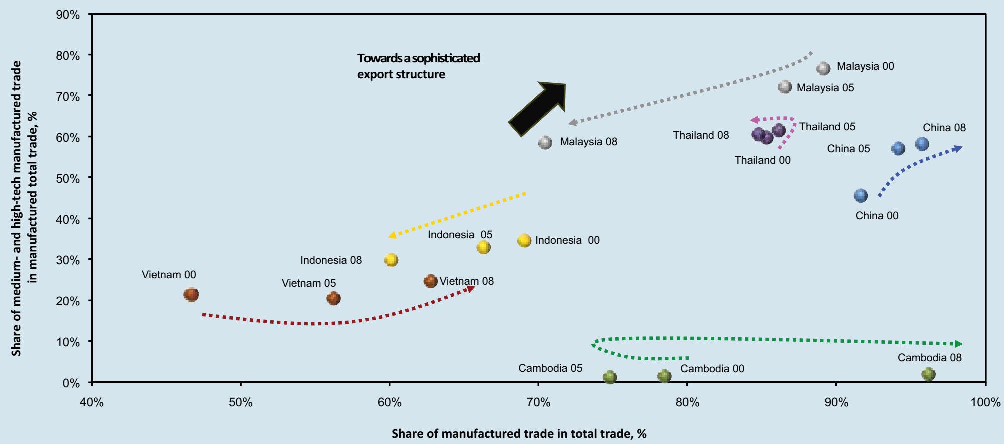
Vietnam may have specialized in industrial sectors facing sluggish demand growth and saturated markets. For instance, between 2000 and 2008 global trade of woven clothing for men and women grew at 4.3 percent and 7.1 percent respectively. These figures were well below the world trade average of 11.5 percent for the period.

Figure 2.28 sums up the evolution of Vietnam's export structure towards more sophisticated products. In general, Vietnam is moving in the right direction. However, the real challenge for Vietnam entails improvement in the technological sophistication of its industry.

- *Low level of value added in manufactured exports*

Compared to other countries in the region, Vietnam's industrial structure is technologically unsophisticated—the share of medium- and high-tech sectors in total manufacturing value added remains just above 20 percent, and it has been unchanged over the last few years. Labor-intensive low-tech industries, mainly the fashion cluster, account for more than 70 percent of Vietnam's manufacturing value added.

FIGURE 2.28:
EVOLUTION OF EXPORT STRUCTURE TOWARD MANUFACTURED AND TECHNOLOGY-INTENSIVE EXPORTS, 2000-2008



Source: UN Comtrade .

TABLE 2.7: EXPORT TECHNOLOGY INTENSITY, 2000 AND 2008

Country	2000				2008			
	High tech	Medium tech	Low tech	Resource based	High tech	Medium tech	Low tech	Resource based
Cambodia	0.1%	1.2%	93%	5.7%	0.1%	1.8%	96.7%	1.4%
China	21.2%	24.3%	45.4%	9.1%	29.9%	28.3%	33.3%	8.5%
Hong Kong	25.8%	11.3%	58.5%	4.4%	20.5%	17.9%	47.1%	14.5%
Indonesia	14.9%	19.6%	31.9%	33.6%	6.4%	23.3%	22.7%	47.6%
South Korea	35.1%	35.3%	17.9%	11.7%	28.4%	44.3%	11.6%	15.7%
Malaysia	55.2%	21.4%	9.8%	13.7%	34.3%	24%	13%	28.6%
Philippines	69%	12.4%	11.9%	6.6%	62.1%	15.5%	8.1%	14.4%
Singapore	59.4%	20.9%	6.9%	12.7%	44.8%	22%	6.7%	26.6%
Taiwan	43.2%	28.2%	24.3%	4.3%	35.8%	32.5%	18.5%	13.2%
Thailand	32.4%	27.2%	21.9%	18.5%	22.7%	37.7%	16.1%	23.5%
Vietnam	**11.1%**	**10.3%**	**64.7%**	**13.8%**	**10.1%**	**14.5%**	**67.1%**	**8.2%**

Source: UN Comtrade .

Export Diversification

- *Market diversification is high, while the relatively low product diversification is improving*

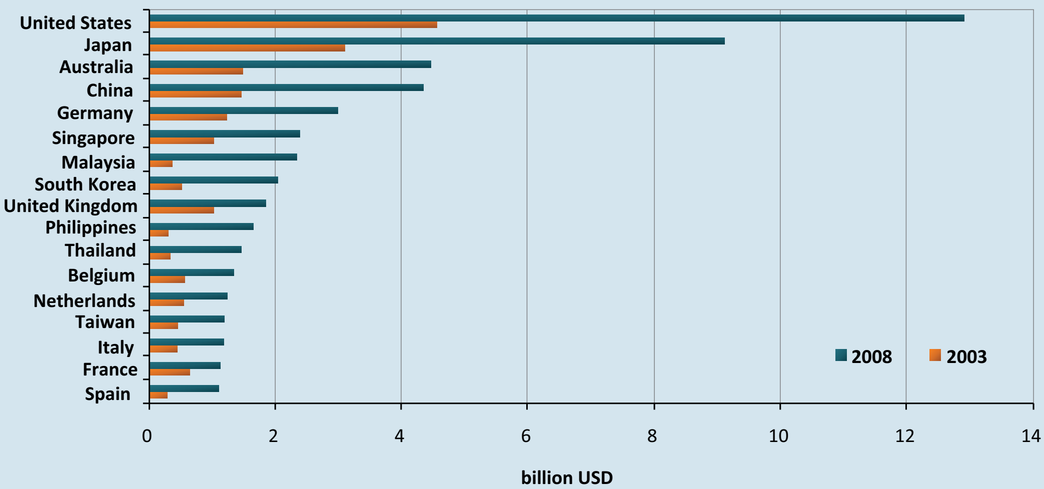
Vietnam's manufactured trade is far from concentrated. Vietnam ranks second in the region in market diversification just shy of China, and ahead of South Korea, Indonesia and Thailand (see Table 2.9). Vietnam's market diversification protects it from the stronger presence of key competitors in large markets. In terms of manufactured exports, the top five export categories accounted for over 50 percent in 2000, but dropped to slightly over 40 percent in 2008 (Figure 2.30) — evidence of increasing diversification.

Export Trading Partners

- *Focus on advanced markets in North America, Europe and Asia*

The US remains Vietnam's most important export market, as shown in Figure 2.29. It is followed by Japan, Australia, China and Germany. The top five export markets account for the majority of all exports from Vietnam, albeit their combined share has declined from 57.2 percent in 2003 to 55.4 percent in 2008. For the 17 major trading partners, the average annual growth rate of total exports was 23.5 percent. The slower-growing countries in that group included the EU countries and Singapore. The overall pattern shows a growing concentration of exports in the region and in Australia with 26.3 percent average annual growth of exports in the latter.

FIGURE 2.29: VIETNAM'S EXPORTS BY MAJOR TRADING PARTNER, 2003 AND 2008



Source: Global Trade Atlas

TABLE 2.8:
EXPORTS OF MAIN PRODUCT CATEGORIES BY MARKETS, 2008-2009

Markets	2008		2009		Share of Vietnam's total exports (%)	
	Key Products	Value (billion USD)	Key products	Value (billion USD)	2008	2009
EU	Footwear	2.51	Footwear	1.71	17.3%	15.1%
	Garment	1.7	Garment	1.44		
	Seafood	1.15	Seafood	0.96		
	Crude oil	2.82	Crude oil	2.21		
ASEAN	Rice	1.52	Rice	1.23	16.3%	13.6%
	Computers	0.73	Computers	0.59		
	Garment	5.1	Garment	4.99		
US	Footwear	1.07	Furniture	1.1	18.9%	19.9%
	Furniture	1.06	Footwear	1.04		
	Crude oil	2.18	Garment	0.95		
Japan	Seafood	0.83	Seafood	0.76	**13.6%**	**11%**
	Garment	0.82	Electric cable	0.64		
	Rubber	1.06	Coal	0.94		
China	Coal	0.74	Rubber	0.86	7.2%	**10.7%**
	Crude oil	0.6	Cassava	0.5		

Source: DEPOCEN's Export Promotion Report 2009 – 2010.

Imports

Import Patterns

- *Imports are high and growing, leading to widening and persistent trade deficit*

Since 2006, imports have risen quickly, surpassing the growth of exports. During 2006–2008, the average annual growth of imports was 30.2 percent. This has led to a rapidly widening trade deficit, from 4.5 percent of GDP in 2006 to 16.8 percent in 2008. In 2009, imports contracted to USD 68.8 billion (equivalent to 62.5 percent of GDP) – a fall of 14.7 percent as compared to 2008. The contraction in imports in 2009 was caused by the sluggish domestic production as a consequence of the global recession. In addition, import prices also dropped due to the contraction in global demand.

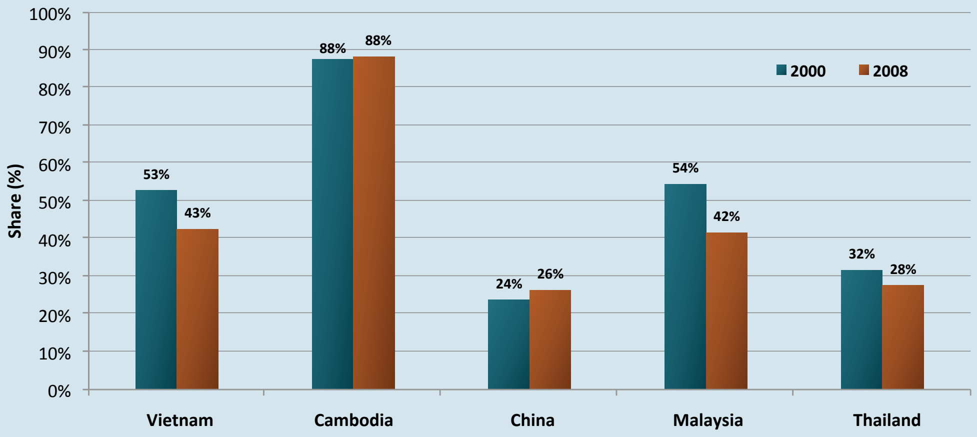
Figure 2.31 illustrates the trend in Vietnam's trade balance and its comparator countries over the period 1990 - 2008. The three comparison countries follow a similar pattern—roughly balanced until 1998, followed by a significant trade surplus in that year, primarily as a result of cutbacks in imports. Vietnam, however, has had a negative trade balance throughout the entire period, slightly less in the years

TABLE 2.9:
MARKET DIVERSIFICATION INDEX, 2000 AND 2008

Country	Ranking		Index value	
	2000	2008	2000	2008
China	3	1	1.0	1.0
Vietnam	**1**	**2**	**1.0**	**0.9**
Korea	4	3	1.0	0.8
Indonesia	2	4	1.0	0.7
Thailand	5	5	0.9	0.7
Philippines	7	6	0.8	0.7
Malaysia	8	7	0.8	0.7
Taiwan	6	8	0.8	0.6
Hong Kong	10	9	0.4	0.4
Singapore	9	10	0.6	0.4
Cambodia	11	11	0	0

Source: UN Comtrade .

FIGURE 2.30: SHARES OF TOP FIVE MANUFACTURED EXPORTS IN TOTAL MANUFACTURED EXPORTS, 2000 AND 2008



Source: UN Comtrade.

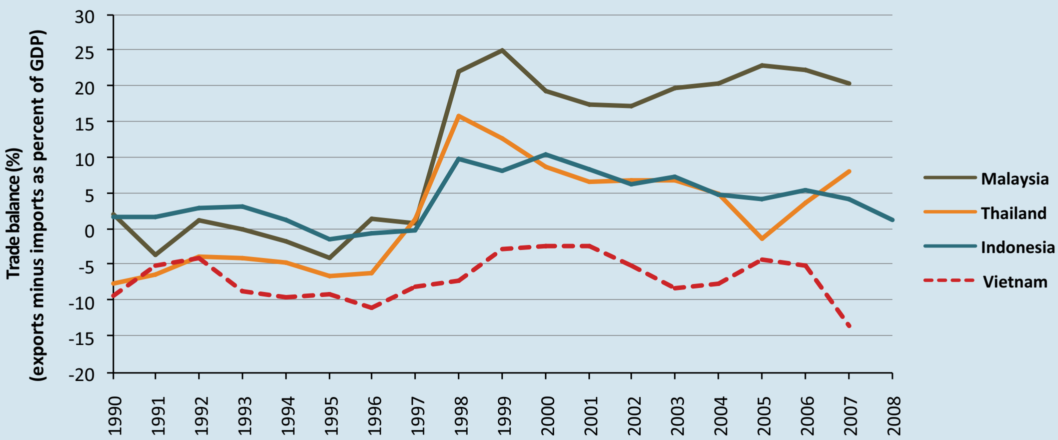
following the financial crisis, but widening substantially again afterwards. In 2009, imports exceeded exports by 20 percent, equivalent to 11.9 percent of GDP. The negative trade balance has affected the overall balance of payments; however, remittances from Vietnamese overseas, FDI and portfolio capital inflows, the balance of payments remains positive.

Import Composition

- *Imports of capital goods dominate, but the share of consumption goods is increasing*

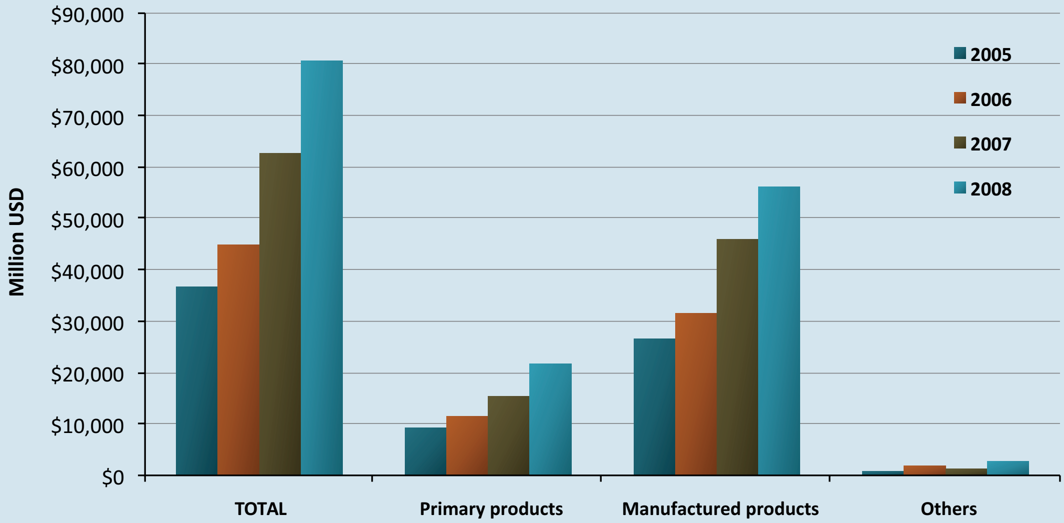
When classified by the Standard International Trade Classification (SITC), the share of manufactured products in total imports has been increasing rapidly at an average rate of 28.8 percent during 2006–2008, and these accounted for 69.7 percent of the total imports in 2008. Among the imported primary products, fuel accounted for the biggest share of 56.6 percent. Among the imported manufactured products, equipment, machinery and input materials accounted for the biggest share of 75.7 percent. This reflects Vietnam's heavy dependence on imported materials and equipment to serve the manufacturing sector.

FIGURE 2.31: TRADE BALANCE, 1990-2008



Source: World Development Indicators

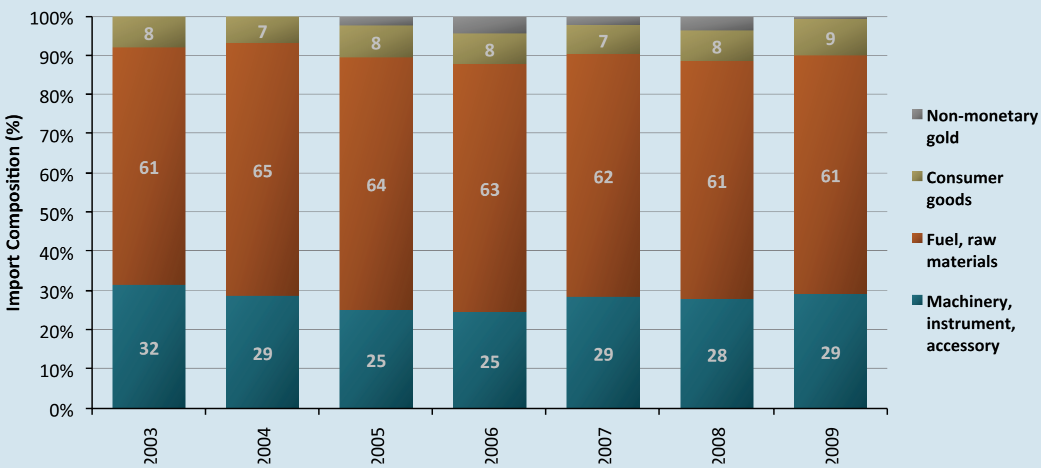
FIGURE 2.32: COMPOSITION OF VIETNAM'S IMPORTS, 2005-2008



Source: General Statistics Office of Vietnam.

In terms of commodity groups, 90 percent of total imports in 2009 comprised capital goods—fuel and raw materials accounted for 60 percent, while machinery and equipment comprised 30 percent of the total imports. Consumption goods accounted for a relatively small, but increasing, share in total imports—from 6 percent in 2000 to almost 10 percent in 2009. This reflects the "typical" structure of the Vietnamese economy which is dominated by low value-added processing industries and higher living standards which encourage consumption. It is more worrisome that imports of cars, motorbikes and other luxury goods for consumption are increasing rapidly while the overall living standards are still relatively low. In 2009, imports of cars and luxury goods accounted for almost 50 percent of the total imports of consumption goods. These trends are adding pressures on the trade balance and foreign reserves as such consumption goods are not used to serve export-oriented production and to create foreign exchange revenues.

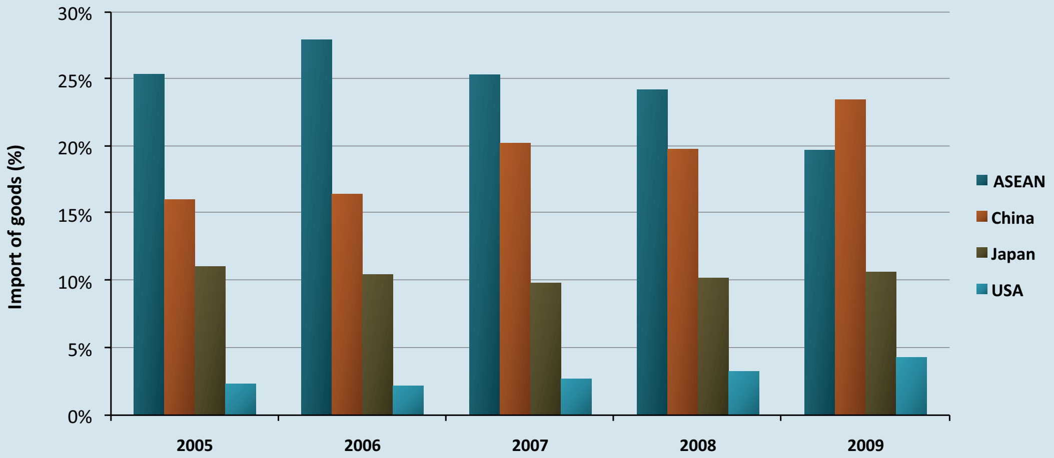
FIGURE 2.33: COMPOSITION OF VIETNAM'S IMPORTS BY COMMODITY GROUP, 2005-2009



Note: In 2003 and 2004 non-monetary gold is included in fuels & raw materials.

Source: General Statistics Office of Vietnam.

FIGURE 2.34: VIETNAM'S IMPORTS BY COUNTRY OF ORIGIN, 2005-2009



Source: General Statistics Office of Vietnam.

Import Trading Partners

- *Neighboring countries (ASEAN, China, East Asia) represent the main sources of imports; the trade deficit with China in particular is widening dramatically*

Vietnam's trading partners focus on some key countries and regions, including ASEAN (20 percent of total imports in 2009), China (23 percent), Japan (10 percent), Korea (10 percent), EU (8.3 percent) and USA (4 percent). These markets alone account for over three quarters of Vietnam's total imports.

Vietnam's imports from ASEAN are decreasing in relative terms while imports from China are increasing rapidly, from 15 percent in 2005 to 23 percent in 2009. This is partly explained by China's import products that tend to be cheaper than those imported from more advanced markets, and partly because Vietnam has not been able to take advantage of geographical proximity and the sizable, less-demanding Chinese market to boost up its exports to China. These trends are raising questions about strengthening the dynamism of intra-regional trade among ASEAN members.

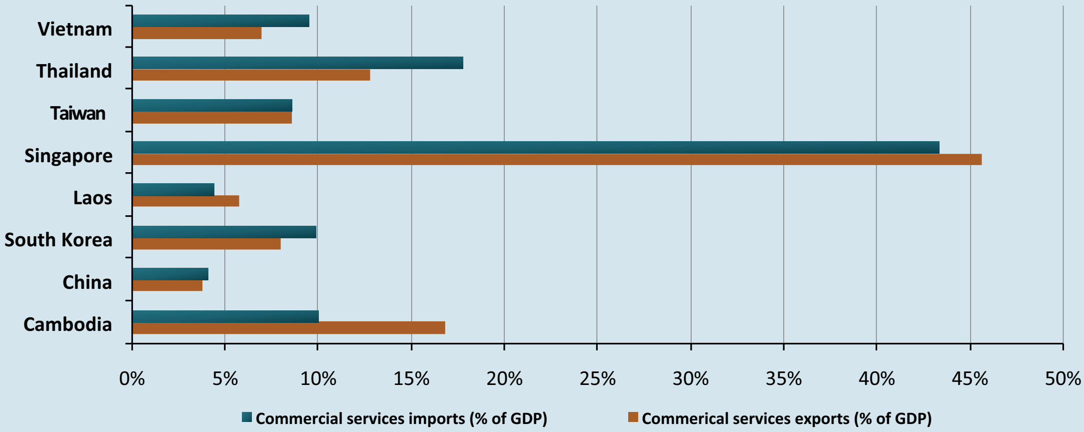
Trade in Services

- *A relatively small share of trade in services in total trade, and an increasing deficit in trade in services*

The value of services exports in 2009 reached USD 5.77 million. Tourism exports still dominate services exports and are estimated at USD 3.05 million; falling 22.4 percent compared to 2008. Next in importance are transportation services with an export value of USD 2.06 million, dropping 12.5 percent compared to that in 2008. Despite decreasing export values, tourism and transportation still accounted for 91.3 percent of Vietnam's total services export volume. Since these two sectors were primarily affected by the 2008 financial crisis, Vietnam's services export volume in 2009 fell 18.1 percent compared to that in 2008.

In a similar fashion, services imports also suffered from the global financial crisis. In 2009, import of services attained USD 6.9 billion, dropping 1.4 percent compared to that in 2008. Although their import values decreased, tourism, insurance and transportation services saw an increasing share in total services import, reaching 83 percent. All services, apart from government- and telecommunications-related ones, had lower import value in 2009 than in 2008.

FIGURE 2.35: SERVICES EXPORTS AND IMPORTS IN 2008



Source: World Development Indicators.

Figure 2.35 shows a regional comparison of patterns in trade in services. The pattern for Vietnam closely resembles that of South Korea, showing an increasing deficit in trade in services. The deficit in 2008 amounted to USD 819 million, while the deficit stood at USD 716 million in 2007.

Entrepreneurship

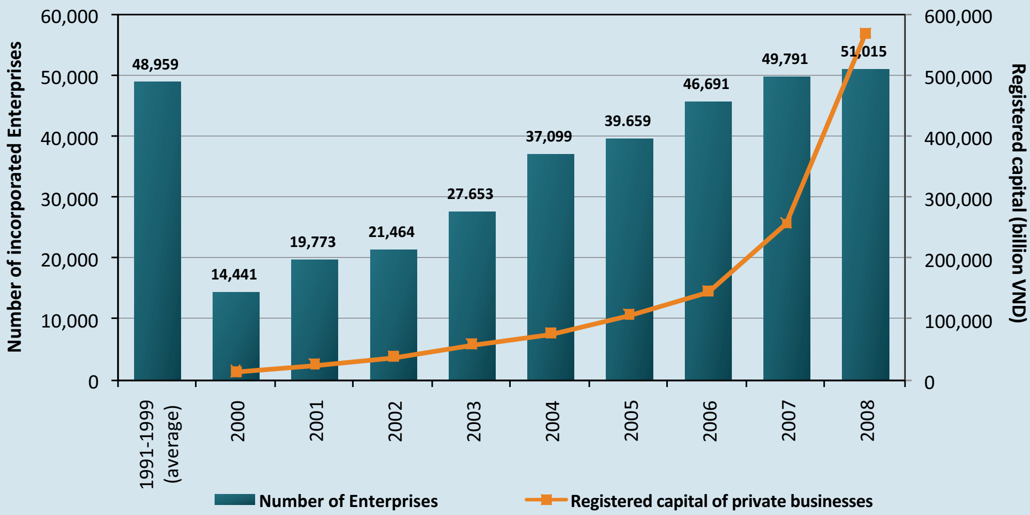
Enterprise Creation

- *The Enterprise Law (2000) triggered a rapid growth in the number and size of private enterprises*

The Enterprise Law adopted in 2000 eased restrictions and conditions in formal market entry. Since then, the number of enterprises has increased rapidly. The total number of business registration in the three years 2000-2002 surpassed the total number of the previous decade. Even when growth slowed in 2008 due to inflation and the global financial crisis, new enterprise registrations (over 51,000) still surpassed those from the year before. According to the data supplied by the Enterprise Development Agency, there were about 355,000 private firms registered in the whole country in 2009, with about 272,680 in operation that are paying taxes.

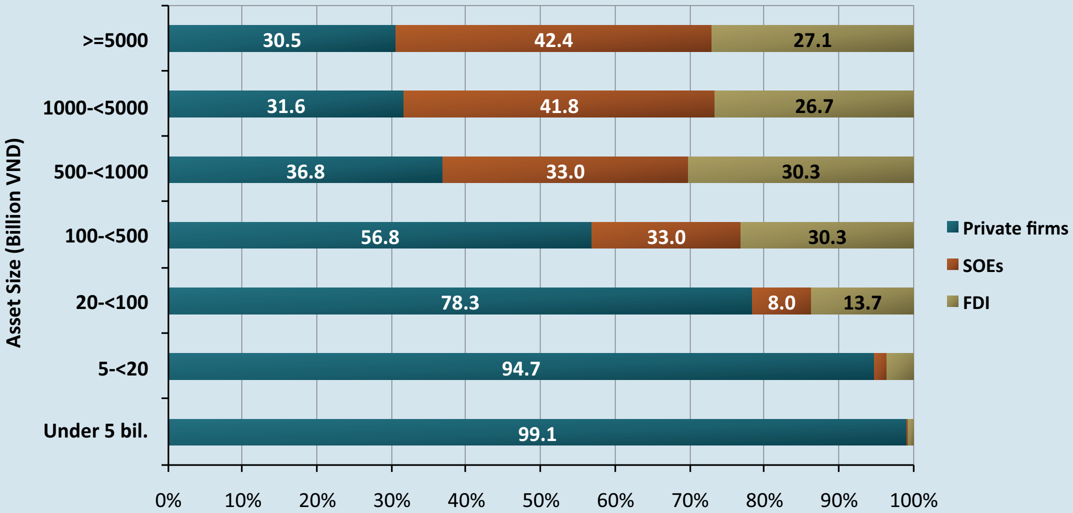
As shown in Figure 2.36, the average investment capital also increased sharply, especially after the Enterprise Law was adjusted in 2005 to simplify the business registration procedures and to allow companies of all sectors to operate in the same forms of governance. The average capital of one start-up in 2001 was VND 1.29 billion and this increased to VND 3.17 billion in 2006, and to VND 11.6 billion in 2008.[11]

FIGURE 2.36: NEWLY INCORPORATED PRIVATE ENTERPRISES IN VIETNAM, 1991-2008



Source: Enterprise Development Agency, MPI

FIGURE 2.37:
SIZE DISTRIBUTION OF FIRMS BY OWNERSHIP, 2008



Source: General Statistics Office of Vietnam; Calculations by CIEM

Business Capacity

- *Private sector development needs to be fostered*

While the Enterprise Law triggered a boom in new and increasingly well capitalized enterprise registrations, there have been few further reforms to encourage intensive growth of the private business sector.

The private business sector in Vietnam lacks both the intellectual foundations and adequate capital to keep up with the demands of today's global economy. Small and medium enterprises (SMEs) make up 98.4 percent of the private firms. The lack of education and training for business management and capital accumulation has clearly hindered their capability to contribute to the move from factor-driven to knowledge-driven, or from labour-intensive to capital- driven economic models. Lack of adequate capital has also prevented private companies from investing in and upgrading their technology.

The development of the business sector also faces a major challenge related to the distortion of the market. Land and real estate speculation is usually far more profitable than investment in upgrading technology, developing new products, or improving worker skills. As a result, this problem has severely diverted efforts of many enterprises from activities that increase productivity and enhance competitiveness, which are critical for avoiding the middle income trap.

TABLE 2.10:
NUMBER OF PROTECTED TITLES GRANTED

Year	Invention protection	Utility solution protection	Industrial design protection	Trademark protection
2001	783	26	376	3,639
2002	743	47	377	5,200
2003	774	55	468	7,150
2004	698	69	647	7,600
2005	668	74	726	9,760
2006	669	70	1,175	8,840
2007	725	85	1,370	15,860
2009	706	64	1,238	22,730

Source: National Office of Intellectual Property (NOIP).

Technology and Innovation

Development of Intellectual Property

- *Low level of protected intellectual property titles*

Although inventions and utility solutions are central to technology transfer transactions, there have been only few technology sales and purchases associated with patents. Among all protected titles, trademark protection in Vietnam has accounted for the highest proportion and also the fastest increase in number for the past 10 years.

The low number of protected titles indicates that technology goods have yet to develop in Vietnam. This is due to the lack of cooperation between inventors and firms, onerous protection registration procedures and low effectiveness of patent protection regulations.

Quality Infrastructure

- *Weak application and enforcement of quality standards among enterprises*

Much remains to be done with respect to upgrading the quality standards of the manufacturing and service operations in the country. Vietnam is lagging behind the region in terms of the percentage of firms with internationally recognized quality certifications. According to the World Bank's Enterprise Surveys, only 11.4 percent of the firms met this criterion, versus 22.4 percent for the region (2005).

Assessment

Vietnam's economic development pattern reflects the standard profile of a transitional economy on the catch-up path. It has been successful in achieving vigorous growth over the last two decades but the dynamism for further sustainable growth is declining as cost pressures rise, while new competitive advantages have yet to be created.

Vietnam's performance on intermediate indicators reflects current strengths which are unsustainable and will contribute little to creating future competitive advantages:

1. Capital deepening appears natural for a labor-intensive economy. The marginal productivity of capital should be much higher in a developing country like Vietnam where capital is scarce. However, in reality, capital has created growth but has failed to improve overall productivity. Decreasing efficiency of investment indicates that few new capabilities are emerging.

2. Low value added in exports dominated by labor-intensive goods is a sign that few if any additional capabilities are emerging. Linkages between the export sector and the local economy are undeveloped.

3. High diversification of markets but low diversification of products suggests that Vietnam has some generic advantages, such as low labor costs, but lacks strong market positions to capture value. The Vietnamese economy does not yet participate effectively in the world's most dynamic export markets.

4. Dependence on foreign investment is higher than that of other countries at the same stage of development, but the foreign sector has shallow roots in the local economy. Lack of entry by growth-oriented private companies and low level of innovation in SOEs suggest that few, if any, domestic growth drivers are emerging.

5. Market distortions and resources misallocation are among the major causes of Vietnam's slow pace of moving up the technological ladder and low efficiency in capital investment.

Endnotes

[1]Poverty rate based on poverty line of GSO and WB with monthly average expenditure per capita of 216 thousand VND.

[2]The Government set the poverty line for 2006-2010 to be VND 200,000 of monthly expenditure per capita for rural areas and VND 220,000 for urban areas.

[3]Industrial centres in Cau River Valley including Thai Nguyen, Bac Giang, Bac Ninh, Hai Duong, and Vinh Phuc Province.

[4]In economics, total-factor productivity (TFP) is a variable which accounts for effects in total output not caused by the growth in traditional inputs, labor and capital. TFP comprises a range of factors, but the predominant driver is technological progress.

[5]Preliminary population survey results in 2009.

[6]The comparable data for later years are not available.

[7]"The other" investment comes mostly from government bonds and accounted as off-budget expenditure.

[8]In 2008, total social investment increased at 10.2 percent while state investment reduced by 15.7 percent compared to that in 2007, mainly due to the measures adopted to control the inflation.

[9]The zone has been facing a delay in land clearance, construction of infrastructure and policy incentives.

[10]This section used some analytical input and data provided by Dr. Manuel Albaladejo (UNIDO). See Albaladejo, M. 2010. 'Benchmarking Vietnam's Industrial Competitive Performance', background paper prepared by UNIDO for the Vietnam Competitiveness Report 2010, Vienna, Austria.

[11]These figures should be interpreted with caution because they are used only for registration.

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Chapter 3

Vietnam's Competitiveness Foundations

VIETNAM'S COMPETITIVENESS FOUNDATIONS

Following the diagnosis of the economic outcomes and intermediate indicators in Chapter 2, this chapter looks into the underlying factors of competitiveness, offering greater insight into the drivers of those outcomes.

Prosperity drivers are the ultimate source of sustained improvements in the standard of living. Prosperity can be inherited, or based on endowments; or created. Competitiveness is about created prosperity which is the result of choices that determine the level of productivity. The factors which raise productivity and competitiveness can be classified into two broad categories. Macroeconomic competitiveness covers conditions that determine the context in which productivity improvements must take place. These are determined by government alone. Microeconomic competitiveness covers factors that have a direct impact on productivity; they depend on the interrelated choices of many public and private sector entities and institutions for collaboration. Figure 3.1, provides the analytic framework for competitiveness which includes all the above determinants.

Natural Endowments

Geographic Location and Population Size

- *The country's central location in Asia and its long coastline are major advantages; but location and climate also expose the population to natural disasters and disease*

Vietnam's central location in Asia and the country's long coastline offer major advantages for economic development. With a total area of 327,500 square kilometers, Vietnam borders China on the North, and Laos and Cambodia on the West. The coastline stretches 3,260 kilometer from East to South, bordered by the East Sea and the gulf of Thailand. These locational endowments provide potential advantages in tourism, agriculture and sea trade. Unfortunately, the country so far has not utilized these potential advantages efficiently, such as developing aggressively its seaport services.

Vietnam has been the center of the Indochina region and the bridge between China and other ASEAN countries– a clear advantage for regional economic cooperation. However, Vietnam has yet to reap the full benefits of its economic geography. Neither the Mekong Delta economic cooperation nor the ASEAN-China regional and sub-regional cooperation have achieved their potential. There is therefore a need for a long-term strategy that will utilize Vietnam's location to contribute to national competitiveness.

At the same time, coastal location and tropical climate expose the country and its population to natural disasters and epidemics. At the Climate Conference in Copenhagen (2009), experts included Vietnam in the top five countries most affected by global climate change. They stressed that the Red River Delta and the Mekong Delta are likely to be the two most heavily hit areas. The impact of global climate change may be exacerbated by Vietnam's socio-economic conditions as well as poor capability to fight climate change.

FIGURE 3.1: COMPETITIVENESS FUNDAMENTALS

BOX 3.1:
IMPACT OF CLIMATE CHANGE ON VIETNAM

Vietnam has been one worst victims of climate change. For the past 50 years, the average temperature has risen 0.7 degree Celsius, while the average sea level has risen by 20 centimeters. El Niño and La Niña are hitting the country harder than before. Floods and droughts are occurring more frequently and at a more severe scale, directly affecting the health of the people and the economy.

With its long coastline, Vietnam is considered highly vulnerable to climate change. In 2007, the World Bank projected that Vietnam, along with Egypt, Suriname, Bahamas and Bangladesh, will be heavily affected by the rise of average sea level. According to the study by the World Bank on the impact of sea level rise on 84 coastal developing countries, if sea level rises by 1 meter, it can flood as much as 5 percent of the area of Vietnam and affect 11 percent of the country's population, reducing GDP by 10 percent.

Source: Dasgupta et al. (2009)

In spite of the dangers of climate change, Vietnam can still leverage its favorable location and large population for development. To date, these advantages have not been fully exploited to increase the country's competitiveness, especially with respect to agriculture, tourism and seaport services advantages.

Natural Resources

- *Vietnam possesses rich deposits of natural assets, but wasteful and irresponsible exploitation poses serious risks*

Vietnam possesses plentiful natural resources, including land, water, forest, mineral and tourism resources. Over 75 percent of Vietnam's 33 million hectares of geographic area is agricultural land. The country also possesses plentiful water resources and a dense river network, offering opportunities to develop waterway traffic, hydropower and agricultural production.

Large mineral reserves in Vietnam include: coal; oil and gas; bauxite; and uranium. Vietnam has over six billion tons of coal reserves, mainly in Quang Ninh, Thai Nguyen. Oil and gas reserves are estimated to be at three to four billion barrels and 50 – 70 billion cubic meters respectively, mainly in the sediments of deltas and continental shelf. Bauxite reserves are projected to be about 6 billion tons and could be over 8 billion tons while uranium reserves are estimated at about 200 – 300 thousand tons.[1] In addition, reserves of ferrous metals (iron, manganese, titan); non-ferrous metals (aluminum, copper, gold, zinc, lead); non-metals (apatite, pyrite) are being exploited.

However, accelerated exploitation of natural resources is posing serious risks to preservation and sustainable development of natural resources[2] and is also to some extent discouraging innovation and investment to build up new capabilities (instead of relying on natural endowments).

TABLE 3.1:
MACROECONOMIC COMPETITIVENESS OF VIETNAM AND COMPARISON COUNTRIES, 2009

	Vietnam	Brunei	Cambodia	Indonesia	Malaysia	Philippines	Singapore	Thailand	China	Hong Kong	India
New Global Competitiveness Index (GCI)	82	34	115	57	37	104	3	55	42	13	77
Macroeconomic Competitiveness (MACRO)	92	11	119	67	47	104	10	61	39	16	93
Social infrastructure and political institutions (SIPI)	72	34	102	60	45	115	7	68	53	16	67
Macroeconomic Policy (MP)	110	5	120	77	59	87	58	52	23	9	113

Source: WEF Global Executive Opinion Survey, Institute for Strategy and Competitiveness, Harvard Business School.

TABLE 3.2:
HEALTH CARE INDICATORS, 2006-2009

Indicators	2006	2007	2008	2009
Communes with health clinics (%)	97.5	98	98.2	100
Communal health clinics with medical doctors (%)	65.1	67.4	68	73
Number of hospital beds per 10,000 people	23.6	24.8	25.7	27
Maternal mortality rate against 100,000 live cases (%)	80	78	75	70

Source: MPI (2009).

Macroeconomic competitiveness

Macroeconomic competitiveness captures the dimensions that set the overall context in which government agencies, companies, and other institutions make the choices that ultimately determine productivity. Macroeconomic competitiveness can be classified into two main categories. Social infrastructure and political institutions describe the basic setting in terms of education, health services, the rule of law, and policy making. These factors tend to change only moderately over time and have a significant long-term impact. Macroeconomic policy describes the macroeconomic context of fiscal and monetary policy as well as of macroeconomic volatility. These factors can change more rapidly and tend to have a more short-term impact. All categories of macroeconomic competitiveness tend to be controlled centrally by government. In 2009, Vietnam ranked 92nd on macroeconomic competitiveness in the Country Competitiveness Index (CCI) 2009[3], or in the 70th percentile of the countries covered. Vietnam's macroeconomic competitiveness is higher than that of the Philippines and Cambodia, but lower in comparison with other ASEAN countries as well as with China and India. Vietnam's indicator for Social Infrastructure and Political Institutions (SIPI) is at average level (ranked 72nd) which is not far below that of higher income countries like Thailand and India. Thus, the main reason for low macroeconomic competitiveness lies in macroeconomic policy (ranked 110th) primarily because of inflation and fiscal policy.

Social Infrastructure and Political Institutions

Basic Social Services

Healthcare services and primary education are two crucial indicators of human development and always score relatively higher than other competitiveness indicators for Vietnam. Nonetheless, Vietnam ranked only 85th on human development in the new CCI 2009. This is lower than the median rank.

- *Primary education: Relatively high levels of enrollment and literacy for the country's stage of development*

TABLE 3.3:
NET ENROLMENT IN SECONDARY EDUCATION BY SUBGROUPS (2006)

	Net enrolment ratio
Area	
Urban	88.8
Rural	76.1
Income group	
Top 20% poorest	59.9
Top 20% richest	91.5
Ethnicity	
Other	64.9
Kinh/Hoa	81.3
Overall	78.8

Source: MICS.

Vietnam's performance on universal primary education and literacy is relatively strong given its current stage of development. Vietnam is among the countries that have achieved the Millennium Development Goals and targets related to primary education ahead of time. In 1990, the net enrollment rate of primary education was 87 percent, but by 2006 the rate had increased to 95.96 percent and the target of 99 percent is being put for the period of 2006 – 2010 (www.mdgmonitor.org).

- *Basic healthcare: Access to basic health care services broadly in line with the stage of development*

- *However, access to services varies considerably among different groups of population and different regions*

In education, inequality remains large in secondary education, most notably by income, then by geography and finally by ethnic minorities.

Similarly, in health care, the level of inequality is also high from basic to higher quality of health care services. Although health care at the grassroots level, like medical stations at the level of the commune or ward, has been available nationwide, the service quality and infrastructure are frequently poor, especially in rural areas and lower-income provinces. This fact results in even a higher inequality in accessing to good health care services due to ability to pay and geographical barrier.

- *The share of investment for education and health care in the state budget is relatively high, but remains small in absolute terms, while private sector financing is not fully mobilized*

The policy of socializing education and health care which has been carried out since the 1990s to mobilize private investment into these two areas has had little effect because of their public service nature and the entry barriers for participation by the private sector. Therefore, expenditures on education and health care are rising in total household spending.

During the last three years, the share of education and training has increased to 20 percent of the total state budget. Over the period 2005-2009, budget spending for education increased most rapidly, at an average annual rate of 22.6 percent, amounting to VND 359,687 billion (USD 18 billion) for the whole period—2.23 times higher than the spending level during 1998–2004. The budget for higher education accounts for only 10–12 percent of the entire budget for education. Besides the state budget, investment for education is supported by official development assistance (ODA) and tuition fees. To date, only four foreign universities have been licensed, but only one university so far started operations. The total registered capital of the four universities is USD 68.9 million – five times higher than the total state investment for fixed capital formation of public universities in 2008 (National Assembly's Standing Committee 2010).

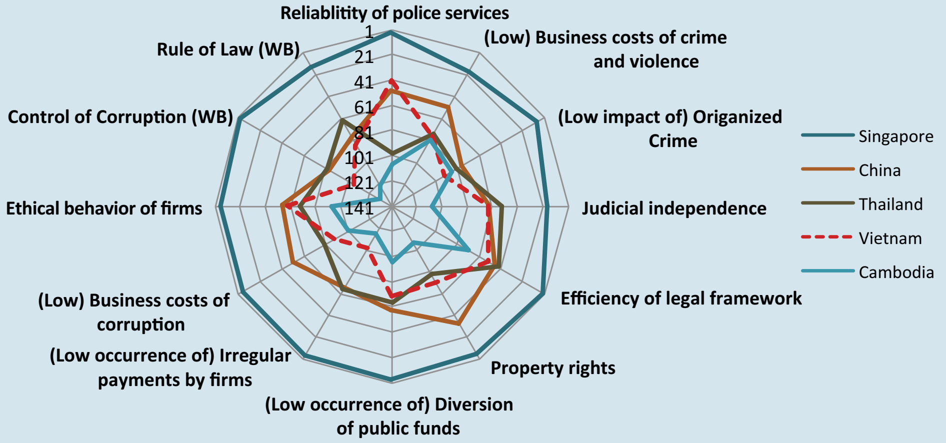
At present, Vietnam's human development indicators in the new CCI 2009 are similar to Indonesia's. They are higher than those of Cambodia, India, and the Philippines but far below that of China (ranked 66th), Malaysia (ranked 52nd), and Thailand (ranked 70th) which are developing economies to escape from the middle-income trap. In fact, Vietnam faces a serious shortage of high quality human resources a major obstacle to productivity growth. If Vietnam were to be satisfied with its achievements on basic human capacity indicators, it would hardly move beyond the current level and climb the competitiveness ladder.

TABLE 3.4:
AVERAGE HEALTH EXPENDITURE PER PATIENT BY SUBGROUPS (2006)

	1,000 VND
Area	
Urban	811.5
Rural	520.3
Income group	
Top 20% poorest	171.8
Top 20% richest	1,244.6
Ethnicity	
Kinh	643.1
H'mong	120.0
Others	160.7

Source: VHLSS 2006. GSO.

FIGURE 3.2:
RULE OF LAW RANKINGS–VIETNAM AND COMPARISON COUNTRIES, NEW CCI 2009



Source: WEF Global Executive Opinion Survey, Institute for Strategy and Competitiveness, Harvard Business School.

Rule of Law

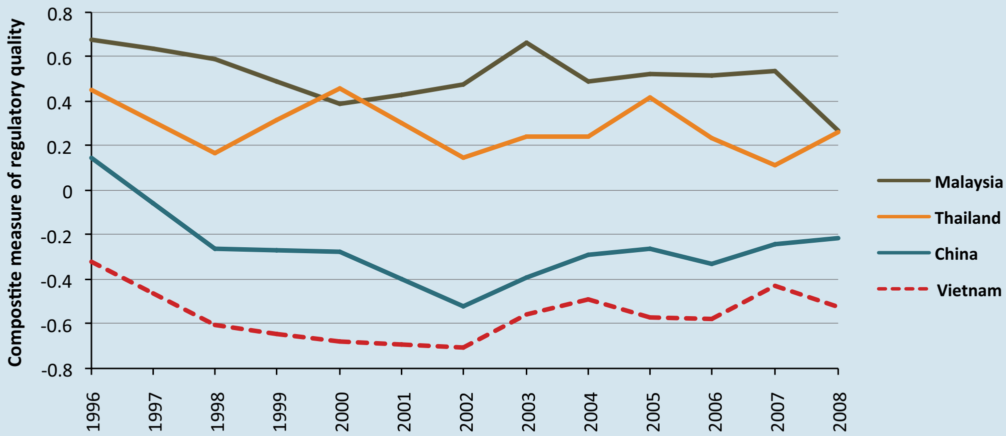
- *The quality of laws on the books is relatively good given Vietnam's stage of development, but effectiveness in implementation is low*

Over the past decade, Vietnam's legal system has improved remarkably through the government's effort to refine the market economic institutions resulting in higher position in rule of law indicators. In 2009, Vietnam ranked 73rd on rule of law, or in the 55th percentile of the countries covered in the new CCI 2009.

Priorities are to complete the legal framework for protection of property rights, to improve the business environment, to reform administrative systems, to strengthen factor and commodity markets, to protect natural resources, and to ensure social security. Since 2002, many legal documents have been issued and implemented[4]. The quality of legal regulations has improved and this is reflected by the fact that the efficiency of Vietnam's legal framework was ranked 53rd in the new CCI 2009. The issuance of numerous legal documents, which is a typical feature of the transition from central planning to market economy, has placed great pressure on the implementation stage, especially when the codes and documents are still inconsistent. Meanwhile, policy implementation at the ministerial, sectoral and local levels is lagging, making it difficult for citizens and enterprises to fully benefit from the provisions of the laws.

Another piece to the puzzle is the performance of Vietnam and its peer countries on the World Bank Institute's (WBI) governance indicator of "regulatory quality" which is comprised of six components. The results suggest that Vietnam lags behind selected Asian peers (Figure 3.3). The indicator for Vietnam tracks that for China which is also below the median, but closer. The other three comparator countries, Malaysia, Thailand and South Korea, are above the median performance for all the countries included in the ranking.

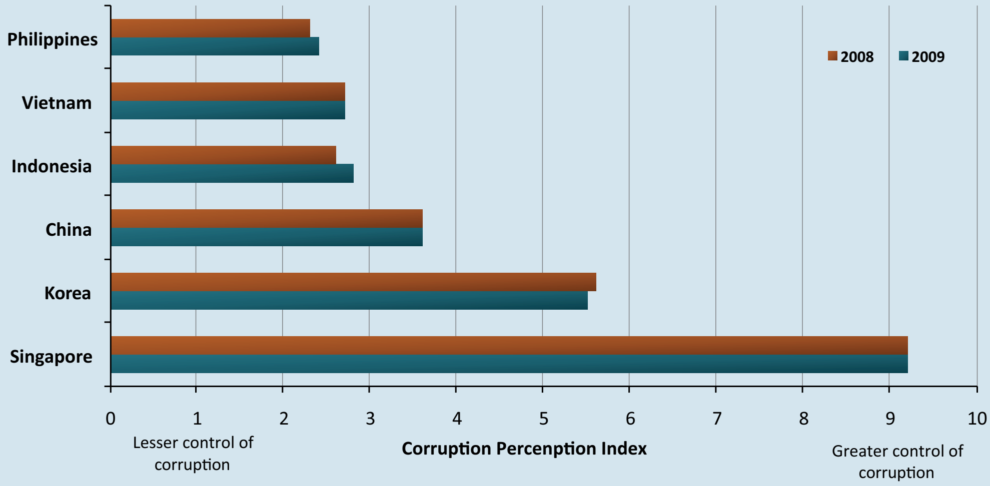
FIGURE 3.3:
PERFORMANCE ON REGULATORY QUALITY–VIETNAM AND COMPARISON COUNTRIES



Note: Values for 1997, 1999 and 2001 have been interpolated.

Source: World Bank Institute, Global Governance Indicators; calculations by CIEM.

FIGURE 3.4:
CONTROL OF CORRUPTION– VIETNAM AND COMPARISON COUNTRIES, 2008 AND 2009



Source: Transparency International's Corruption Perception Index 2008 - 2009.

- *Transparency of regulations is low and irregular payments by firms persist*

According to the Provincial Competitiveness Index (PCI) study for 2009, there has also been deterioration in other areas of governance; most notably in transparency and informal charges. Despite LNDs becoming easier to access, businesses report that access to planning documents has become more difficult. Businesses also indicate that personal relationships with provincial officials are more important in accessing provincial documents in 2009 (61.26 percent say it is important or very important in the average province) compared to 2007 (56.6 percent) and 2008 (49.82 percent).

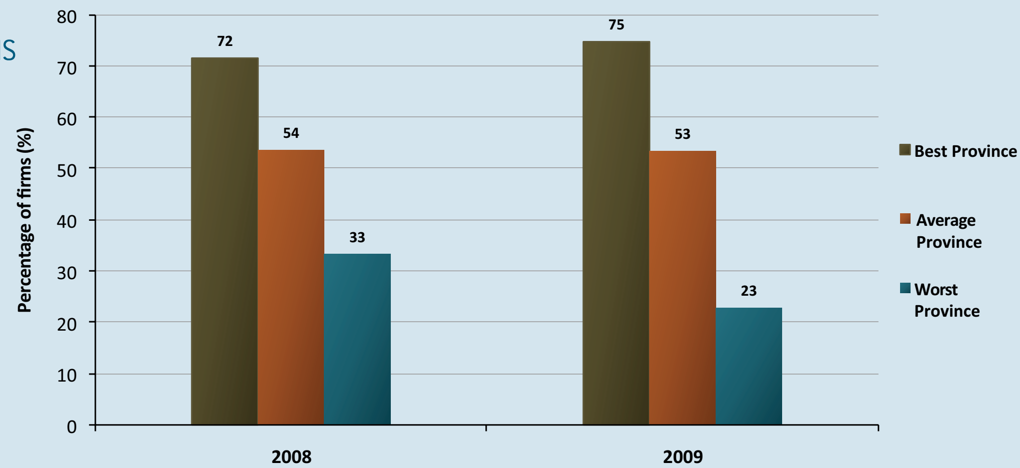
PCI 2009 also reveals that although the percentage of firms paying over 10 percent of their revenue on extra payments declined in 2009 and fewer enterprises felt their fellow businesses were subject to local bribes, there were some worrying increases in informal charges. At the local level, the number of firms that felt local regulations were being used for informal charges increased significantly.

- *Corruption remains significant and shows little signs of abatement*

According to Transparency International (TI)'s Corruption Perception Index, in 2009, Vietnam was ranked 120th out of 180 countries—behind most of its regional peers (except for the Philippines). Vietnam's absolute score on this index is low (2.7 out of 10 points) and remains unchanged as compared to that in 2008, while Indonesia has seen a slight improvement in its score (from 2.6 up to 2.8 points).

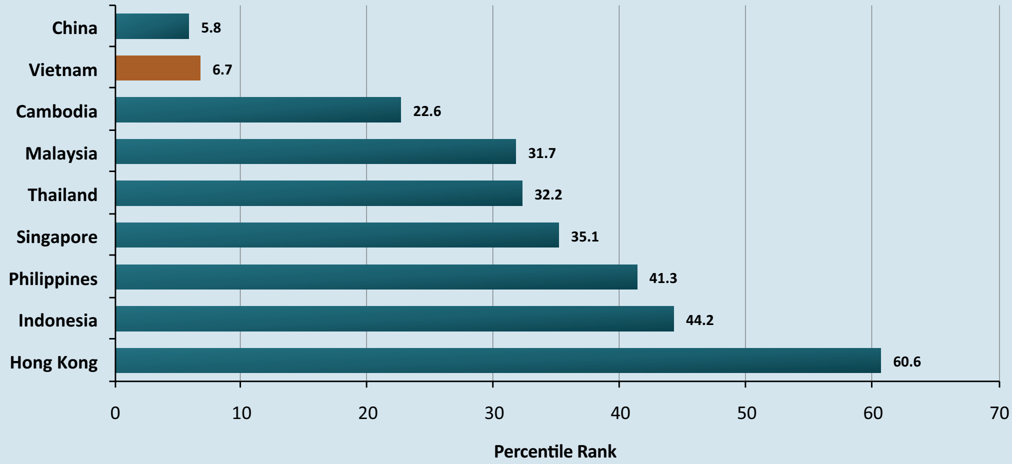
According to the PCI 2009, paying commission on government contracts remains a serious problem with about 50% of firms involved in this practice. However, this rate varies larger among provinces with 72% for the worst province and 24% for the best one in 2009 (Figure 3.5). This variation suggests that it is feasible to reduce this problem if every province is forced to model after the best province.

FIGURE 3.5:
PERCENTAGE OF FIRMS PAYING COMMISSIONS ON GOVERNMENT CONTRACTS



Source: Provincial Competitiveness Index 2009

FIGURE 3.6: VOICE AND ACCOUNTABILITY–VIETNAM AND COMPARISON COUNTRIES, 2008



Source: World Bank Worldwide Governance Indicators, 2008.

Political Institutions

- *A high level of political stability*

Both the Country Competitiveness Index (CCI) using data from the WEF Global Executive Opinion Survey and the World Bank's Worldwide Governance Indicators rank Vietnam highly on political stability (according to the latter, Vietnam is only behind Singapore and far above other countries in the region, including China). In this regard, Vietnam is much more stable than peer countries in the region which is an important advantage for Vietnam to attract investment and boost its competitiveness.

- *Moderate efficiency of the political system*

Indicators on the efficiency of Vietnam's political system receive moderate rankings in the CCI; for example: transparency of policy making—45th in 2009 (from 32nd in 2008); wastefulness in government spending—37th; favoritism in government decisions – 34th.

- *A high level of decentralization is one of the factors leading to dispersed power across different parts of governments and regions; there are major differences in the application of policies and regulations*

Vietnam's decentralization of policymaking is rated relatively highly (ranked 25th in the CCI 2009). In Vietnam, the supply of education, health care and environment services has been decentralized to localities since the start of economic transition period. For issues like investment approvals, this policy was carried out step by step, starting in the 1990s and accelerating in 2001. However, in the process of decentralization, little thought was given to financial capability and resources at the local level. Central monitoring and evaluation were inadequate, resulting in low efficiency in distributing and using resources, especially in terms capital and land resources. The decentralization efforts have also given rise to the uneven implementation of rules and regulations among provinces, especially regarding licensing and land management. An example of variable application of rules and regulations is in the provision of incentives beyond the national laws on foreign investment attraction. In addition to the investment incentives permitted by the central government, local governments often provide extra incentives, ranging from investment premiums and accelerated depreciation to tax holidays and reductions of land use fees. Out of 48 provinces surveyed by the Ministry of Finance (MOF) in 2006, 32 provinces issued extralegal documents granting extra incentives to investment projects. Most of the incentives are related to land or taxation. The Ministry of Finance reported that among those 32 rule breakers, 18 violated budget regulations, 21 offered land incentives that go beyond the framework established by national land policy, and 11 broke corporate income tax regulations. Many provinces were found to have violations in more than two areas. Most provinces offered very generous incentives with respect to land use fees and extended the exemption period for up to 10 to 20 years (Vu Thanh et al. 2007).

A high decentralization indicator for Vietnam does not necessarily mean good political institutions. This issue represents another weak point of Vietnam that could have negative effects on the improvement of Vietnam's macroeconomic competitiveness indicators.

- *Weaknesses in "voice and accountability"*

The ranking on "voice and accountability" in the World Bank's Worldwide Governance Indicators constitutes one of Vietnam's weak points. Its citizens are used to "obeying" administrative orders of the government at various levels. Similarly, administrative accountability is still weak and has not satisfied the public demand. Although the regulation[5] of democracy at grassroots level came into force since 1998, public participation was not effective and active, while the government has not encouraged and promoted popular policy participation. Until now there is still a lack of effective sanctions to deal with cases in which accountability was not carried out or was carried out ineffectively at each level in the administrative system. The World Bank's Voice and Accountability index ranks Vietnam only slightly above China and far behind nearly all peer countries.

Policy Making in Vietnam

Policy Instruments

The instruments of economic policy in Vietnam comprise the following:

- Overarching national ten-year socio-economic development strategies and national five-year socio-economic development plans;
- Legal normative documents (LNDs), such as National Assembly's laws, ordinances and resolutions, Government's decrees and resolutions, Prime Minister's decisions, Ministries' circulars; and
- Non-normative policy instruments such as strategies or master plans of specific sectors, industries or regions which are ratified by Prime Minister's or regions' administrative decisions or Ministries' official letters.

Policy Making Procedures and Organization

While there is clear guidance on procedures for issuing legal normative documents (LNDs) under the Law on Promulgation of LNDs (Law on Laws), procedures for issuing other non-normative documents are not yet defined clearly and remain discretionary.

- Under the Law on Laws, the process of developing and issuing LNDs is summarized as follows: A focal Ministry in charge of the specific policy area proposes the development and issuance of a LND. That Ministry establishes a drafting committee to review existing relevant policies and regulations, conduct a Regulatory Impact Assessment (RIA); draft the policy or regulation and share it with other government agencies and related parties for review and consultation. Upon completion of the consultation process, the Ministry in charge submits the draft to the Ministry of Justice for appraisal in terms of necessity, relevance, appropriateness, legality and compatibility of the draft. Once the Ministry of Justice approves, the draft is then be submitted to the Government for review and ratification. Depending on the legal nature of the policy instrument, it will then be submitted for debate, approval and promulgation by the Prime Minister or the National Assembly.
- Other non-normative policy instruments do not have to comply with any specific legal procedures, and therefore their promulgation remains discretionary. In theory, the issuance of non-normative documents should follow similar procedures as for the LNDs, except that the drafts will not have to be submitted to the Ministry of Justice for appraisal or to the National Assembly for debate and approval. Depending on the legal nature of the policy instrument, it will be promulgated by the drafting agency (such as a Ministry or a provincial government) or by the Prime Minister.

Shortcomings of the Current System

The current process raises a number of issues:

- A protracted and inflexible process: It takes in average about two years to issue a new law, ordinance, or add or amend a current one;
- Irrelevance and vagueness of the policy: Policies in many cases are too general, vague and unclear, and often do not respond to social and market requirements;
- Procedural deficiencies: A systematic mechanism (criteria, process and organization) for evaluating and verifying the content of the policy is lacking. The assessment process usually takes a deeper look into the legal aspect of the document; rather than into the socio-economic and technical dimension of the policy or regulation;
- Lack of vision, focus and prioritization in making policies, especially at provincial levels;
- Inconsistency, overlap and even conflict among different policies and regulations; lack of connection between short term plans and long term strategies;
- Discretion and lack of transparency in interpretation and application of policies; and
- Low effectiveness in implementation and enforcement of policies.

Root Causes of Shortcomings[6]

Vietnam's system of policy formulation is saddled with the legacies of planning days, and cannot cope effectively with problems in the age of global competition. The main procedural and organizational problems are interrelated and constitute the main sources of formalism and the general lack of creativity and responsiveness in policy making.

(i) The involvement of the private sector and other affected groups in designing and executing policies remains inadequate

The policy making process in Vietnam is closed within the government with little involvement of other stakeholders. The drafting team is usually lightly staffed and has limited budgetary resources mainly for securing external data and analyses as well as organizing interviews and hearings. Although the draft policy is circulated for comments and review, comments are rarely substantive, and debates on fundamental directions or crucial issues rarely take place. Significant delay may occur at internal review or final approval. The drafting team is routinely overworked with a large number of policy documents to finish each year, which does not allow sufficient time (or money) to think creatively, interact with non-government stakeholders, or publicize the final result. If a domestic or foreign firm wants to raise its voice, it must devise its own way since the current procedure does not allow meaningful involvement of the business community.

Although public consultations are becoming more popular in recent years, an effective mechanism to follow-up on how comments are taken into the draft is missing. In other East Asian countries, private sector participation is institutionalized; private sector representatives serve as members of the steering committee and task forces in drafting the policy, or the private sector is involved heavily in deciding targets and action plans.

(ii) Inter-ministerial coordination on policy substance as well as implementation details is poor primarily because mechanisms are lacking to encourage different Ministries to work together.

Compartmentalization of the government along Ministerial lines is a common problem around the world, but most governments manage to somehow ameliorate it. One solution is to have a strong top leader with a good economic mindset who directs various ministries and becomes the hub of policy making him or herself. Another way is to establish a powerful team of technocrats directly serving the president or the prime minister who makes key policy decisions while Ministries become executing agents of the plans emanating from this team; South Korea's Economic Planning Board, 1961-1994, exemplifies this option. Still another way is to let a super Ministry, with sufficient policy authority and instruments at its disposal, lead policy making and be responsible for it—Japan's Ministry of International Trade and Industry in the 1960s. Finally, it is also possible to install a mechanism to guarantee the representation of all relevant ministries and nongovernment stakeholders in the official drafting process as well as in informal exchange—Malaysia's drafting of the Industrial Master Plan at present. In Vietnam, though all policy documents specify a leading Ministry and a list of related Ministries, the mechanism to make them participate substantively and work as one is still missing.

(iii) Lack of accountability:

Vietnam's decision making tends to be based on consensus. This system can produce stability and continuity but it is not suitable for staging bold reforms or responding quickly to a changing world. Policies remain mostly reactive rather than pro-active. When a serious problem is identified, an inter-ministerial committee is called and its chair is appointed. Each Ministry proposes solutions from its perspective, which are summarized into general policy recommendations without execution details. Bureaucracy can supply broad ideas touching every aspect of the problem, but it does not set priorities or provide selectivity for real action. There should be an interaction between the high level and the implementing level of the government to produce policies that are both realistic and sharply focused.

(iv) An inadequate civil service system tends is prompting an exodus of talented people to other sectors.

Vietnam's public service must overcome the problems of overstaffing, low salary, nepotism, corruption, relation-based promotion, and ODA-related benefits (foreign travel, training, benefits associated with supervising aid projects, etc.). These were the legacies of the subsidy system existing up to the 1980s, where the public sector was the provider of jobs, minimum income and social security for all and where no alternative employment opportunities were available in the private or foreign sectors with far more attractive salaries and rewarding duties. Under the present circumstance of market orientation and global integration, the public sector only attracts people who want stability, people who genuinely believe in the importance of public service, or people who want to take advantage of official privileges to study abroad or receive training as a stepping stone to a better-paying job in the future. As a result, highly qualified and motivated people are becoming difficult to recruit or retain for public service.

Minor repairs or ad hoc adjustments cannot solve these problems. To reverse the hollowing-out of the Vietnamese government, far reaching reforms to remake the public administration completely are needed as soon as possible which will be discussed in more details in Chapter 4.

Macroeconomic Policy

Overall Macroeconomic Performance

Following a period of macroeconomic stability,[7] the macroeconomic conditions have turned volatile since 2007. The success of the economy, and especially investors' optimism about the country's WTO accession, has encouraged inflows of foreign investment pouring into Vietnam. The unprecedented increase of capital inflows, while both the economy and macroeconomic management were not ready, triggered the most serious macroeconomic instability since the "price-wage-money crisis" in the second half of the 1980s. Vietnam experienced macroeconomic instability during 2007-2008 before the eruption of the global financial crisis; the principal culprits were internal, not external factors. Table 3.5 provides a summary of Vietnam's macroeconomic conditions during 2004-2009.

Fiscal Policy

- *Increasing and persistent budget deficits result in a narrower fiscal space*

Vietnam's fiscal deficit, including both on-budget and off-budget, had been moderate at 3 to 4 percent of GDP until 2006, however since 2007 it has risen to the 7 to 7.4 percent range. The limited fiscal space has narrowed further because of the ambitious stimulus package amounting to about 9 percent of GDP passed in 2009 in the wake of the global financial crisis.

TABLE 3.5: MACROECONOMIC INDICATORS FOR VIETNAM AND COMPARISON COUNTRIES (2004-2009)

Note: Figures are averages for the period 2004-2009.

Source: Economist Intelligence Unit.

	Vietnam	China	Indonesia	Malaysia	Philippines	Thailand
Fiscal Policy (% GDP)						
Overall fiscal balance	-5.8	-0.9	-0.9	-4.3	-2.1	-1.1
Fiscal revenue	26.8	18.4	17.9	21.6	15.5	18.3
Gross capital formation	36.2	40	22.6	22.2	17.7	22.3
Public debt	46.9	20.1	39.1	43.8	64.7	43.8
Monetary Policy (% per year)						
Growth of money supply M2	32.2	19.4	14.5	15.1	12.3	7
Growth of domestic credit	37	15.7	12.4	8.1	7.1	4.4
Balance of Payment						
Current account balance (% GDP)	-5.7	7.7	1.4	15.5	3.5	2.2
Net FDI (% GDP)	6.8	3	1.6	3.4	1.6	3.8
FX Reserves (months of imports)	3.5	18.9	7.9	7.9	6.9	7.5
GDP Growth and Inflation (%)						
GDP growth	7.4	11.1	5.5	4.5	4.7	3.5
Consumer price index (CPI)	10.2	2.9	8.4	2.7	5.8	3.1

- *Public debt has increased rapidly over the last decade*

By the definition of the Ministry of Finance (MOF),[8] Vietnam's total public debt by the end of 2009 was about 44.7 percent of GDP, of which the central government debt was 35.4 percent of GDP, debt guaranteed by the central government was 7.9 percent of GDP, and local government debt was 1.4 percent of GDP.[9] Although this level of public debt is not a cause of concern, it is higher than the common level of 30 – 40 percent in other developing and emerging economies. On a per capita basis, Vietnam's public debt rose nearly four times, from USD 144 to USD 548, during the 2001 – 2009 period, or 18 percent annually (EIU), while GDP per capita growth was only 6 percent during the same period.

This coupled with the increasing fiscal deficit may jeopardize sustainable debt management; particularly since Vietnam's sovereign debt rating has been downgraded by all rating agencies (Table 3.6). As a fast growing economy, Vietnam still needs to invest heavily to build up infrastructure and provide public services, while the domestic investment – saving gap tends to widen very quickly, from 6 percent of GDP in the mid-2000 to 15 percent of GDP by 2009. This implies that the country's public debt will keep rising.[10]

FIGURE 3.7: VIETNAM VS. ASIAN PEERS ON MACROECONOMIC INDICATORS—BUDGET BALANCE, 2005-2010

Note: Data for 2010 are estimates.

Source: Economist Intelligence Unit.

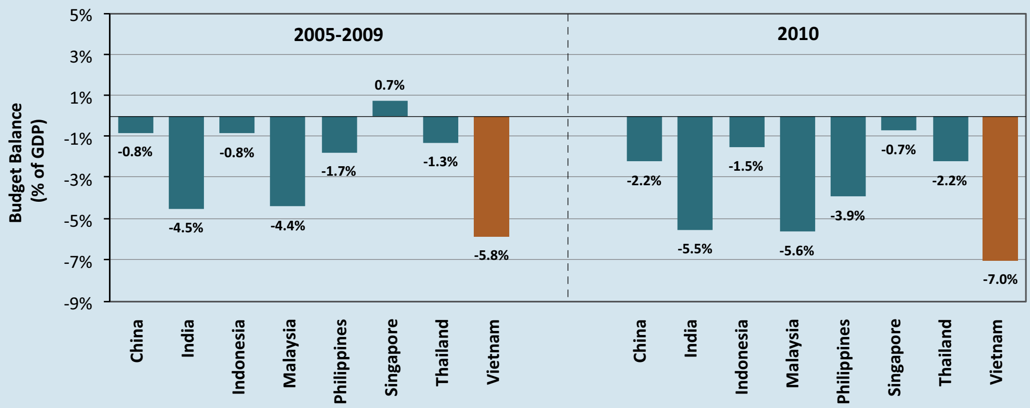


TABLE 3.6: SOVEREIGN CREDIT RATINGS, VIETNAM VS. ASIAN PEERS

Country	S&P			Moody's			Fitch		
	2008*	2010**	Change	2008*	2010**	Change	2008*	2010**	Change
Vietnam	BB/Stable	BB/Negative	Worse	Ba3/Positive	Ba3/ Negative	Worse	BB-/Stable	B+/Stable	Worse
China	A/Positive	A+/Stable	Better	A1/Stable	A1/Stable	Unchanged	A+/Stable	A+/Stable	Unchanged
Indonesia	BB-/Stable	BB/Positive	Better	Ba3/Stable	Ba2/ Positive	Better	BB-/ Positive	BB+/ Stable	Better
Malaysia	A-/Positive	A-/Stable	Worse	A3/Stable	A3/Stable	Unchanged	A-/Stable	A-/Stable	Unchanged
Philippines	BB-/Stable	BB-/Stable	Unchanged	B1/Stable	Ba3/Stable	Better	BB/Stable	BB/Stable	Unchanged
Singapore	AAA/ Stable	AAA/Stable	Unchanged	Aaa/Stable	Aaa/Stable	Unchanged	AAA/ Stable	AAA/ Stable	Unchanged
Thailand	BBB+/ Stable	BBB+/ Negative	Worse	Baa1/Stable	Baa1/Stable	Unchanged	BBB+/ Stable	BBB/ Stable	Worse

Notes: * as of January 10, 2008; ** as of November 6, 2010.

Sources: Data from ADB Asia Bond Online (http://asianbondsonline.adb.org/)

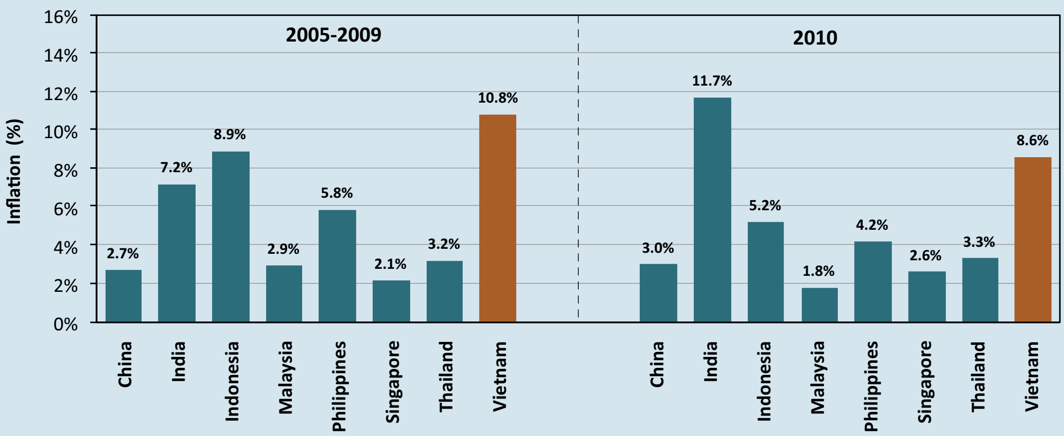
Higher interest rates increase the cost of financing the public debt. The demand for money in Vietnam has always been high in order to finance growth, leading to high inflation (Figure 3.8) and interest rates. As a consequence, the yield of government bonds in 2010 has been as high as 11-12 percent, while the equivalent yield in Malaysia, Thailand, or China is less than 3 percent. Similarly, compared to Indonesia or the Philippines, Vietnam had to pay a higher premium for its sovereign bonds issued in early 2010. In addition, now that Vietnam has moved out of the low-income status, preferential loans will gradually be replaced by commercial loans with much higher interest rates.[11]

- *High but structurally unsustainable fiscal revenue levels*

The government's fiscal revenue has increased from 13 percent of GDP in 1991 to nearly 30 percent of GDP in 2009. Table 3.5 shows that Vietnam had the highest fiscal revenue as a percentage of GDP during the 2004 – 2009 period vis-à-vis countries in the region.[12] The public sector has consistently expanded its size relative to the economy, not only in the provision of public services such as administration, education, or healthcare, but also in economic activities, especially by investing heavily into general corporations (GCs) and state conglomerates (SCs).

By 2008, which is the most recent year for which state budget data are publicly available, about three quarters of fiscal revenue come from four sources: value-added tax (VAT), corporate income tax (CIT), crude oil and foreign-trade related taxes (mostly tariffs and excise tax on imports). Revenues from VAT and form CIT have increased over the years and accounted for 25 percent and 15 percent of fiscal revenues in 2008 respectively. The contribution of the other two sources, oil revenue and trade related taxes which accounted for 20 percent and 15 percent in 2008 respectively, is expected to decline due to declining oil reserves and the process of trade liberalization following WTO accession.

FIGURE 3.8: VIETNAM VS. ASIAN PEERS ON MACROECONOMIC INDICATORS– INFLATION, 2005-2010



Note: Data for 2010 are estimates.

Source: Economist Intelligence Unit.

TABLE 3.7:
STRUCTURE OF BUDGET EXPENDITURE (IN PERCENT)

	2005	2008
Total	100	100
Development Investment	30.2	27.5
Of which: capital spending	27.7	25.2
Social and economic services	50.4	52.3
Of which:		
Education and training	10.9	12.9
Healthcare	2.9	4
Science, technology and environment	1	1.6
Pension and social relief	6.8	10.2
Other	28.8	23.7
Additional to finance reserve fund	0	0
Others	19.5	20.2

Notes: 2008 data is for the first three quarters.

Source: Vietnam's Ministry of Finance.

- *Large but inefficient capital spending*

Table 3.7 suggests that the share of development investment expenditure has declined slightly from 2005 to 2008, but remains high. Capital spending accounted for over 91 percent of development investment in 2008.

In an economy like Vietnam, the ability to use scarce capital efficiently to create new jobs and build up industrial capacity is essential for improving competitiveness. However, as discussed earlier, large but inefficient investment exerts pressures on the price level and imposes constraints on monetary policy, as the 2007–2008 slump showed.

Monetary Policy

- *An expansionary monetary policy and growing credit supply*

Vietnam has generally adopted an expansionary monetary policy throughout the last decade. During the period 2004 – 2009, the average growth rate of credit and money supply (M2) were 37 percent and 32 percent respectively (Table 3.5). These growth rates were almost twice as high as those of China, which was the most overheating economy in the 2000s. The rationale behind this expansionary policy was to accommodate an expansionary fiscal policy, and to satisfy the investment needs of a growing economy. The upside of this policy is that it produced a relatively high growth rate of 7.3 percent during the period of 2000 – 2009. The down side of it, however, is that growth was achieved at the cost of increasingly serious macroeconomic imbalances.

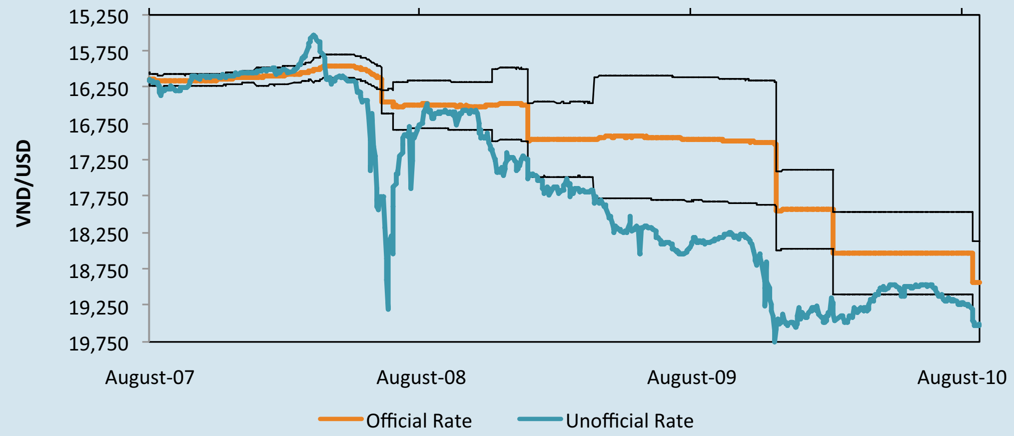
As noted earlier, macroeconomic instability predated the global financial crisis. The major trigger of the two-digit inflation in 2007-2008 was the sharp increase in capital inflows while the economy was functioning inefficiently.[13] Since these massive capital inflows were not properly sterilized, they resulted in the record growth rate of money supply, credit and investment, in which a lion's share was allocated to inefficient state enterprises and speculative markets (real estate and equity). When too much money is chasing too few goods, inflation is inevitable. Specifically, during 2007 – 2008 the money supply increased by 80 percent while GDP grew by only 15 percent, and inflation at some point was as high as 28 percent.[14]

By the second quarter of 2008, the government became very determined to give priority to taming inflation, achieving macroeconomic stability, mitigating negative social impacts, and ensuring sustainable development by tightening monetary policy. The growth rate of credit and money supply was cut from 55 and 35 percent in the first half of 2008 to 33 and 20 percent respectively in the second half of 2008.[15] As a result, CPI then fell to a single-digit level in early 2009.

- *The current account deficit has created significant depreciation pressures*

Any gap between official and unofficial exchange rates is a reliable indicator for the government's macroeconomic management. In Vietnam, the unofficial rate is always higher than the official rate by a significant margin (Figure 3.9). In 2009, the unofficial rate rose substantially above the upper bound dictated by the State Bank of Vietnam.

FIGURE 3.9: USD/VND EXCHANGE RATES, 2007–2010



Note: Unlabeled lines are the upper and lower bounds.

Source: Global Financial Data and State Bank of Vietnam.

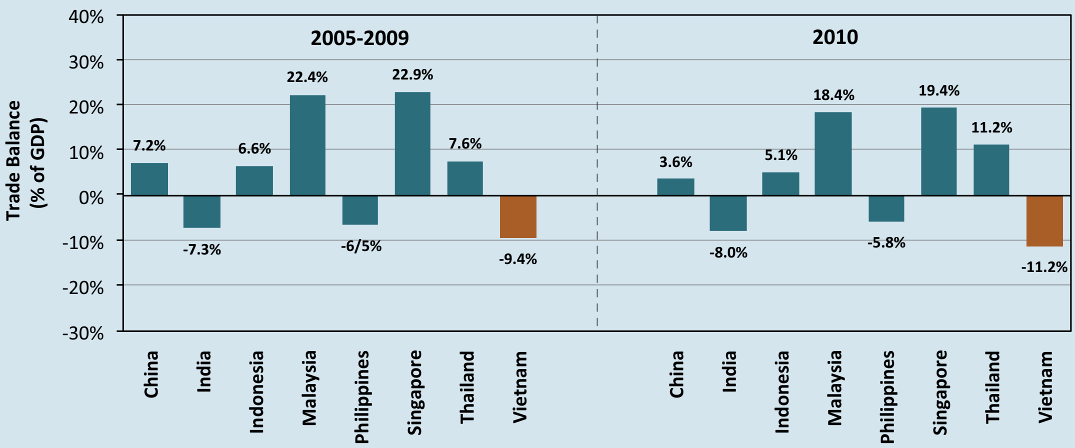
Several factors contribute to this strain in the foreign exchange market. First, high inflation during 2007–2008 led to further appreciation of the already overvalued dong by about 20 percent compared to the beginning of 2007.[16] Second, the balance of payments shifted from a big surplus in 2007 (USD 10.2 billion) to a large deficit (USD -5.7 billion) in the first three quarters of 2009 (Table 3.8 and Figure 3.10), putting further pressure on the dong.

There were two main reasons for this balance of payment deficit. First, the trade deficit increased sharply, because of currency appreciation and the ambitious stimulus measures led to higher imports. Second, throughout 2009 the government's stimulus program provided a 4-percent interest rate subsidy for short-term borrowings in VND to eligible firms to support their working capital. This policy led to a surge in money and credit supply. At the same time, high interest rates for USD and gold deposits, together with the expectation of VND depreciation, encouraged firms and people to shift their portfolio by hoarding USD and gold instead of VND. This caused the "errors and omissions" item in the balance of payment to go up to USD 9 billion in the first three quarters of 2009 and USD 13 billion in the whole year.

In summary, the fixed exchange rate maintained throughout most of 2009 together with the depreciation pressure on the dong had resulted in a widening gap between the official and the unofficial exchange rates. On the one hand, these factors caused a surge in the trade deficit to USD 12 billion. One the other hand, the portfolio shift towards USD and gold also significantly contributed to a very high balance of payment deficit, estimated to be USD 13 billion. Foreign exchange reserves fell sharply from 4.6 months of imports by the end of 2007 to less than 3.0 months of imports by the end of 2009. This level of reserves was much lower than that of other countries in the region (Figure 3.11). This put the SBV in a very difficult situation to manage monetary policy and maintain the market confidence, especially when the "twin deficits," fiscal and current account deficit, still exist, and the uncertainty in global financial markets and downside risks regarding the world economy remain.[17]

Facing the increasing pressure on the foreign exchange market throughout 2009, the government devalued the dong twice, the first time by 5.0 percent in November 2009, and the second time by 3.3 percent in February 2010.[18] As a result, the foreign exchange market was cooling down and the unofficial rate was converging towards the official rate. However, since mid-July 2010, the two exchange rates

FIGURE 3.10: VIETNAM VS. ASIAN PEERS ON MACROECONOMIC INDICATORS– TRADE BALANCE, 2005-2010



Source: Economist Intelligence Unit

TABLE 3.8:
BALANCE OF PAYMENTS IN MILLION USD, 2006-2009

	2006	2007	2008	2009(E)
Current account balance	-164	-6,992	-10,787	-7,440
Trade balance	-2,776	-10,360	-12,782	-8,306
Investment income (net)	-1,429	-2,168	-4,401	-4,532
Remittances	3,800	6,180	6,804	6,018
Others	241	-644	-408	-620
Financial account balance	3,088	17,540	12,341	11,452
Official	1,025	2,045	992	4,473
Private (FDI, portfolio investment, trade credit)1	3,598	12,872	10,672	7,284
Net financial assets of commercial banks	-1,535	2,623	677	-305
Errors and omissions	1,398	-349	-1,081	-12,178
Overall balance	4,322	10,199	473	-8,166
Memorandum items				
Gross official reserves (excluding government deposits)2	11,491	20,964	23,022	14,148
Current account balance (in percent of GDP)3	0	-10	-12	-8
Trade balance (in percent of GDP)3	-5	-15	-14	-9
GDP (in millions of U.S. dollars)	60,933	71,111	90,274	93,164

Notes: 1/ Includes the sovereign bond issuance of USD750 million in 2005 and USD 1 billion in 2010; 2/ Data for 2009 include the SDR allocation of SDR 267.1 million; 3/ Data for 2009 include gold re-exports.

Source: IMF Article IV Consultation (2010)

started to diverge, once again because of the return of trade deficit (approximately USD 1 billion per month) together with the recovery of the economy. The reality is that the massive inflows of foreign capital had saved Vietnam from the risk of a currency crisis. Capital flow reversals would be detrimental to the economy. Attracting and maintaining FDI will still play a key role in Vietnam's development policy in the future.

Assessment of Macroeconomic Management

Vietnam lacks a coherent and holistic framework for macroeconomic management. Policies are designed and undertaken with little linkages and coordination. Monetary policy is either reactive and non-market driven—for example, imposing administrative price controls to curb inflation—or inconsistent and unpredictable—such as exchange or interest rates. Fiscal policy requires more transparency and discipline to balance government revenues and expenditures in a way that is consistent with a long-term budget constraint of the public sector. Monetary and fiscal policies are not consistently and effectively coordinated. Policy measures often address the symptoms, not the root causes of the problems. Macroeconomic management is not effective in preventing the build-up of unsustainable bubbles in the economy, for example in the real estate, credit, or equity markets, and strengthening the soundness of the financial market and institutions.

The State Bank of Vietnam is not fully equipped and empowered to play the role of an independent central bank. Its capacity in institutional surveillance and risk management remains weak. In addition, availability and transparency of information, such as fiscal position of the country or SOEs, credit rating of financial institutions, are limited.

In summary, Vietnam has followed an investment-led growth strategy but much of the investment—especially of the SOEs—has been inefficient. The economy faces a constant pressure to maintain a fairly high growth rate to create employment for a young and growing population. The government has pursued an expansionary fiscal and monetary policy in most of the 2000s to support growth, leading to fiscal deficit, inflation and other macroeconomic imbalances.

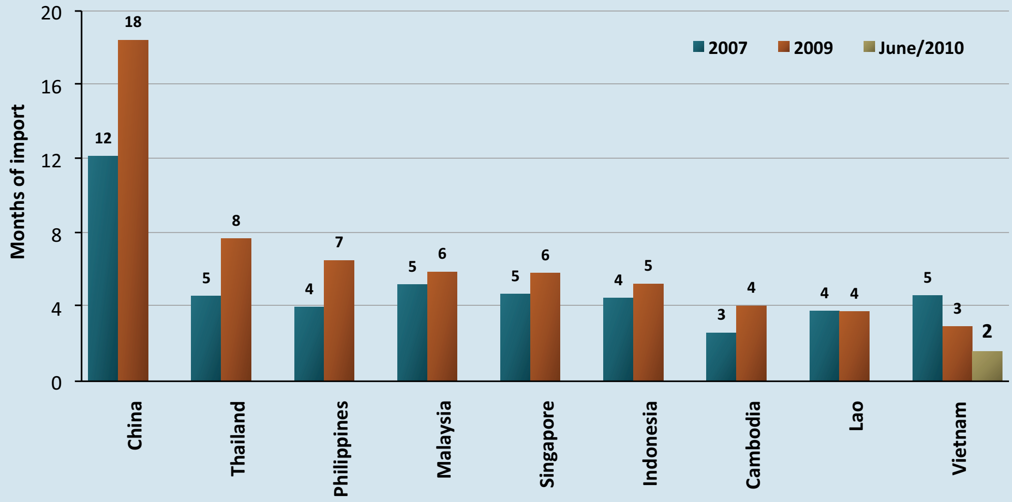
In addition, the shallow value-added of the economy has created persistent trade deficits. High inflation and major "twin deficits" put the dong under constant devaluation pressure. Vietnam has fallen into a dilemma, which is pushing for high economic growth risks macroeconomic instability. Unless the economy's efficiency is improved, starting with public investment, it will be very difficult for the country to maintain a sufficiently high growth rate for a sufficiently long period of time to escape the middle income trap.

Microeconomic Competitiveness

Business Environment Quality

Given the macroeconomic framework, the productivity of firms depends upon a set of interlinked microeconomic factors which underpin the business environment. The business environment sets the stage (and incentives) for company strategy and operations and shapes interaction between firms. As firms respond, they in turn trigger changes in the business environment. Microeconomic

FIGURE 3.11: FOREIGN EXCHANGE RESERVES IN MONTHS OF IMPORTS, 2007 VS. 2009



Source: IMF, International Financial Statistics.

competitiveness is therefore the result of a complex interplay of the decisions of public and private actors. Effective strategies for upgrading competitiveness require an understanding of these interactions and their impact on innovation and productivity.

Professor Michael Porter's 'Diamond' framework seeks to capture the interactions that determine competitiveness at the microeconomic level (Porter 1990). The four corners of the diamond describe the four dimensions of the business environment for a country, region or cluster. The four dimensions are: factor input conditions, the context for the strategy and rivalry among companies, demand conditions and the presence of related and supporting industries.

Factor Input Conditions

Physical Infrastructure

- *Significant investments over the last few years have created basic physical connectivity*

In recent years, the Government has increased investment in the North-South highway system and in the improvement of inner city roads, especially for large cities such as Hanoi and Ho Chi Minh City. Vietnam's investment in infrastructure has been high, amounting to over 10 percent of GDP. This is a higher percentage than that for Thailand and China which currently spend between 7 – 8 percent of GDP – more in line with World Bank recommendations (Fulbright Economic Teaching Program 2008, 3).Public investment has been the major source of financing, contributing almost three quarters of the total infrastructure investment. While any developing economy like Vietnam requires high infrastructure investment, efficiency and impact of investment are not necessarily achieved by higher investment intensity.

- *However, the efficiency of investment is low and deteriorating, and the resulting quality and impact of infrastructure are questionable*

Despite the huge amount of investment, Vietnam's infrastructure capacity remains inadequate and quality still remains low according to respondents to the WEF's Executive Opinion Survey (EOS).

TABLE 3.9: INFRASTRUCTURE INVESTMENTS IN VIETNAM, 2000 AND 2006

	2000	2006
GDP (billion USD)	31.2	61.0
Infrastructure investment (billion USD)	2.6	6.5
Public infrastructure investment (billion USD)	2.4	4.8
Infrastructure investment/GDP (%)	8%	11%
Public infrastructure investment/ Total infrastructure investment (%)	94%	74%

Source: Infrastructure Challenges in Vietnam, Fulbright Economic Teaching Program, 2008.

TABLE 3.10:
INFRASTRUCTURE INVESTMENT EFFICIENCY – COMPARISON OF SEVERAL RAILROAD PROJECTS IN VIETNAM AND CHINA

	Ha Noi-Vinh	Beijing-Shanghai	Qinghai-Tibet
Length	334 km	1,318 km	1,142 km
Speed	200 kph	300-350 kph	120 kph
Travel Time	1.5 hours	5 hours	-
Cost	$12.9 billion	$22.6 billion	$3.68 billion
Mil USD/km	38.6	17.1	3.2

Source: Vietnam's Infrastructure Development Challenges, Fulbright Economics Teaching Program, 2008.

Also according to the PCI survey, 71 percent of manufacturing firms report that their products are being damaged due to poor road quality, causing an annual average loss of VND 43 million per firm.

- *Logistical performance is relatively poor compared to other countries in the region*

Vietnam's score on the World Bank's Logistics Performance Index (LPI) is shown in Figure 3.12. The LPI is a composite index, combining seven sub-indices, on a scale of 0 to 5. Of the comparator countries, only Cambodia shows a lower score than Vietnam.

- Infrastructure and utilities (electricity and water) are struggling to keep pace with growth and urbanization

Obsolete and inadequate infrastructure is hindering Vietnam's socio-economic development: traffic congestion is occurring more frequently; people are wasting more time on the road; and many roads are degrading, yet receiving little maintenance. The Executive Opinion Survey shows that weak infrastructure has been a major barrier to production and business activities in Vietnam (ranked 1st in 2009 and 2nd in 2010 in terms of negative impact).

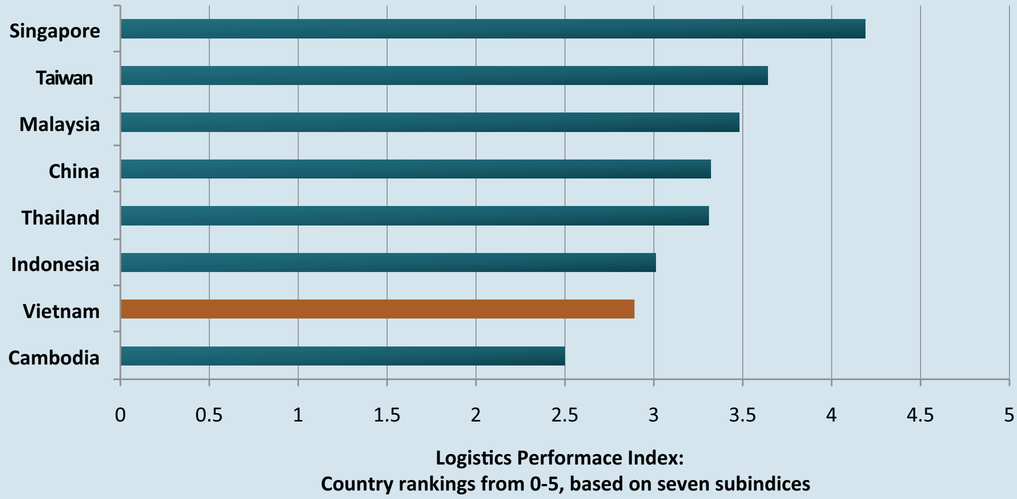
Although Vietnam has 2,600 kilometers of railways, the railroad infrastructure is outdated. The market is entirely controlled by the State which is unable to meet the growing demand. Railway density is 0.8 km per 100 km2, and notable railway lines include the North-South (1726 kilometer); Hanoi-Laocai (230 kilometer); Hanoi-Haiphong (100 kilometer); and two transnational ones (Hanoi-Laocai-Kunming and Hanoi-Dong Dang-Beijing). Even though the North-South railway is being upgraded, the fact that there is no alternative line means even a slight congestion at one location can cause the whole line to halt. Moreover, the country lacks railway lines to economic zones, industrial zones, seaports, and to neighboring countries such as Laos and Cambodia. The existing railways have poor quality; narrow gauge which limits train speed; and too many railway crossings at roads in residential areas, causing frequent accidents.

TABLE 3.11:
RANKINGS ON INFRASTRUCTURE (CCI), 2009

	Rankings			
Country	**Roads**	**Railway**	**Port infrastructure**	**Air transport infrastructure**
Vietnam	**96**	**51**	**85**	**79**
China	55	28	70	80
Singapore	1	8	1	2
Malaysia	25	21	33	32
Indonesia	87	61	92	67
India	92	20	91	71
Thailand	34	54	41	25
Philippines	110	99	128	119
Cambodia	69	100	97	91
South Korea	16	10	27	18
Japan	21	3	36	50

Source: WEF Global Executive Opinion Survey, Institute for Strategy and Competitiveness, Harvard Business School.

FIGURE 3.12: LOGISTICS PERFORMANCE INDEX, VIETNAM AND COMPARISON COUNTRIES



Source: Logistics Performance Index 2007, World Bank/Turku School of Economics.

Though there are international seaports (in Saigon, Danang, Haiphong etc.) receiving large ships, their services do not meet the requirements of shippers. For instances, service costs are too high; customs clearance takes too much time, usually between 3 and 7 days but in some cases up to one month (for Singapore the figure is 10 minutes); international container transshipment port is lacking; railways and roads are not connected to the seaport system. Infrastructure development has not kept pace with export growth.

The principal port for Vietnam is Ho Chi Minh City, which ranks 36th among the busiest container ports in the world. Since 2004, traffic has been increasing at an average of 4.2 percent per year, but it has not kept up with the expansion of total container shipping worldwide, as illustrated in Figure 3.13. Its share in total container traffic (as measured by the total volume for the 40 top seaports) has declined from 1.3 percent to 1.0 percent between 2004 and 2008.

Airports are also hitting capacity barriers, especially international airports. Passenger capacity is low, service quality is poor, domestic flights are frequently delayed. Up to now, the size of Vietnam's domestic aviation market is only nine to ten million passengers per year.

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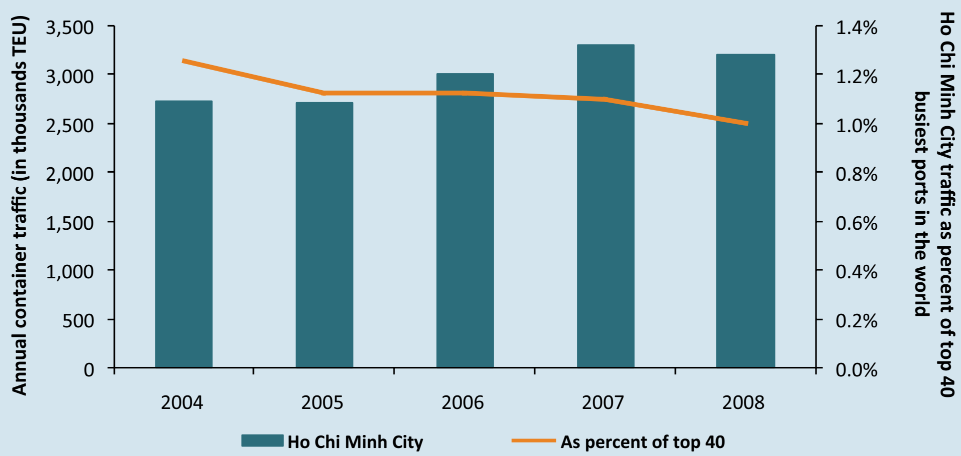
FIGURE 3.13: CONTAINER TRAFFIC FOR HO CHI MINH CITY SEAPORT, 2004-2008



Source: List of world's busiest container port.

TABLE 3.12:
AIR TRAFFIC VOLUME COMPARISONS

Airport	Total Passengers (million)	Growth rate, 2005-2006 (%)
Hongkong	**43.3**	**8.7%**
Singapore	33.4	8.6%
Bangkok	29.6	10.3%
Incheon – Korea	27.7	8.1%
Narita – Tokyo	27.5	1.7%
Shanghai	16.1	10.4%
Kuala Lumpur	15.1	6.8%
Tan Son Nhat	**4.26**	**2.1%**

Source: Fulbright Economics Teaching Program, Vietnam Infrastructure Challenges, 2008.

percent per year, but it has not kept up with the expansion of total container shipping worldwide, as illustrated in Figure 3.13. Its share in total container traffic (as measured by the total volume for the 40 top seaports) has declined from 1.3 percent to 1.0 percent between 2004 and 2008.

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Electricity demand increased at an annual rate of 16-17 percent; twice as fast as the growth rate of the economy. Domestic electricity capacity is inadequate to meet growing demand, thus the country has to import electricity from Laos and China. According to the PCI survey in 2009, on average, firms had to deal with 50 hours of power outages in a month as compared to 44 hours in 2008. In about half of these instances, users did not receive any prior notice about the power cut.

Water supply coverage rate for urban areas remains low; about 70-80 percent in first- and second-tier cities; 50-55 percent in third-tier cities; and only 15-20 percent in fourth- and fifth-tier ones. Designed capacity of water supply facilities is unrelated to demand, resulting in excess capacity in some regions and capacity shortages in others. Water loss rate usually ranges from 30-40 percent, but in some places, it can be as high as 50 percent. Water quality does not meet standards.

Generally, Vietnam's urban areas do not have a separate waste water drainage system; instead, a common system for both rain and waste water is still being used. In addition, the drainage system has not been built in a synchronous manner and many downgraded culverts are limiting drainage capacity. Waste water from industrial zones has caused severe pollution in large rivers such as Dongnai, Saigon, Thi Vai, Day, Nhue, To Lich and Cau. Large cities are susceptible to being flooded whenever there is heavy rain or high tide. In short, drainage capacity and waste water management are still two major problems in this field.

- *Demand for further investment is huge, but lacks focus and prioritization; donor interests may affect selection of projects*

According to the plan, investment demand for electricity, roads, railways, and seaports over the next 10 years will amount to about USD 120 – 150 billion (40 billion for electricity; 53 billion for roads; 3 billion for railroads excluding elevated railways and subways; 25 billion for seaports). Thus, an investment of about USD 12 – 15 billion is required every year. However, traditional capital sources including the state budget, SOEs, ODA and government bonds can only satisfy at most 50 percent of that demand. Private investment in infrastructure accounts for less than 5 percent of demand. The Government has called for private investment in infrastructure through public private partnerships (PPP). PPPs are expected to be an important factor for infrastructure development in the coming years. Vietnam has applied the PPP model to a number of highway development projects. So far there have been around 80 implemented PPP projects in the form of BOT, with total invested capital of nearly VND 90 trillion (The Motherland 2009). Recently, the Government has drafted regulations allowing the pilot implementation of several infrastructure projects under the PPP model. Specifically, the Government may subsidize up to 30 percent of required capital, or even 50 percent for projects with long operating periods and high levels of capital recovery (Saigon Online 2010).

Meanwhile, the infrastructure development plan is scattered and lacks strategic focus. For example, over the next ten years, Vietnam plans to develop 39 seaports with 108 terminals to be built or upgraded (of which 32 seaports are to be newly built). Meanwhile, there are only three main ports on the West Coast of the U.S. (over 1900km long). In Malaysia, there were only two major ports in 1970 but then the Government decided to develop four more national and three sub-national ports which led to redundant capacity and fierce competition among ports.

BOX 3.2:
NORTH – SOUTH HIGH-SPEED TRAIN PROJECT

The feasibility and efficiency of the North – South high-speed train project is being debated. With a total length of 1,570km, the project is estimated to cost USD 56 billion (current price) – equivalent to over 50 percent of Vietnam's GDP. To date, there are only 11 countries in the world having high-speed train system -- all of them are developed countries (except China) and the popular length of the system is between 100 - 400 km, which is the optimal length for the ef-ficiency and safety of a high-speed train system (according to experts of the Vietnam's Construc-tion Association, with the length of more than 800km, airway transportation will be more effi-cient than railway transportation).

It is estimated that the annual investment cost is USD 2.63 billion, two thirds of which is external borrowing from donors (with the condition that the project cost will remain unchanged and the annual GDP growth rate is kept stable at 6.4 percent over the next 25 years). This is raising con-siderable concerns about the financing feasibility and sustainability of the project, even among the donor community, given the current high levels of fiscal deficit and external borrowings. The impact of project is still questionable as high-speed train can only serve transportation of a small group of passengers who can afford the relatively high price rather than mass transportation of lower-income passengers and commodities. The experts of Vietnam's Environment Protection Association also estimated that the construction of the system will cause deforestation of 1,383 ha of natural forests and affect the lives of 16,592 households who will have to relocate for building the system.

Source: Collected from VietnamNet, Dan tri, VnExpress

Communication Infrastructure

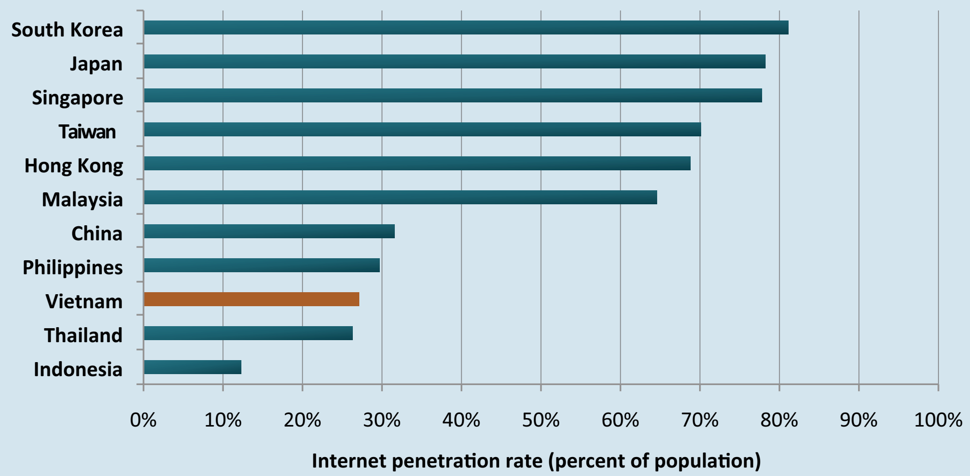
- *Solid and high penetration rates with potential for further growth driven by the young population*

Vietnam came late to the Internet, with service first being offered in 1997. Since then, however, internet use has expanded rapidly. As Figure 3.14 illustrates, the latest data (second quarter of 2009) show an Internet penetration rate of about 25 percent. In 2006, the government announced its plans to increase the internet penetration rate to 35 percent by 2010. Reaching this target would obviously require a huge jump within a single year, which appears unlikely.

Figure 3.14 shows three distinct levels of internet penetration. The top six countries show penetration rates between 65 and 77 percent. Vietnam belongs to the second group with penetration rates between 24 and 27 percent, which also includes China, the Philippines and Thailand. Indonesia lags behind the others with a penetration rate of 12.5 percent.

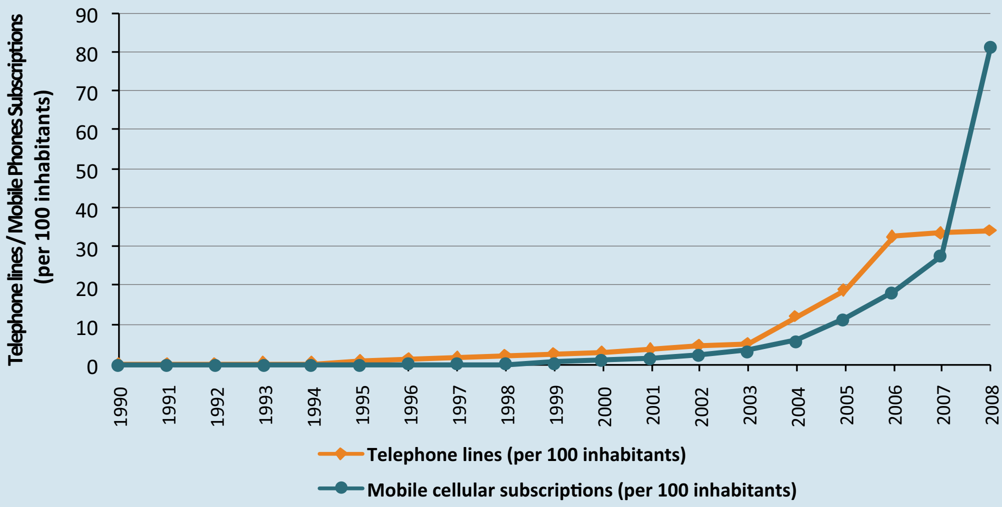
The same historical pattern applies to telecommunications —a slow start, followed by a more aggressive catch-up phase. Vietnam originally fell short of meeting the ambitious goals set by the government for the expansion of the telecommunications sector. In response, the government adopted a new approach introducing greater competition into the market. The mobile telephony market is the most dynamic.

FIGURE 3.14:
INTERNET PENETRATION RATES FOR VIETNAM AND COMPARISON COUNTRIES, QII 2009



Source: Internet World Stats, http://www.internetworldstats.com/stats3.htm

FIGURE 3.15:
VIETNAMESE TELEPHONE SERVICES PENETRATION, 1990-2008



Source: World Development Indicators.

As Figure 3.15 shows, Vietnam had only 100,000 telephone subscribers in 1990, that is, 0.14 fixed lines for every 100 persons, one of the lowest rates in the world. By 2000, it was approaching three million fixed lines; the equivalent of 4 for every 100 persons. By 2008, penetration reached 34.32 per 100 persons for fixed line services and 81.2 per 100 persons for mobile services.

- *The telecommunications market in Vietnam reflects the benefits of liberalization and competition. Prices have fallen and coverage has increased.*[19]

Telecommunications is one of several sectors in Vietnam reserved largely for state ownership on "strategic" and "security" grounds, thus the approach to liberalization has been gradual and cautious. In recognition that telecommunications is a key component of the infrastructure required for national economic development, the government has made substantial investment in the sector, expanding and upgrading capacity and gradually easing control. In 1990 the sector operated under strict state control, with effectively only one state-owned service provider.

Since then, however, foreign companies have been allowed to establish operations to produce telecommunications equipment and material or to assist domestic local operators in the provision of services. Since 1995, new domestic companies have been allowed to provide telecommunication services in competition with the state-owned monopoly and new services have been introduced. Since the late 1990s, service providers have been allowed greater flexibility in setting prices; authorities have sought to make regulations more transparent and streamlined, and a number of state-owned telecommunications companies have sought to increase the role of the private sector in providing capital for further investment in the industry. In areas where there is strong competition, operators are authorized to set tariffs and service charges, while the state-owned provider retains control over tariffs and service charges in monopoly areas.

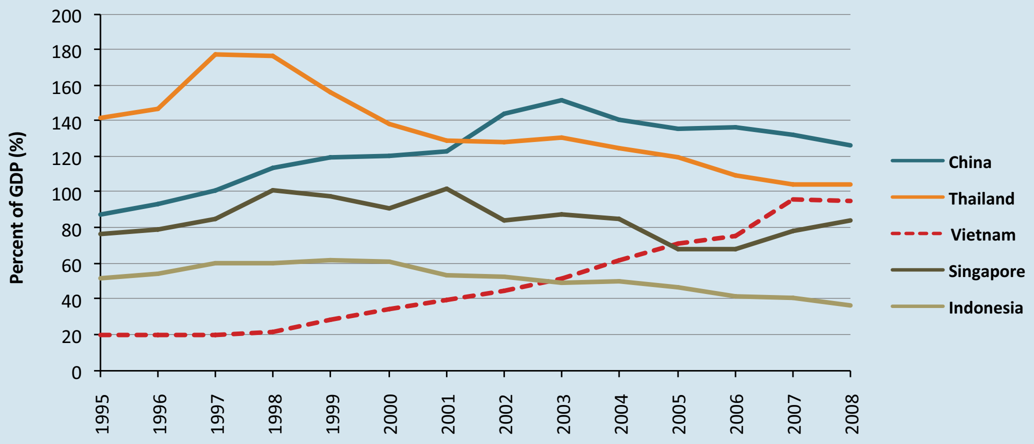
The changes outlined above have brought about rapid growth in fixed lines and mobile phones, as well as a marked widening in the geographical and socioeconomic coverage of the expanding and multiplying networks. The Vietnamese telecommunications sector has been growing at a rate of around 25 percent per year; double the average for the Asian region and triple the world average.

Financial Infrastructure[20]

- *The financial sector has expanded quickly, yet it is still shallow and unsophisticated*

As illustrated in Figure 3.16, domestic credit provided by the banking sector corresponded to about 20 percent of GDP in the mid-1990s, but it has since been roughly at par with the corresponding figures for key comparison countries.

FIGURE 3.16:
DOMESTIC CREDIT OF VIETNAM AND COMPARISON COUNTRIES



Source: Key indicators 2010, Asian Development Bank.

The market has also become more diversified but is still largely bank-based, while equity market capitalization grew rapidly. Bond and insurance markets have been established but they remain relatively small. Despite the prominence of banks in the formal markets, their penetration rate within the Vietnamese population is estimated to be only about 10 percent (Leung 2009, 47), and informal finance still plays a significant role in the economy.

- *Actual access to capital remains limited and the access is inequitable among different segments of the economy; state-owned banks dominate the market*

The rapid growth of Vietnam's financial sector, however, has not equally benefited all segments of the economy. Lending practices of state-owned commercial banks (SOCBs), for example, still tend to favor state-owned enterprises. There has been a downward trend in SOE lending, however, according to some estimates, SOEs accounted for less than 30 percent of the credit growth in recent years. Certain regulations (supposedly for prudential purposes) still imply that SOCBs would continue to discriminate against private sector borrowers and in favor of SOEs; these regulations include the requirement that unsecured lending will be provided only to private enterprises with at least two consecutive years of profits (Leung 2009, 47). SMEs, which generate most employment for the economy, still face the greatest difficulties in obtaining access to credit.

Although the number of non-state commercial banks has increased rapidly since 2005 and there are currently 37 joint-stock commercial banks, state-owned commercial banks still dominate the credit market. As of September 2009, the four large state-owned commercial banks (Agribank, BIDV, Vietcombank and Vietinbank) accounted for 51 percent of total loans and two thirds of all loans in the interest rate subsidy program (Fitch Ratings 2009).

- *Soundness and performance of banks are still an issue; credit is increasingly going to real estate and speculative activities*

For both 2006 and 2007, the average rate of return on assets for three of the four major SOCBs were below the average for Asian banks, and their capital adequacy ratios, although meeting the international requirements of 8 percent, are below the regional averages of 13.1 percent for Asia and the Pacific, and 12.3 percent for East Asia (Leung 2009, 48).

As stipulated in Decree No. 141/2006/ND-CP dated November 22, 2006, a commercial bank is required to have a minimum chartered capital of VND 3 trillion. However, of the 37 commercial banks there are seven whose chartered capital is VND 5 trillion or above; seven are capitalized at VND 3-4 trillion; the remaining 23 have less than VND 3 trillion. The majority of commercial banks have low chartered capital which has limited liquidity, especially in 2008-09 when monetary policy was tightened to fight inflation. Low capital also hindered the competitiveness of these banks. To strengthen the banking system and reduce liquidity risk, banks will have to increase their chartered capital to at least VND 3 trillion by December 21, 2010 according to the roadmap. Conditions for new establishment will also be more rigorous, consistent with WTO commitment on opening financial market.

A further weakness of the banking system is that the bad debt ratio is still high and persistent. It was estimated at 2.52 percent of total outstanding loans by the end of June 2009 (The Motherland 2009). According to SBV, as of September 27, 2010, the total outstanding loans have increased by 19.27 percent over the same period last year (Sai Gon Giai Phong Newspaper 2010). The real estate bubble in 2008 was partly due to excess bank lending, while credit market monitoring was lacking. This situation also means that SMEs have greater difficulty in gaining access to official sources of credit for export and production activities. Thus, the assessment of credit satisfaction for Vietnam in the Country Competitiveness Index may be somewhat overstated and optimistic. Besides, the maturity mismatch has barely changed, posing risks for both banks and businesses. As a consequence, businesses must borrow short-term loans for long-term investment, thus requiring them to pay high cost of borrowing and also making production and business activities more prone to market risks.

TABLE 3.13: SELECTED EDUCATION DEVELOPMENT INDICATORS, VIETNAM AND COMPARISON COUNTRIES

Indicators	Vietnam	Indonesia	Philippines	Malaysia	Thailand	China	India	Year, Source
School enrollment, secondary (%)	76	63	85	76	71	74	56	2005, ADB
School enrollment, tertiary (%)	16	17	28	32	43	20	11	2005, ADB
Internet penetration (per 100 population)	24	8	6	56	24	22	5	2008, WDI
Students studying in the US (per 100,000 population)	15	3	<10	22	13	7	9	2008/2009 a

Note: a Data from Institute of International Education (IIE), available at www.opendoors.iienetwork.org.

- *The regulatory framework is lax and supervision and risk management capacity remain weak*

Lax banking regulations have increased systemic risks of the sector. In 2007, the SBV freely licensed rural credit institutions as urban commercial banks, leading to a leap in credit expansion and fuelling inflation. In 2005, the SBV required banks to complete the set up of credit classification system within three years, but by end-2008, only two out of over eighty commercial banks have completed this process (Leung 2009, 48).

Also, there is a tendency among SOEs to expand into the financial sector by setting up their affiliated joint stock banks (JSBs) or investing in existing JSBs, contributing to the rapid growth of the sector. There have been 15 applications for banking license from large SOEs and three of those have been issued during 2008. This makes it even harder for regulators to supervise the credit channeled among companies within the same economic group and increases systemic risk.

- *High volatility on equity markets is a sign of limited maturity*

The equity market has grown rapidly in recent years from about 5.5 percent in 2005 to the peak of 43 percent during the bubble in 2007 before falling back to 15 percent towards end-2008. The legal framework is in place, but the soundness of market institutions and capacity of regulators remain weak.

Volatility and speculation are common in the Vietnamese equity market. In 2007, the average P/E ratio of the 20 firms with largest market cap was 73, compared with average P/E ratios in other Southeast Asian markets of between 10 and 20 (Leung 2009, 50). Transparency and disclosure of the listed companies is very poor and insider trading is still common. Corporate governance standards and investor protection measures have not been enforced effectively. The market has recently lost over 60 percent of its value compared to the peak in 2007. Speculation has prevented the capital market from becoming an effective channel for raising capital for the economy.

Human Infrastructure

- *Strong performance on secondary and post-secondary education given the country's stage of development*

Vietnam ranks favourably relative to other Asian countries on secondary school enrollment. Vietnamese students have also rapidly embraced education opportunities abroad. For example, Vietnam has become one of the 10 nations with the largest student populations studying in the US.

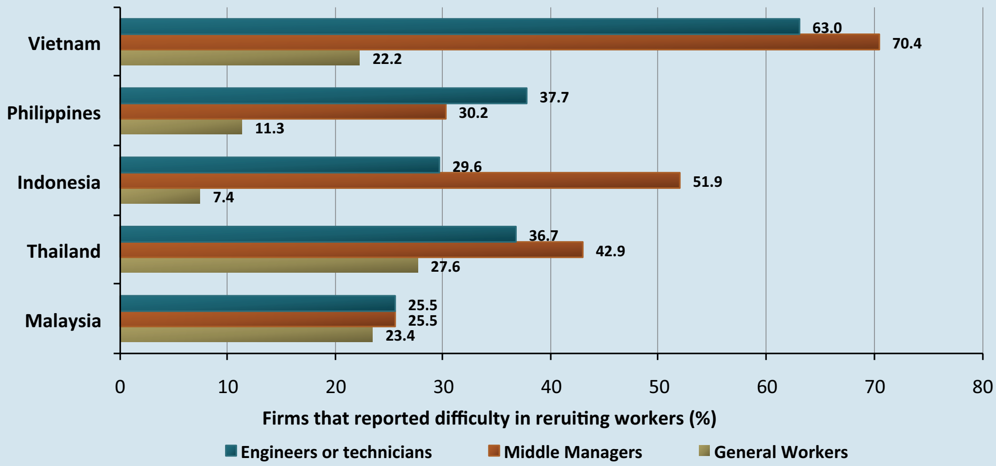
- *New educational capacity has been added recently, but concerns remain about quality and relevance of education*[21]

As of September 2009, the country had 412 colleges and universities, 78 of which were private. There were a total of 1,719,499 college and university students in the academic year 2008-2009, which represents a thirteen-fold increase since 1987. The ratio of students to population has risen from 80 per 10,000 in 1997 to 195 per 10,000 in 2009, and is expected to reach 200 per 10,000 in 2010. From 2005 to 2009, 195 colleges and universities were established and upgraded (139 public schools and 56 private ones). Only four foreign-invested universities/colleges have obtained establishment permits and only one has started operating. While establishing foreign-invested universities/colleges appears to be difficult, establishing domestic schools and/or upgrading colleges/vocational schools to universities can be accomplished quite easily. Since criteria are somewhat lax, many domestic schools, especially private and local ones, provide poor educational quality because of inadequate facilities and incompetent teaching staff.

A number of private schools have been established on a small scale, purely for profit and are only focused on getting more students rather than improving the quality of education. For instance, nearly 20 percent of private schools operate in rented facilities at locations different from their registered location and most of them do not have space or facilities for sports and other extra-curricular activities.

According to the Ministry of Education and Training (MOET), while the total number of students increased by 13 times between 1987 and 2009, the number teachers increased by only three times. The ratio of students to teachers was higher than stipulated (in 2008-2009 the ratio was 28 students per teacher). Many teachers teach up to

FIGURE 3.17: DIFFICULTY IN RECRUITMENT IN SELECTED ASIAN COUNTRIES, 2007



Note: Data drawn from Japanese-Affiliated Manufacturers in Asia, JETRO.

Sources: Junichi Mori , Nguyen Thi Xuan Thuy, and Pham Truong Hoang (2009).

1,000 lessons per year, far more than the eligible maximum number of 260 lessons per year. All schools have to follow MOET's educational framework which was formulated and issued in the early 2000s. A large proportion of this content is now obsolete.

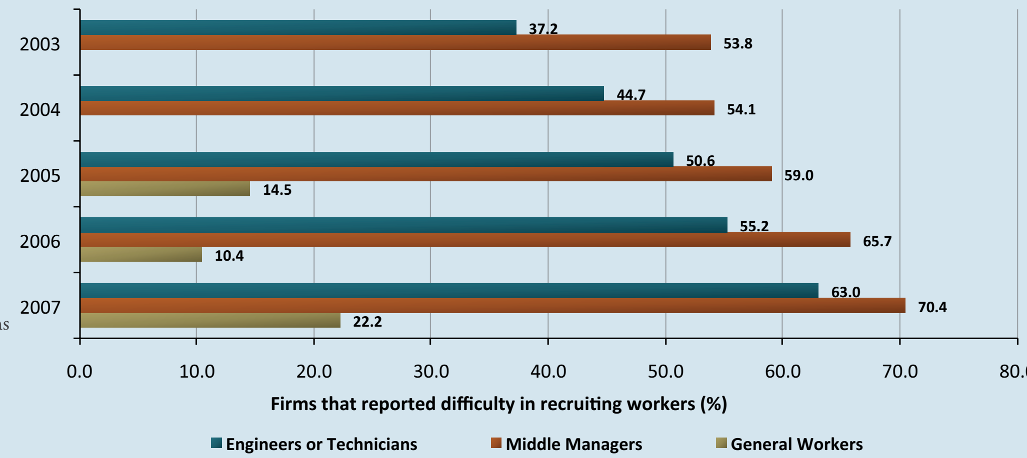
There has not been an effective quality evaluation system for higher education, and quality evaluation activities are more or less just experiments. Higher education quality is currently assessed only through students' examination grades. Although quality evaluation for higher education started in 2006, so far only 169 schools (92 universities and 77 colleges) have submitted their self-assessment. In addition, the National Committee for Evaluation of Education Quality has assessed only 20 universities and the results are yet to be announced (National Assembly's Standing Committee Report 2010).

Government policy towards education is highly centralized and very much control-oriented. The Ministry of Education and Training determines how many students can enroll at a particular university and (in the case of public universities) how much university instructors are paid. Even administrative and operational decisions are controlled by the Ministry, such as the promotion of faculty. This system denies universities and institutes the incentive to compete or innovate. Remuneration is based on seniority and official salaries are so low that university instructors must moonlight to support themselves. International connections are lacking, and the system is very inward looking and does not benchmark itself with international standards (Thomas Vallely and Ben Wilkinson 2009, 3-4).

- *The business community is increasingly concerned about shortages of skilled labor*

Cooperation among educational/training institutions, enterprises and other units employing people is rare. As a result, graduates often lack the skills being demanded in the market. A survey conducted by the Vietnam Student Association (VSA) showed that 50 percent of graduates in Vietnam cannot find jobs in their field and those who have to be retrained account for a significant share. According to AmCham's discussion paper presented at the Vietnam Business Forum in June 2010, about 65 percent of the Vietnamese labor force is unskilled and about 78 percent of the population aged 20-24 is untrained or lacks the necessary skills (AmCham 2010).

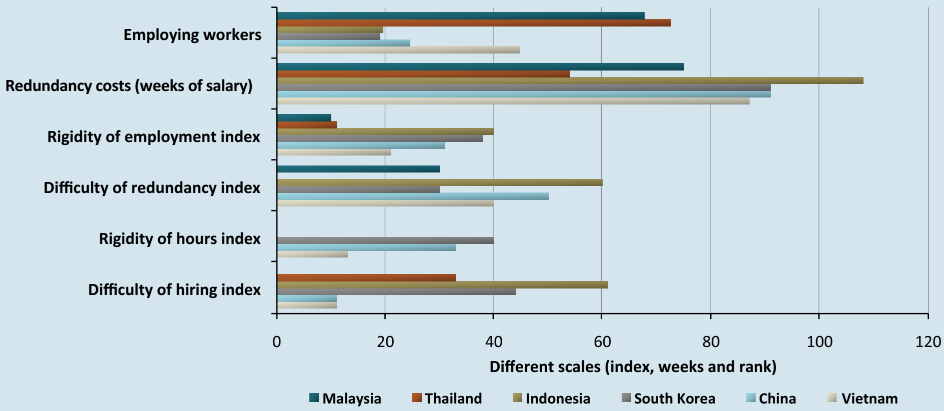
FIGURE 3.18: DIFFICULTY IN RECRUITMENT—VIETNAM, 2003-2007



Note: Data drawn from Japanese-Affiliated Manufacturers in Asia, JETRO. Surveys in 2003-2004 did not include questions about recruitment of general workers.

Sources: Junichi Mori , Nguyen Thi Xuan Thuy, and Pham Truong Hoang (2009).

FIGURE 3.19:
SELECTED DOING BUSINESS INDICATORS ON "EMPLOYING WORKERS" FOR VIETNAM AND COMPARISON COUNTRIES, 2009



Source: World Bank/IFC, Doing Business (2010).

The results of the Japanese JICA surveys of Japanese-affiliated manufacturers in Asia show that the shortage of skilled labor is more severe for Vietnam than for its ASEAN peers (Figure 3.17), and this difficulty has tended to increase over time in Vietnam (Figure 3.18).

Intel's struggle to hire engineers to staff its manufacturing facility in Ho Chi Minh City is illustrative. When the company administered a standardized assessment tests to 2,000 Vietnamese IT students, only 90 candidates passed (5 percent), and of this group, only 40 individuals were sufficiently proficient in English which is a hiring prerequisite. Vietnamese and international investors cite the lack of skilled workers and managers as a major barrier to expansion (Thomas Vallely and Ben Wilkinson 2009, 2).

Apart from the fact that formal education and training do not match market requirements, another reason for the lack of skilled workers is inadequate focus on vocational training. The current vocational training management system is fragmented and scattered across different government bodies, such as MOLISA, MOET, or specialized management agencies. Vocational training facilities and the teaching staff have not received adequate funding; and society still undervalues this type of training and graduates of vocational schools.

- *Rigid and inefficient labor markets*

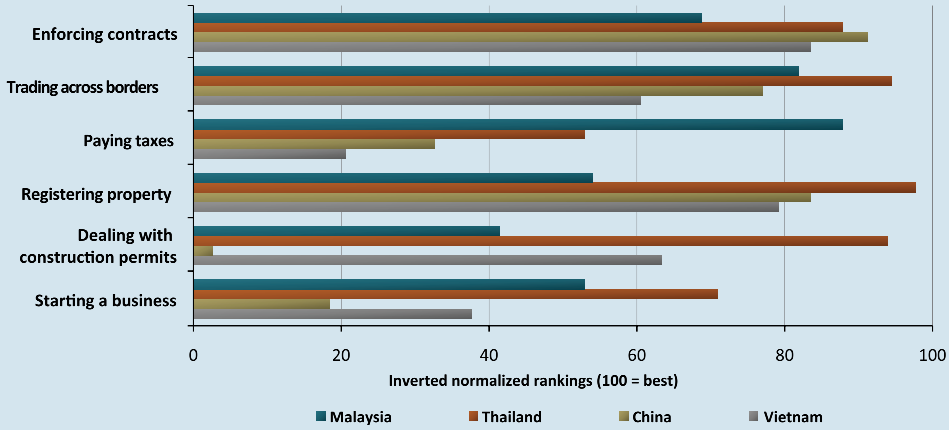
With respect to labor markets, the major issue remains the development of effective solutions to rapidly upgrade the skills of the workforce. Figure 3.19 shows some of the regulatory constraints on labor markets as defined by the Doing Business approach ("Employing workers").

Vietnam scores higher than China, South Korea and Indonesia on this indicator, but lags behind Malaysia and Thailand. The construction of the "Employing workers" indicator depends largely on the cost of laying off workers ("redundancy costs") and any restrictions on hiring and firing expressed in the "rigidity of employment" sub-indicator: a higher score means worse performance.

There are several reasons for the low flexibility in the Vietnamese labor market. First, the imbalance between labor supply and labor demand still persists. In reality, unemployment in urban areas and job shortages in rural ones are likely to be higher than reported because of a large informal sector, the seasonality of jobs and attempts by firms to minimize non-wage labor costs such as social, health or unemployment insurance. Second, supply of skilled workers is low while demand has been increasing over time in almost all firms, activities, economic regions, urban areas as well as rural ones. The problem of skilled labor shortage has grown in both scope and scale, which is likely to increase competition for skilled workers and push up labor costs—a disadvantage from competitiveness viewpoint. Third, labor costs themselves tend to increase, driven in part by the upward adjustment of the minimum wage by the Government, making it harder for labor supply and demand to meet.

The Navigos Vietnam's salary survey report in 2008 based on data for 64,905 employees of 206 companies shows that the average salary increased by 19.5 within a year, the highest annual rate of increase in the past five years. Salary increases at that level may lead to the gradual loss of competitiveness of labor-intensive industries, unless they are able to increase productivity.

FIGURE 3.20:
SELECTED DOING BUSINESS INDICATORS FOR VIETNAM AND COMPARISON COUNTRIES, 2009



Source: World Bank/IFC, Doing Business (2010).

Administrative Infrastructure

- *Modest performance on overall administrative environment*

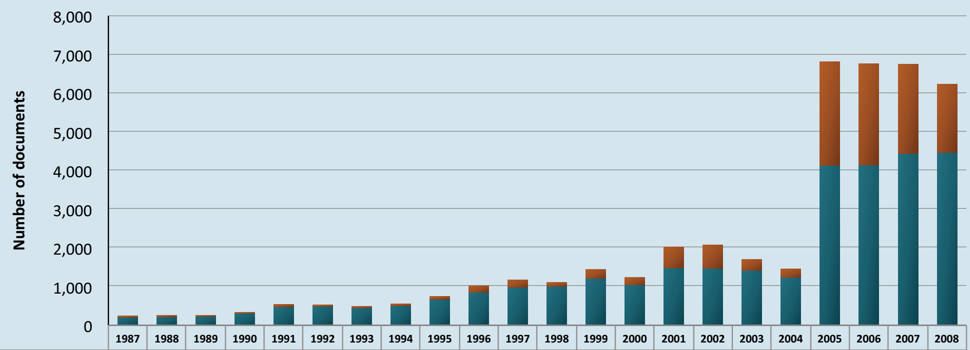
The Doing Business rankings provide one perspective on the performance of a country's administrative infrastructure. Of the ten indicators, arguably six refer to administrative efficiency, including the enforcement of contracts. Figure 3.20 presents a comparison of Vietnam's performance to that of three comparison countries. Overall, China is doing worse, especially on construction permits, while Vietnam lags behind Malaysia and especially Thailand.

- *The administrative burden is imposing costs on business and citizens*

On average, a company has to spend 1,050 hours per year to deal with administrative procedures for paying taxes, while the figure in Singapore is only 84 hours. Closing a business takes 5 years in Vietnam as compared to one year in Hong Kong (Doing Business). The Government estimates that if 30 percent of the current administrative burden is cut down (as per commitments of the Project 30), a significant amount of VND 6,000 billion (USD 300 million) could be saved in the economy.

The total number of regulations in Vietnam that affect businesses has increased dramatically since 2005. Over the period 2005-2008, Vietnam issued more legal normative documents (LNDs) that affected businesses (17,164 LNDs) than the previous 18 years put together (1987-2004). In addition, during 2005–2008, the number of official letters containing legal norms has more than tripled compared to the previous 18 years (Quang and Bentley 2009). (Figure 3.21)

FIGURE 3.21:
NUMBER OF LEGAL DOCUMENTS[22] ISSUED BY CENTRAL REGULATORY AUTHORITIES



	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Official Letters	2	6	8	26	63	38	41	47	72	168	189	97	242	196	551	606	283	217	2683	2621	2310	1767
Legal Normative Documents	236	249	253	311	479	484	447	506	670	853	982	1008	1207	1043	1478	1476	1423	1241	4130	4137	4434	4463

Source: www.luatvietnam.vn

This large unknown number of regulations is problematic in many ways. The uncertainty of the existing stock of regulations (in terms of legal consistency, applicability or even necessity) is likely to entail unnecessary costs for citizens and businesses when trying to find the right regulation to comply with. It also creates an opportunity for rent seeking by corrupt officials. Such an uncertain environment is friendly to neither businesses nor citizens.

- *Several substantial regulatory and administrative reform efforts are underway*

(i) Prime Minister's Master Plan to Simplify Administration Procedures in State Management – Project 30

Project 30 entails a comprehensive approach with a target of simplifying at least 30 percent of all Administration Procedures in 2010. Over 5,700 Administrative Procedures at all four levels of government across all 63 Provinces have been collected in an electronic database. They will be reviewed and then either abolished, simplified or remain. The review process is using the principles of regulatory impact analysis (RIA) to assess the legality, necessity and business friendliness of administrative procedures. Project 30 has been conducted by the Special Task Force in the Office of Government (OOG) with involvement of the international agencies (mainly USAID) and private sector through the Advisory Council for Administrative Procedures Reform (ACAPR). A new agency called the Administrative Procedures Control Agency in OOG has been set up to continue the role of Project 30 on an ongoing basis and also to manage the flow of new administrative procedures.

(ii) 2008 Law on the Promulgation of Legal Normative Documents – Law on Laws)

The process for drafting new legal normative documents has been enhanced through the requirements for public comment and impact analysis of the proposed LND during the drafting process. These requirements support greater transparency and introduce evidence-based policy making for better regulatory decisions. However the requirements are clearly stipulated for Laws, Ordinances and Decrees, while lower level LNDs and non-normative instruments are not subject to these same formal requirements.[23]

The success of programs such as Project 30 is critical for Vietnam to improve its administrative and legal environment rapidly and gain competitiveness.

Innovation Infrastructure

- *Innovative and technological capacity remains weak*

On the key indices that seek to measure the innovative capacity and activity of countries, Vietnam's position is uncompetitive:

- World Economic Forum—National Innovative Capacity Index: based on the institutional and policy environment for innovation. In 2009, Vietnam was ranked 73rd, behind most of its regional peers – China (42nd), Thailand (49th), Malaysia (29th) and India (33rd);
- World Bank—Knowledge Economy Index: a highly flexible index based on several components. Vietnam is ranked 100th out of 146 countries; and
- INSEAD – Global Innovation Index: evaluates the aspects of the environment required to stimulate innovation within an economy and measures the results of innovation within the economy. Vietnam was ranked 71st out of 132 countries in the 2009 – 2010 index.

One of the main concerns for Vietnam given its high degree of openness is the insignificant spill-over effects from the FDI sector into the domestic economy. A recent study by Tue Anh (2009), for example, suggests that the expected knowledge spillovers from foreign direct investments can be modest, calling for a proactive policy of promoting such spillovers in the context of a national system of technological learning.

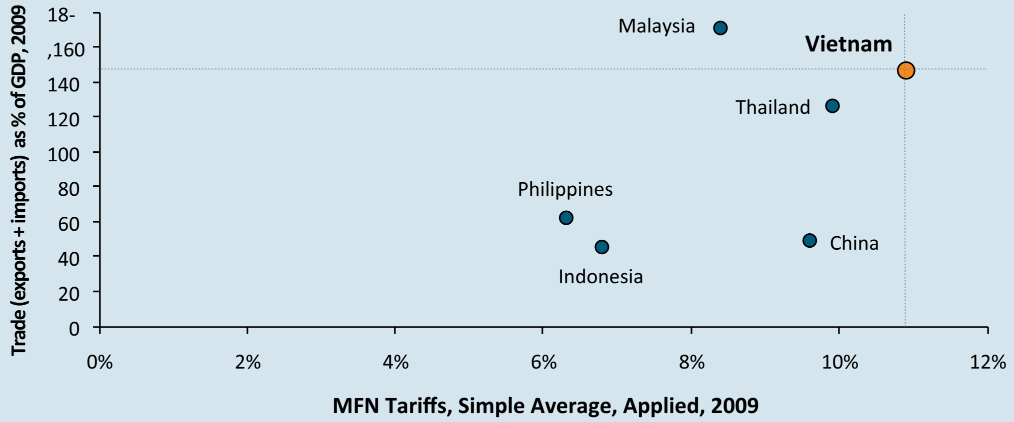
Based on qualitative evidence, Vietnam appears to lack a coherent structure for active technological learning and innovation. A key institution in that process is the National Institute for Science and Technology Policy and Strategy Studies (NISTPASS) in the Ministry of Science and Technology. NISTPASS has the appropriate mandate, but it is unclear whether it actually has the resources and influence to lead the way from a "passive FDI-dependent" structure to the next level, and ultimately to an autonomous innovation system.

Infrastructure for innovation and creativity has not seen much improvement in recent years. In early 2007, Vietnam had 1,200 science and technology organizations (institutions, research centers, and universities), which is 2.5 times higher than the 1995 figure (Theo, http://www.most.gov.vn); 60 percent of these organizations are state-owned. Although the number of science and technology organizations increased, their quality remains low. Annual investment on science and technology activities accounts for only 2 percent of total state budget spending, and there were only few practical research results.

The number of employees in professional, scientific and technological activities only accounts for 1.3 percent of total employees in all establishments; and only 65.5 percent of total employees used PCs in 2007. Of all professional, scientific and technological establishments, only 28.5 percent are connected to the Internet, and only 0.2 percent had e-commercial transactions. The lack of adequate domestic training institutions, sufficient research activities in training institutions and effective university-research institution-enterprise cooperation undermines innovative capacity, limiting the country's competitiveness.

- *Inadequate IPR legislation may fail to create incentives for innovation-based competition*

FIGURE 3.22:
TRADE OPENNESS–VIETNAM AND COMPARISON COUNTRIES, 2009



Source: EIU (for the export share); WTO (for the tariff).

There are diminished incentives for knowledge search by Vietnamese entrepreneurs. Adopting existing technology represents "inside-the-frontier innovation" which ultimately is readily available but lacking adequate intellectual property protection. Thus, the pioneering firm is likely to see its successful application of some innovation replicated by other firms. The implied risk provides little incentive for innovation.

There have been many cases in which IPR violations are either inadequately sanctioned or even not sanctioned at all. This has discouraged enterprises from renovating their technology. According to the National Intellectual Property Office, in 2008, there were 2,766 cases of intellectual property infringement, up by 300 cases in comparison with 2007. However this is only the tip of the iceberg as many cases are not discovered or reported by the regulator. In the European Commission's IPR Enforcement Report 2009, Vietnam was classified as one of the priority countries in which IPR protection and enforcement are seriously worrisome. The report cited several reasons for the serious IPR violation in Vietnam, including deficient enforcement of the domestic IPR regulations, lack of trained IPR officials and lengthy and burdensome proceedings, civil and criminal procedures, provisional measures, and particularly customs procedures as being deficient or not implemented.

- *Investment in R&D and innovation remains limited*

Empirical analysis of the 2008 Enterprise Survey shows that among the 205,529 surveyed enterprises there are 1,340 in the field of science and technology (or 0.65 percent). 26.3 percent of which are in the state sector; 63.3 percent in the private sector; and the remaining 10.4 percent in the foreign-invested sector (FIS). Average technological and scientific R&D investment among these enterprises is equivalent to 1.15 percent of their pre-tax profit; 0.4 percent for R&D activities and 0.69 percent for technology adaptation. The figure for all surveyed enterprises was much lower, equivalent to 0.27 percent of pre-tax profit, of which 0.1 percent for R&D activities and 0.16 percent for technology renovation.

Context for Strategy and Rivalry

Openness

- *High level of economic openness*

The economic reforms ushered in by the doi moi initiative in the late 1980s opened the economy to privately-owned firms. Subsequent policy developments went further to encourage private enterprise, and to reduce the role of state-owned enterprises (SOEs). Vietnam began to integrate substantively into the regional and international trade and economic system by becoming a member of the ASEAN Free Trade Area (AFTA) in 1996. However, the breakthrough lever in its integration process was actually the signing of the Bilateral Trade Agreement with the U.S. (US BTA). Vietnam has fully participated in the global economy and trade since its accession into the World Trade Organization (WTO) in 2007.

As discussed in chapter 2 Vietnam is one of the most open economies in the ASEAN region both in terms of trade and foreign direct investment. Vietnam has removed most of its trade and investment barriers in compliance with its integration commitments. For example, the amended Enterprise Law (2005) has superseded previous laws and put all enterprises of different segments (FDI, SMEs and SOEs) under a common legal framework. In some cases, especially at the provincial level, FDI firms receive even more privileges and special treatments than local private firms, such as lower tax rates or access to land.

Vietnam's openness to both trade and investment is expected to increase further in the future since its current average applied MFN tariffs are still high relative to its Asian peers and will decline in accordance with Vietnam's multilateral and bilateral trade commitments. Vietnam's robust integration into the world economy has enabled the country to benefit from the globalization process, yet this poses challenges for regulating a more complex and exposed economy.

Level of Rivalry

- *Weak competition policy and enforcement*

Vigorous domestic competition is essential for promoting innovation. As part of Vietnam's transition to an efficient market economy, the National Assembly adopted the country's Competition Law in December 2004; it entered into force in July 2005. The Law applies to all enterprises: domestic private, SOEs and foreign invested enterprises (FIEs).

The Law created the Competition Administration Department (VCAD) with a broad scope of responsibilities—restraint of competition, unfair competition, management of competition, anti-dumping, consumer protection and international cooperation. The combination of protecting domestic competition and taking on an important role in international trade relations is somewhat unusual, and may pose particular challenges to the new institution.

Exemptions are possible for instances where agreements among enterprises may enhance efficiency or set standards that may enhance competition. However, exemptions may also be possible for the protection of SMEs, or for the formation of export cartels. The Law also allows for state monopolies, authorizing VCAD to take action only if the state monopoly is acting outside its monopoly grant. Competition policy relies heavily on market shares as one of the principal indicators of dominant position. Thus, agreements in restraint of competition are prohibited only where the participating parties' have a combined market share of 30 percent or more of the relevant market. Below the 30-percent threshold agreements among firms are not prohibited, even if they do end up restraining competition. Even once anti-competitive behaviors have been identified and confirmed by the VCAD, penalties and enforcement measures do not appear strong enough to effectively stop the violation.

Vietnam's experience with the full application of the Competition Law is limited. Initially, few businesses were aware of any potential violations, either by themselves of by others affecting them. For the domestic private sector, outreach and education therefore are key priorities.

Another issue concerns the cooperation between the new competition agencies and the sectoral regulators. There is an overlap of responsibilities as VCAD has assumed jurisdiction concerning competition-related complaints. The agency has reached an understanding with some sectoral regulators, such as for telecommunications, electricity and banking. Even so, there is a continuing challenge to educate the sectoral regulators regarding the competition impacts of their decisions, and the respective roles of the competition agencies with an economy-wide mandate vis-à-vis the more limited sectoral optic. Moreover, the fact that VCAD operates under the jurisdiction of the Ministry of Industry and Trade, which is in turn the regulator of key industrial sectors, affects the independence and objectivity of its operation.

More needs to be done to ensure clarity in the roles and responsibilities of the competition agencies and sectoral regulators, and to tackle situations where different standards are applied by different agencies. More broadly, all government agencies need to embrace the likely impact of policies and activities on competition.

- *Unequal treatment of companies, with SOEs receiving special treatment and privileges*

As in other instances, the formal legal framework has been established, but effective application lags behind. State monopolies and special arrangements for SOEs continue to distort the playing field. While equitization of local SOEs appears to have removed much of the SOE bias at the provincial level, central authorities still treat SOEs as special concerns. That special role may also undermine competitiveness more broadly, since SOE performance is critical for a range of supporting industry functions.

At the same time, FIEs as a rule have relatively few complaints about uneven treatment, although cases of course do occur. One issue is the relative isolation of FIEs from the rest of the economy—they are primarily part of global value chains with relatively shallow roots in the Vietnamese economy. Foreign investors, however, often lead the charge with respect to deficiencies in terms of administrative environment, supporting industries, in particular infrastructure and logistics services.

SOEs are receiving special treatments from the government in many different forms, both explicitly and implicitly. They are sheltered from competition and market discipline which other economic segments are obliged to comply with. Examples of special, anti-competitive treatments that the state-owned sector is enjoying include:

- Access to subsidized credit, either directly through financing from government's budget or government's guarantee or indirectly through state-owned commercial banks with whom they have traditionally strong ties.[24] Government's guarantees for corporate borrowings have been used more widely recently and are increasing rapidly to the equivalence to 7 percent of GDP, of which 90 percent is for SOEs (State Bank of Vietnam's estimates).
- Access to land: SOEs usually possess property of high commercial value in lucrative locations, but pay land rental fees much lower than the market rates.

Undervaluation of property and other state assets is quite common, especially when SOEs go equitized (see examples in Box 3.3 below);

- Exclusively obtaining government contracts through non-competitive bidding or access to insider information through connection, especially in public invested projects; and
- Exemption from prudential governance and financial management regulations which are currently applied to all public companies such as information disclosure, independent audit, etc.

SOEs are holding monopoly or dominant positions in almost all key major economic sectors and they are possessing huge assets as compared to other segments in the economy. However, their performance is disappointing on many fronts.[25] The debt of 70 conglomerates and general corporations had built up to an astonishing USD 28 billion (40 percent of GDP) by the end of 2007. In addition, SOEs' investment increased abruptly by nearly 60 percent, resulting in a surge in fiscal deficit in 2007. According to a report of the Ministry of Finance, the debt-to-equity ratios of conglomerates are very high: 42 times in the case of Cienco 5, 22.5 times for Cienco 1, 22 times for Vinashin, and 21.5 times in the case of Lilama (Harvard's Fulbright Economics Teaching Program 2008, 8).

Anti-competitive practices undermine the efficiency of SOEs' in the long run as they are not motivated to strive for better performance. SOEs believe that they are "too big to fail" entities and are therefore willing to take extra risks and enter into highly speculative areas in a quest for short-term profitability. This anti-market treatment imposes great costs on other more efficient segments of the economy by having them compete for much scarcer resources. These conditions therefore limit the capacity of other business entities from pursuing productive opportunities within the domestic economy.

- *Equitization (privatization) efforts have targeted only smaller SOEs and have focused on diffusing state ownership rather than improving efficiency and governance of enterprises*

The equitization process has been implemented since 1992 and it has been well emphasized in the government's policy statements. However, the progress of the equitization process in Vietnam has not been very promising. In 2009, the number of equitized enterprises (105) is only equivalent to 8.4 percent of the plan for 2009 – 2010 (Ministry of Finance 2010). Only smaller SOEs that once reported to provincial governments and line ministries are equitized, while bigger and more important SOEs have been consolidated into state conglomerates and put under the direct oversight of the central government. In most cases, SOEs are only partially equitized while the state still retains a controlling share of the enterprises. The current approach to equitization focuses on selling state shares to outside investors rather than on improving governance and efficiency of the enterprises. The state's intention in retaining control of the equitized SOEs fails to create institutional mechanisms necessary to drive performance improvement, which makes equitization less attractive to strategic investors. Lack of transparency and standards in valuation of the equitized assets such as land, real estate and machinery further provides avenues that can lead to misallocations of state assets.

- *Competition focuses on price, not on features and quality*

The garment industry is a clear example of competition based on low cost. It has grown almost 30 percent per year over the last few years, and the country has now become one of the world's ten biggest garment exporters. However, the industry's average profitability rate is only 5 – 8 percent.[26] The industry has to import up to 90 percent of cotton and 70 percent of accessories from abroad and generate only marginal profits from simple CMT (cut, make, trim) process. Competition on design, branding and product differentiation is also very limited within the industry.

BOX 3.3:
THE STATE SECTOR MAINTAINS INEFFECTIVE PERFORMANCE DESPITE HAVING LAND INCENTIVES

The Hanoi Department of Natural Resources and Environment has just released a report after the inspection by the municipal People's Committee of the 420 projects which had been allocated land or eligible for land rent from January 1st 2003 to December 31st 2008.The inspection team has discovered 20 projects (taking up a total area of about 365,000 m2) with serious violations which need to be withdrawn. In particular, the Hanoi production services import-export company (Haprosimex) is being suspected for improper use of a "beautiful" area located at the centre of Hanoi.

As decided by the Hanoi People's Committee on February 18th 2009, Haprosimex was allowed to rent the area of 353.4 m2 at 22 Hang Luoc (Hoan Kiem, Hanoi) to locate their head office for 50 years. Annual land rental fee was VND 339,300 per m2, which would remain stable for five years. The land lease contract between the Committee and Haprosimex again stated that this land is to be used for location of the head office by the city's decision. However, on July 15th 2009, Haprosimex subleased this land to the Fashion Joint-stock Company NEM for a period of 34 years with total rental fee of VND 24 billions. At the cost of VND 339,300 per m2, in 50 years Haprosimex only pays for the Committee around VND 6 billion.

Source: CIEM

- *Unclear definition of government's roles in a market economy*

Since the mid-1980s, the Government of Vietnam has experienced a significant transformation in its role in the economy. While the Government remains an important factor in most spheres of the economy, a new role needs to evolve to keep pace with a more complex and rapidly changing economic environment.

First, the government's role as an owner should be sufficiently separated from its regulatory functions. This is not particularly notable in the area of SOE management. The biggest conglomerates are reporting directly to the Prime Minister, while smaller SOEs are reporting to line Ministries, and more recently SCIC. Their major investment and business decisions are made or approved by those owners who, at the same time also, are the regulators of the economy or specific economic sectors. This creates serious conflicts of interest as SOEs have special ties and connections with the regulators which provides significant advantages for them vis-à-vis their rivals from other economic segments. Moreover, as the state conglomerates expand, the Government will not have sufficient staffing and other resources to control closely their operations, leading to loopholes in governance and management of the SOEs.

The Government has taken the first step in establishing an investment management arm, the State Capital Investment Corporation (SCIC), to represent the government's ownership in SOEs. However, the SCIC to date has received transfers of only smaller, less important or loss-making enterprises from the government, ministries and provinces, while the most powerful and lucrative ones are still under the direct management of the government. Also, SCIC management team is all drawn from the government (notably Ministry of Finance) and its operation is still heavily influenced by the government which prevents it from separating commercial business from political agenda.

In addition, the government's traditional approach to regulating the economy is through imposing control and administrative measures which in many cases are either ineffective or not compliant with market principles. Examples of such anti-market intervention include mandatory requirements for financial institutions to buy treasury bills or imposing price controls for taming inflation. The current approach in government intervention fails to create a level and competitive environment for all enterprises to compete for excellence and quality.

Demand Conditions

- *A sizeable and growing market*

Domestic demand patterns reflect both growing per capita incomes and growing sophistication among domestic consumers. The discussion of rising per capita incomes in Section 2.1 suggests a growing middle class while market size in terms of effective domestic demand is also expanding. The A.T.Kearney Global Retail Development Index (GRDI) ranks Vietnam as the 14th most attractive markets for retail expansion in 2010.

BOX 3.4:
PRICE WAR AMONG TELECOMMUNICATION CARRIERS

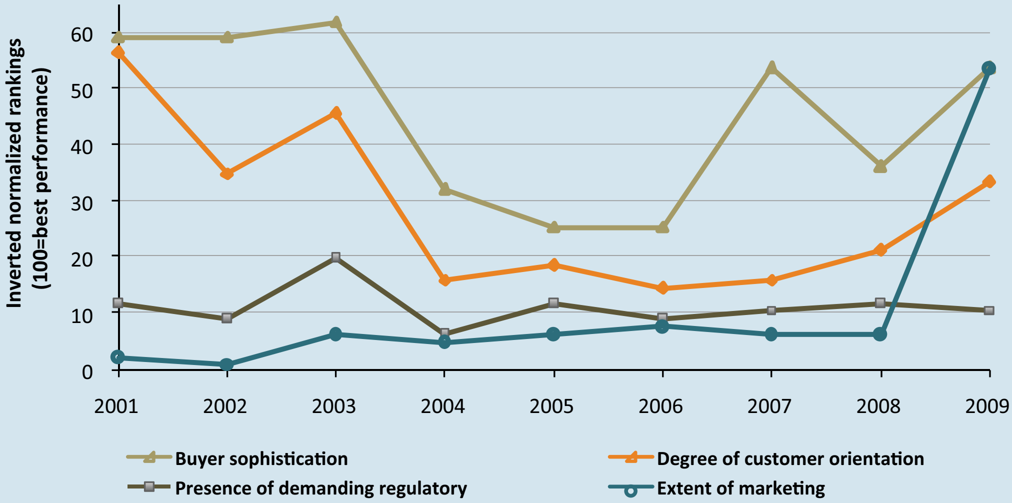
The Head of the Telecoms Department, Ministry of Information and Communication (MOIC), said that the Ministry will require Vietnam Post and Telecommunications Group (VNPT) to abandon its plan to reduce mobile phone tariff by 20.29 percent for two tariff schemes as this violates the Ministry's regulations on the band of tariff reduction no more than 15 percent.

Accordingly, VNPT will have to adjust its tariff reduction plan and submit it to the Ministry to ensure that the plan is in line with the government's regulations on the 15 percent cap. Previously, Vinaphone and MobiFone announced to cut down mobile phone tariff for their 60 million customers as of August 10, 2010. All tariff schemes will be reduced by 10-15 percent, except for the Vinaphone's TalkEZ-Teen and MobiFone's Q-Teen schemes which enjoy up to 20.29 per-cent tariff reduction. Meanwhile, another telecom carrier, EVN Telecom, said that they don't have any plans to reduce the tariff further, but instead will focus on improving the service quality and improving customer services.

According to the representative of the MOIC, more competition will benefit customers and en-courage companies to improve. However, competition merely based on price or dumping is un-healthy and unfair. Such unhealthy competition behaviors aim to establish a monopoly or domi-nating position for the companies and deteriorate the competitive environment of the market. MOIC encourages, supports and urges companies to improve productivity, reduce costs to be-come more competitive, but does not support those companies who aim to dominate the market by dumping the price or establishing monopoly positions. Such types of competition behaviors are not in line with international practices and regulations on market competition.

Source: VietnamNet

FIGURE 3.23: PATTERNS OF MARKET DEVELOPMENT FOR VIETNAM, CCI 2001-2009



Source: WEF Global Executive Opinion Survey, Institute for Strategy and Competitiveness, Harvard Business School.

- *Sophistication among domestic consumers is improving, yet still low*

Figure 3.23 suggests that domestic consumers are in fact becoming more sophisticated. There has been no change with respect to "demanding regulatory standards." The same observation would apply to the "extent of marketing," with the exception of the major leap between 2008 and 2009. It is difficult to find a reason for that jump. The other two categories, "degree of customer orientation" and "buyer sophistication" follow a similar U-shaped trend. Vietnam scored high on that measure in the early 2000s, followed by a decline until about 2006. The country's relative performance since then has improved on both of these measures.

These patterns suggest that Vietnam, as seen by survey respondents, is making progress in terms of goods and product markets given its changing demand conditions and improved customer orientation. The upshot of these trends is that competition for local markets is likely to become more challenging, as Vietnamese producers are facing foreign firms in an increasingly open market. Meeting that challenge therefore calls for constant innovation to maintain or gain market share.

State of Cluster Development

Presence and Dynamism of Clusters

- *Natural process of specialization and geographic co-location of similar activities have occurred*

A cluster is a geographically proximate group of interconnected companies and associated institutions in a particular field, linked by commonalities and complementarities. In reality, individual firms often face sector-level constraints that they cannot address alone, and cluster approach will help increase broad-based competitiveness which is hardly achieved through supporting individual firms.

In Vietnam, the traditional type of village-based industrial clusters has grown historically and they tend to specialize in crafts and other traditional products. An example of this is Hanoi's guild streets. The more modern types of clusters of supporting enterprises which build around anchor firms (industrial castle town) or clusters in large cities where lots of basic production processes are treated (urban processing clusters) have emerged recently in Vietnam (IDE JETRO 2005)

Tourism clusters are currently located in the Central coast while the oil and gas cluster is concentrated in the Southeast coastal region where there is abundance of these resources. The agricultural cluster is found in the Mekong Delta. Light industrial and export-oriented clusters tend to concentrate in the Southern region, especially in Ho Chi Minh City and surrounding provinces (garment, footwear, food processing, electronics etc.). On the other hand, heavy and more capital-intensive clusters tend to concentrate in the Northern region, especially in Hanoi and surrounding provinces (mechanical and engineering, electronics, ship building, etc.). One of the reasons for this distribution is explained by the fact that import-substituting heavy industries and SOEs were once concentrated in the Northern region, while the Southern region has emerged as the centre for export-oriented industries after the economic reform and market opening that started in 1986. As a result, the Southern region is also the centre of export-supporting services such as port and logistics. In summary, co-location and clustering of firms is evident in Vietnam, but the formation process has occurred naturally rather than being driven by effective cluster policies.

- *Sophistication and dynamism of clusters are low, with shallow linkages among cluster participants; mostly all doing the same activities*

The 2005's IDE-JETRO study found out that access to land and infrastructure (connectivity with markets and ports) have been the key factors driving the distribution of clusters rather than labor and business linkages.

A study carried out by students of the microeconomics of competitiveness class at the Harvard Business School (Dost et al., 2008) found that the success of Vietnam's electronics and footwear clusters rested on some weak foundations that threatened long-term sustainability. One of the factors is the fleeting nature of competitive advantage based on low-cost productive labor. Similar situations apply to other product categories where Vietnam's exports have been growing.

Leveraging on FDI anchor firms to develop and facilitate formation of clusters seems to be unsuccessful so far. The two reasons behind this are that FDI firms operate as part of their own global value chains and have very shallow roots in the local economy, and that supporting and related industries are almost non-existent. Despite impressive growth and export records, local value-added remains modest. It is estimated that the local content of automobiles or motorcycles produced in Vietnam is only at 5 – 10 percent. This is also evident in other industries of the economy. For instance, the garment industry has low value-added because firms have to import up to 80 – 90 percent of materials and accessories. Similarly, Intel buys less than 10 percent of its input from the local market. While Canon is often cited as a success story for developing a local supply chain, 90 percent of their suppliers are actually FDI firms operating in Vietnam.

The lack of local suppliers have limited forward and backward linkages within clusters and prevented local firms from participating deeper in global value chains.

- *Inconsistent understanding of the cluster concept, leading to a lack of systematic cluster policy*

The "cluster" concept is new to Vietnam, and so it is sometimes misunderstood and misconstrued with industrial parks which merely define the co-location of firms in a common industrial estate without significant linkages and interaction among them.

There has not been any formal discussion on cluster policy among policy makers in Vietnam. Despite some on-going individual discussion and efforts touching on certain aspects of clusters, such as industrial park development, supporting industries, business–research collaboration, etc, a holistic view and policy approach towards clusters is still absent.

The CCI's ranks Vietnam relatively positive on cluster development probably as a result of the different perceptions of the "cluster" concept among respondents of the WEF Global Executive Opinion Survey in Vietnam. These misconceptions have likely contributed to an over-optimistic assessment of cluster development in Vietnam.

- *Interventionist approach towards industrial policies*

Vietnam is taking an ambitious approach towards industrial policies, yet without clear targets and priorities. About 74 strategies and master plans for sectoral development have been developed and issued for the period until 2020 and beyond. All of these plans appear to focus on developing their respective sectors to become the leading industry in the economy.

Policy measures proposed or adopted usually focus on providing intervention, protection and subsidies with an aim to shelter industries from competition or create economies of scale. The automotive industry is just one example of such protection and intervention. Local content requirements were promulgated and generous financial incentives have been provided to encourage local outsourcing. However, these passive and direct interventions and subsidies have created opportunities for fraudulent activities (with regards to Certificate of Origin) or the wholesale import of components and parts and doing only simple assembly work in Vietnam in order to benefit from the incentives. The shipbuilding industry is another example where subsidies and protection have been provided to build a national champion, but ultimately these resources and support were misused and abused

Cluster policy needs to be integrated closely in regional policies, but in reality regional strategies are either developed in isolation or copied from each other without thinking about how to create linkages and synergy among regions through cluster formation.

- *Industrial parks are not oriented towards clusters*

Industrial parks are widely used by provincial governments as a tool to offer ready-made infrastructure and simplified administrative procedures to investors. By 2007, there are 550 industrial parks or economic zones established in Vietnam (see Table 3.14). However, there have been few efforts to encourage the development of supporting and related industries and services which help form cluster linkages. Recently, there is evidence about success in building up supporting industries in Que Vo industrial park to support the anchor firms, i.e. Canon and Foxconn. However, most of the suppliers of supporting parts/components were brought in by the FDI anchor firm from their home country or China. Linkages are also rarely established beyond the industrial parks' boundaries. To date, industrial parks just play the role of an industrial estate solution rather than a platform for forming clusters.

TABLE 3.14: NUMBER AND STRUCTURE OF ECONOMIC ZONES AND PARKS BY TYPE AND BY REGION

	Structure (%)					
	Number	Industrial Zone	Export Processing Zone	High-tech	Economic Zone	Park (or so-called cluster)
Operation status	550	36.7	1.1	0.4	1.3	60.55
In operation	332	44	1.8	0.3	2.1	51.81
In process of construction	112	33	-	0.9	-	66.07
In warm up phase	105	17.1	-	-	-	82.86
By region						
Red River delta	165	27.3	1.2	-	0.6	70.91
North east	31	32.3	-	-	-	67.74
North west	-	-	-	-	-	-
North central coast	55	38.2	-	1.8	5.5	54.55
South Central Coast	119	20.2	-	-	2.5	77.31
Central Highlands	16	40.8	-	-	6.3	50
South East	103	65.1	3.9	-	-	31.07
Mekong river delta	61	45.9	-	-	-	54.1

Source: General Statistics Office of Vietnam.

Company Sophistication

Economic Composition by Type of Company

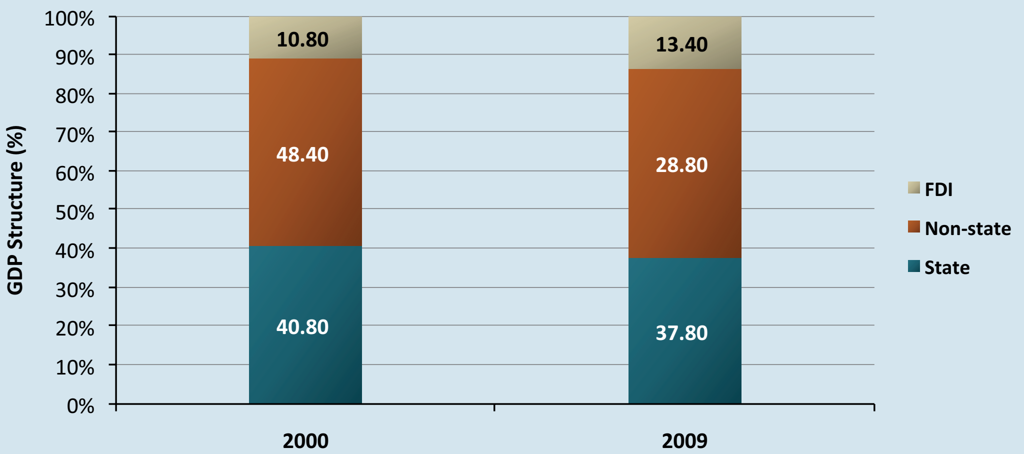
- *Slight changes in GDP structure by ownership over the last decade, with the slight decline in state sector's share taken up by the foreign invested sector*

The GDP structure by ownership is quite stable, with the state sector's share decreasing slightly from 40.8 percent in 2000 down to 37.8 percent in 2009. The non-state sector's share stood at 48–49 percent over the same period and the foreign invested sector gained grounds from 10.8 percent to 13.4 percent between 2000 and 2009. Although SOEs has declined as a result of the equitization process, the state sector has not been shrinking in terms of scale because it has been reconsolidated into conglomerates and refinanced to create economies of scale. On the other hand, while the non-state sector has seen growth in terms of quantity and employment, it still lacks the dynamism to become a growth driver.

- *Unbalanced structure, with SOEs taking a lion's share of investment but creating modest revenues and employment*

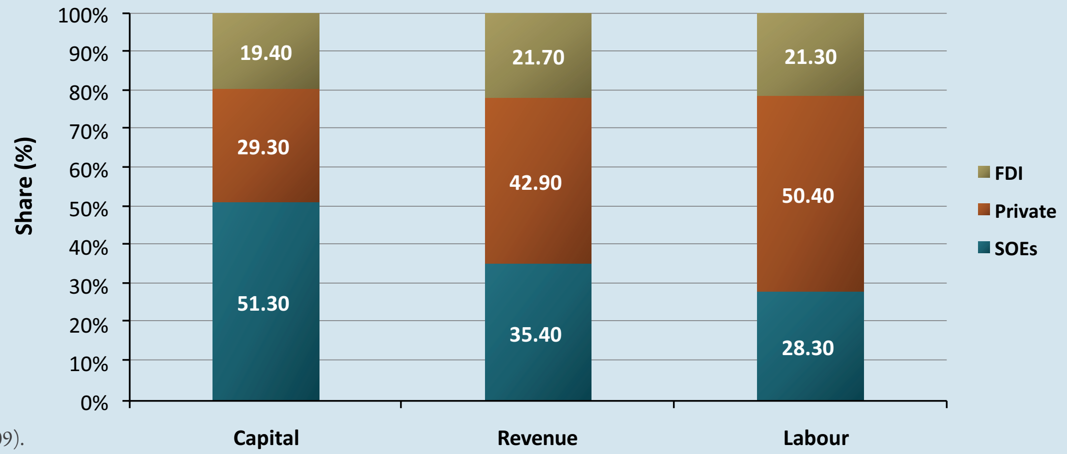
According to the recent report titled "The Execution of Policy and Law on State Assets and Capital Management by the State General Corporations and Conglomerates" of the National Assembly's Standing Committee (NASC November 2009), during the period of 2005 – 2007, the SOEs accounted for 51.3 percent of total business sector capital, but contributed only 35.4 percent and 28.3 percent to revenue and employment growth respectively. In contrast, the private firms generated more revenue, and more importantly, the sector created more jobs while having much less capital share compared to the SOE sector.

FIGURE 3.24: GDP STRUCTURE BY OWNERSHIP 2000 AND 2009



Source: General Statistics Office of Vietnam.

FIGURE 3.25: CAPITAL, REVENUE, AND EMPLOYMENT STRUCTURE OF ENTERPRISES BY OWNERSHIP, 2005–2007



Source: Report of the National Assembly's Standing Committee (2009).

The non-state sector also outperforms the state sector in industrial production, which is considered to be central in Vietnam's overall development strategy toward industrialization. In 1995, the state and non-state sectors had an equal share in the total value of industrial output. But by 2009, the share of the non-state sector has exceeded that of the state sector by threefold. Following the same trend, the state sector's contribution to industrial growth has decreased sharply from more than 40 percent in 1995 to lower than 10 percent in 2009.

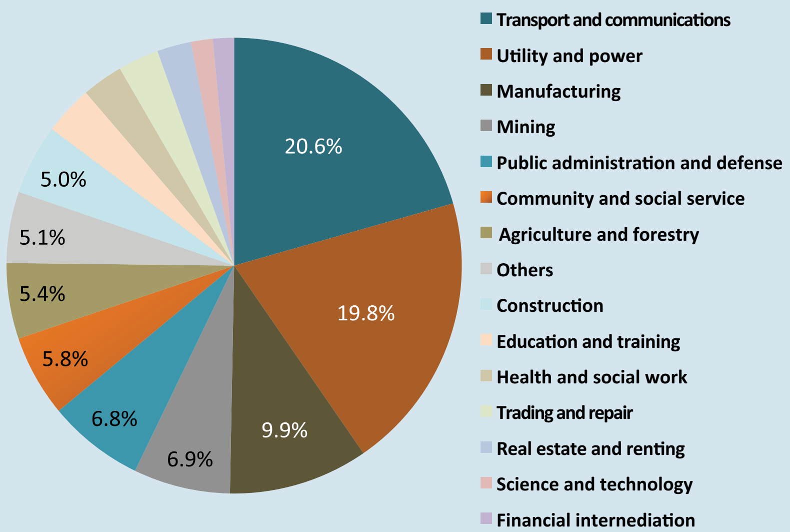
- *Investment focus varies by ownership*

The state sector's investment structure in 2009 can be characterized as follows:

- Transportation and utility account for the biggest shares of the state sector's investment (20 percent of the total investment in each sector) as a consequence of the policy toward intensive infrastructure investment to fuel growth. Other public goods such as administrative services, education and healthcare, social services altogether account for 20 percent of the total investment. While the share of investment for these sectors in the total budget spending is high, their share in the total public investment is relatively small as it is overshadowed by the dominant share of infrastructure investment.

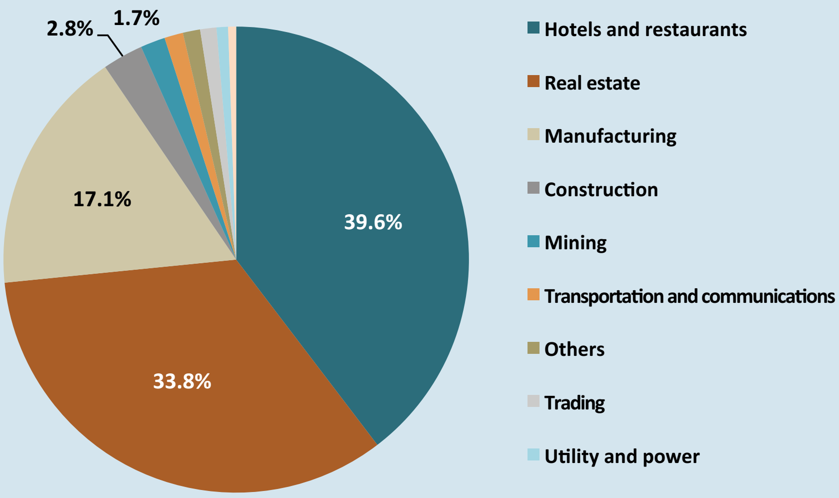
- Among the remaining 40 percent for investment in economic activities, manufacturing accounts for 10 percent, mining 7 percent, and agriculture 5.4 percent. The investment share in real estate and construction is relatively high—up to 7.4 percent, while investments for science and technology amount to only 1.6 percent.

FIGURE 3.26: STATE INVESTMENT STRUCTURE BY INDUSTRY, 2009



Source: General Statistics Office of Vietnam, Enterprise Census, 2006 – 2008.

FIGURE 3.27: FDI SECTOR'S INVESTMENT STRUCTURE BY INDUSTRY, 2009



Source: General Statistics Office of Vietnam, Enterprise Census, 2006 – 2008

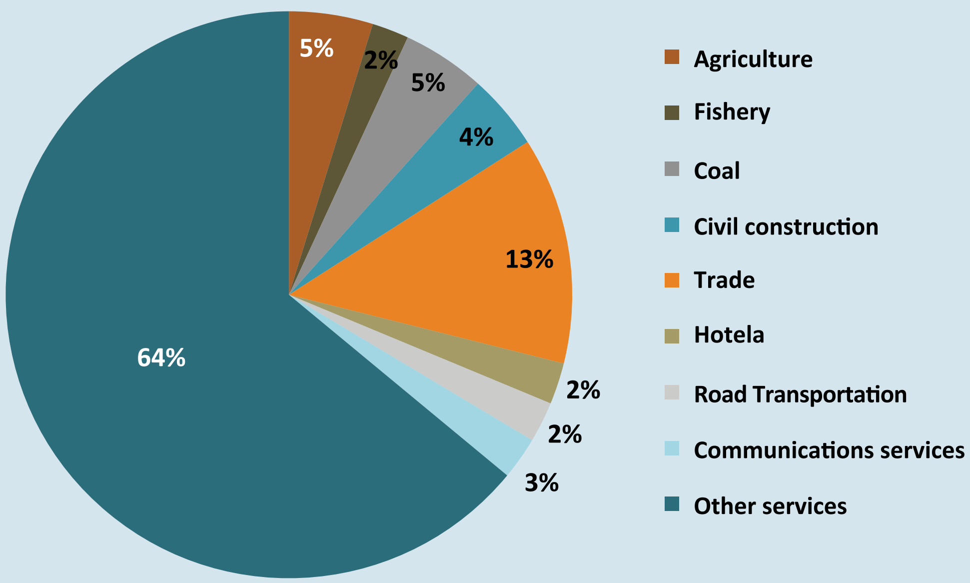
For the FDI sector, its investment structure exhibits the following characteristics:

- The FDI sector's investment in 2009 is heavily concentrated in the real estate (34 percent of total FDI registered investment) and hotels and restaurants (40 percent) sectors—accounting for three quarters of the total investment in 2009.
- Of the remaining one quarter, investment in manufacturing counted for the largest share of 17 percent. Over the period 1988–2009, investment share in manufacturing amounted to 45.6 percent while the combined investment in the real estate, hotels and restaurants sectors came up to 33 percent, a sign of the recent rapid shift of FDI into real estate and speculative areas.
- FDI investments in the agriculture and utility sectors are still very limited (0.6 percent and 0.8 percent respectively), which is a reflection of the low attractiveness or high entry barriers in those areas.

Finally, the non-state sector's investment structure seems to be unchanged overtime. In 2005, key areas attracting non-state sector's investment were trading, agriculture and coal mining as illustrated in Figure 3.28 below.

Currently, 65 percent of the sector's total investment is concentrated in trading, hotels and restaurants, construction, transportation, coal mining, telecommunications and seafood processing.

FIGURE 3.28: INVESTMENT STRUCTURE OF THE NON-STATE SECTOR, 2005



Source: General Statistics Office of Vietnam.

TABLE 3.15:
DELEGATES TO 12TH NATIONAL ASSEMBLY FROM THE ENTERPRISE SECTOR

Source: Vietnamese National Assembly, List of Delegates of the 12th National Assembly, www.quochoi.vn.

Delegates	Number
Vietnamese business community (associations)	2
State-owned enterprises	7
Private-owned and joint-stock enterprises	15
Cooperatives	2
Total	26

In summary, state enterprises concentrate on capital-intensive activities such as transportation and utilities. Private enterprises focus more on more short-term and service-oriented activities such as retails, hotels and restaurants, real estate, etc. FDI enterprises initially focused on import-substitution manufacturing and then gradually shifted more to export-oriented light industries and more recently to real estate.

Sophistication of Companies

Despite impressive growth in quantity, sophistication and quality of companies in Vietnam remain weak as characterized below:

- *Low level of education and extent of staff training*

Level of education and extent of staff training largely varies depending on the size of enterprises. Survey findings on household businesses suggest that entrepreneurs having graduate degrees account for only 0.2 percent of the total number of entrepreneurs, while entrepreneurs with undergraduate degrees make up 4.3 percent (GSO Survey of business and administrative entities 2007). More than two-fifths or 41.9 percent of entrepreneurs never attended any business training courses and 24.6 percent do not speak any foreign languages (National Scientific Study 2009).

- *Weak corporate governance and transparency*

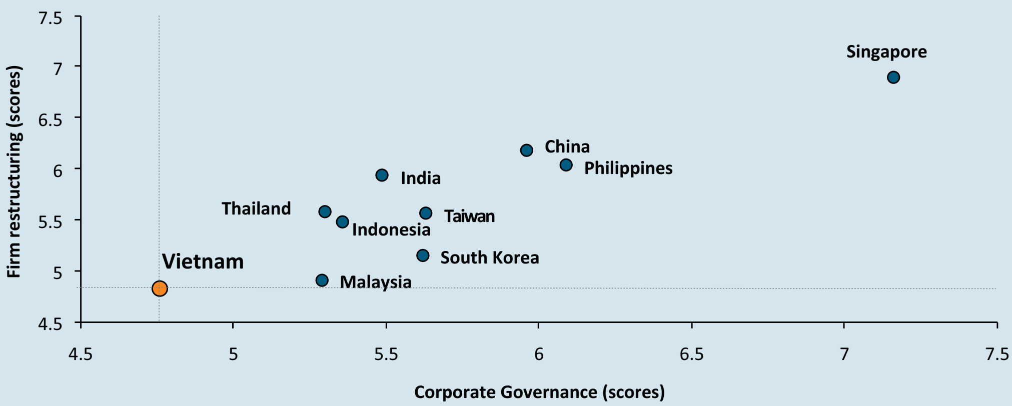
The adoption of modern corporate governance standards is still relatively poor, even among large companies. The operations of boards or directors, appointment of management, information disclosure and protection of minor investors are most often cited by investors as leading concerns on corporate governance. Nepotism is common; in many companies, senior management is appointed by connection rather than by professional qualifications.

Another optic of the company sophistication represents a segment of the Institute for Industrial Policy Studies' National Competitiveness Research 2008–2009. In this study, Vietnam is ranked behind peer countries in corporate governance and restructuring efforts as shown in Figure 3.29 below.

- *Limited role in policy dialogue and advocacy*

Representation of various stakeholders from the business sector in policy dialogue seems to be inadequate in Vietnam. Quite often, big MNCs and large SOEs have better influence on the policy agenda. Meanwhile, the majority of smaller companies have yet to play active roles in policy advocacy, either because they do not have chances to participate or because their level of awareness and interest in the broad policy spectrum is still limited. Among current 493 National Assembly deputies, only 26 are representatives from the business community.

FIGURE 3.29:
CORPORATE GOVERNANCE AND RESTRUCTURING EFFORTS, 2008-2009



Source: Institute for Industrial Policy Studies, National Competitiveness Research 2008 - 2009

FIGURE 3.30: VIETNAM COMPETITIVENESS FOUNDATIONS

Openness and Responsiveness to Customers' Needs

- *Strong commitment to international integration, information technology, and collaboration with customers*

The VCCI- ACI joint survey (2009) with 630 enterprises revealed that 78.4 percent of the respondents are confident that global integration is important to boost economic growth and improve their competitiveness. 65.1 percent of the companies stressed the role of exports as the main factor boosting their company growth in the following years. 97.3 percent of interviewees were connected to the Internet and 64.1 percent have their own websites. 67 percent of the surveyed enterprises also noted that cooperation with customers is highly important in their business activities—a much higher percentage than those recognizing the importance of cooperation with the government and research institutes.

Assessment

Vietnam exhibits the standard profile of a transition economy on the catch-up path. But efforts to upgrade competitiveness fundamentals tend to be reactive and are becoming increasingly insufficient to keep pace with demands of a growing economy. The competitiveness fundamentals are signs of an economic strategy that has made the country's existing advantages available to the global economy but is struggling to find the right role for government to systematically create new competitive advantages:

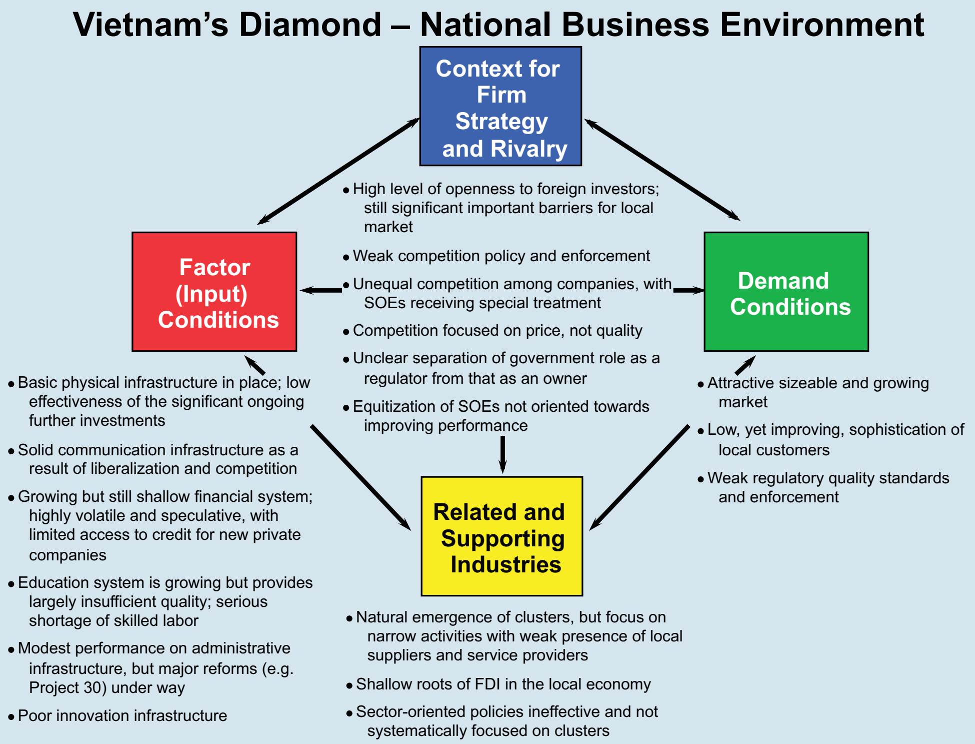
1. Macroeconomic competitiveness is generally in line with the country's stage of development but does not meet the needs of a more prosperous country.

2. Microeconomic competitiveness is shaped by the transition to a market economy integrated in the global economy and the many individual attempts to upgrade competitiveness fundamentals without clear prioritization or coordination.

3. Overall, a strategic approach is lacking towards defining the competitiveness profile Vietnam aims to provide and the steps it intends to take to get there.

Figure 3.30 and Figure 3.31 below provide a summary of macroeconomic and microeconomic foundations of Vietnam's competitiveness.

FIGURE 3.31:
VIETNAM'S DIAMOND – NATIONAL BUSINESS ENVIRONMENT



Summary

Vietnam's transition since the mid-1980s has been accompanied by major structural changes. It transformed the governance of the economy from planned to market, opening up Vietnam for integration with the global economy. Structural change has transformed the composition of the economy, moving millions from subsistence agriculture into capital-intensive manufacturing and services. Both of these changes have contributed to the country's underlying competitiveness, essentially the presence of low cost labor. Growth has been fueled by these macro-level, "systemic" changes. More recently, the policy responses have mainly focused on intensifying investment, especially in SOEs and infrastructure, with an emphasis on generating growth rather than on upgrading productivity and efficiency.

However, this growth model ultimately has limited potential. The highest level of prosperity that Vietnam can reach given this approach is in fact capped by the level of productivity unskilled workers can reach in manufacturing. If Vietnam is unable to move beyond this model, it will remain stuck at a lower middle-income level, with poorer economies threatening its position. Furthermore, the over-reliance on externally-financed investment as a driver of growth is generating dangerous macro-imbalances that may ignite crises.

In summary, the current economic model is characterized by the following main features:

- Roles of different economic segments: The dominant role of state-owned enterprises whose efficiency increasingly poses questions. The role of the FDI sector as the export driver is growing, but beyond that, its role in improving productivity and innovation remains murky. The rapidly growing local private sector is asserting its role, but innovative capacity is still limited.

- Investment-driven growth: Growth is driven by investment in capital goods formation, while domestic savings (especially in the public sector) are decreasing, leading to greater reliance on external financing sources, namely FDI, ODA and remittances. This strategy creates unsustainable macroeconomic imbalances. Growth policies focus on breath rather than depth, on quantity rather than quality, thereby creating high, but ultimately unsustainable, growth rates rather than upgrading productivity and improving efficiency.

- The transformation of the economic structure: Growth has been fueled by the one-off structural change from agriculture to capital-intensive manufacturing and services, rather than by within-sector productivity upgrading. Productivity of the manufacturing sector is low which impedes not only the sector's moving up but also spillovers in upgrading overall productivity across the board.

- Low value-added economic structure: Despite impressive growth and export records, the level of local value-added of the economy remains low, even in the dynamic export sector. Low cost labor is the main advantage which helps generate export growth, while most of the machinery and materials are still imported. FDI companies bring in capital to combine with local cheap labor to produce for their own value chains, with little, if any, linkages with the local economy. Without such forward and backward linkages with the FDI sector, local companies fail to participate effectively in the global value chains.

- Social and institutional infrastructure does not keep pace with dynamism and vibrancy of economic growth: In spite of good records on universal basic education and healthcare services, there are increasingly worrying signs about the quality and accessibility of higher education and healthcare services. Institutional capacity has not kept pace with the sophistication and complexity of the market economy and external environment.

- Regional development: Economic activities are clustered around the two main poles, Hanoi and Ho Chi Minh City, with the rest of the country lagging behind. The aim of regional policy is to mitigate inequality among regions. However, this policy approach is actually demotivating regions to create unique advantages and upgrade competitiveness. Heavy concentration in the two poles has also created serious urbanization problems, such as traffic congestion, pollution and microeconomic bottlenecks.

- Industrial policy: Industrial policy focuses on intervention, protection and subsidies rather than on upgrading productivity and strengthening industrial linkages. Industrial parks and financial incentives are widely used as a tool of industrial policy, while little attention is paid to upgrading workforce skills, improving productivity, facilitating innovation or building cluster linkages.

- Deep integration into the global economy: With the WTO's accession and other multilateral and bilateral agreements, Vietnam has integrated deeply in the global economy and benefited greatly from that process. However, signs of volatility and vulnerability to external shocks and fluctuations are increasingly emerging, requiring Vietnam to have a more proactive, long-term approach not just to respond to but also to forecast and manage external factors effectively.

The necessity for change is not only driven by internal factors. As a country increasingly integrated into the global economy, Vietnam has to acknowledge shifts in the external environment it is facing. Some of these are significant opportunities, while others provide challenges to be dealt with:

- The rise of Asia provides increasing market opportunities in Vietnamese neighborhood, especially in consumer markets. Many of these markets have needs much more in line with Vietnam's domestic market than the markets in the US and Western Europe it traditionally serves. To tap into this potential, however, Vietnam has to dramatically improve its attractiveness as a platform for foreign companies to serve the region. And it has to create an environment in which Vietnamese companies can emerge that have the products, brands, and distribution channels to serve the growing demand across Asia.

- The global reallocation of manufacturing activities provides opportunities for Vietnam. Global companies are under continued cost pressure, and many of them are looking for ways to rebalance their strong dependence on China. Vietnam can be competitive in this race among alternative locations, if it manages to significantly increase its ability to support higher productivity in export-oriented operations integrated into global value chains. On the flip side, it may also pose a risk of relocating low value-added labor-intensive and polluted activities from "early mover" countries like China to Vietnam.

- The increasing level of global competition, a trend Vietnam has itself taken ample opportunity of in the past, is more and more also becoming a challenge. New competitors with even lower wages and/or more productive business environments are challenging Vietnam's attractiveness among foreign investors. Within ASEAN, the agreed path of trade liberalization is exposing Vietnam's domestic market more and more to competition. ASEAN's free trade agreements with other countries add to the pressure. This is good for Vietnamese consumers but a challenge that companies in Vietnam have to prepare for. Vietnam's commitments within ASEAN but also the WTO have in the meantime closed the door for using protectionist countermeasures.

- The risks to the global trading system have so far been contained, but can easily erupt with significant consequences for Vietnam. The large global capital flow imbalances have led to significant talk about currency wars. Protectionism has so far been held at bay, but could become a more important factor. The disruptions in trade and investment flows would have increasingly significant impact on Vietnam as its economy integrates more deeply. Vietnam also is exposed to risks from economic crisis in individual countries, for example a double-dip in the US or an overheating and subsequent contraction of the Chinese economy.

- Climate change, energy supply, and food security are other issues that are inevitably on the rise. They all have global dimensions but also national implications for Vietnam. These trends can undermine Vietnam's current competitive position in a number of important economic sectors, for example agriculture. And they can have a significant direct impact on the prosperity of its citizens.

There is a widely shared acknowledgement that Vietnam needs to move beyond the current economic growth model which is based on low labor cost and intensive capital investment towards a commitment to raising productivity and competitiveness as the core of growth. Vietnam's future growth has to move beyond providing access to and leveraging existing economic fundamentals. It needs to be based on a consistent upgrading of these fundamentals and creating new advantages. Success will require changes on both macroeconomic and microeconomic conditions driving productivity. This new vision is a critical prerequisite for Vietnam's quest to move up sustainably to the next stage of development.

Endnotes

[1]Vietnam has over six billion tons of coal reserves, mainly in Quang Ninh, Thai Nguyen. Oil and gas reserves are estimated to be at three to four billion barrels and 50 – 70 billion cubic meters respectively, mainly in the sediments of deltas and continental shelf. Bauxite reserve is projected to be about 6 billion tons and can be over 8 billion tons while uranium reserve is estimated at about 200 – 300 thousand tons.

[2]The aggregate annual coal output in Northern Vietnam is around 40 million tones and a majority of the output is for exports, especially to China. In 2009, the total export volume was estimated at 24 million tones, not including cross-border smuggled exports. Meanwhile, Ministry of Industry and Trade plans that Vietnam will need to import coal in large volume as fuel for production by 2012. The import volume may reach 34 million tones by 2015 and 114 million tones by 2020 (Vietnam Energy Portal – http://www.vietnamep.com/energy).

[3]The new CCI was developed by Michael Porter, Mercedes Delgado, Christian Ketels and Scott Stern using data from the World Economic Forum's Global Executive Opinion Survey as well as other data sources. See their chapter in the 2008 Global Competitiveness Report for further background.

[4]From 2002-2007, more than 120 law projects and ordinances have been submitted to the National Assembly and the Standing Committee of the National Assembly. It was preliminary estimated that 42 laws, 462 decrees, 12 ordinances, 245 instructions, 957 circulars, 168 resolutions and thousands of other normative acts were promulgated. Many important codes were enforced in this period, for example Intellectual Property Law, Thrift Practice and Waste Combat Law, Corruption Prevention Law and many economic codes were modified, added like Enterprise Law, Budget Law, Land Law, Investment Law, Tendering Law, Environment Protection Law, Social Insurance Law, modified Labor Law.

[5]The Standing Committee of the National Assembly (the tenth) promulgated resolutions number 45/1998, number 55/1998 and number 60/1998 asking the Government to issue Decrees on implementing Democracy Regulations at 3 forms of grassroots level. The Government issued 3 Decrees: Decree number 29/1998/NĐ-CP Democracy implementation regulation at communes (11-5-1998); Decree number 71/1998/NĐ-CP Democracy implementation regulation for offices' activities (8-9-1998); and Decree number 07/1999/NĐ-CP Democracy implementation regulation at state-owned enterprises (13-2-1999).

[6]This subsection follows the analysis of Ohno (2009) with minor revisions and editing endorsed by Kenichi Ohno. See Ohno, Kenichi 2009. "Avoiding the Middle-income Trap: Renovating Industrial Policy Formulation in Vietnam," ASEAN Economic Bulletin, 26-1, pp.25-43.

[7]The Consumer Price Index (CPI) stayed at single-digit levels, the budget deficit remained below 3 percent, the trade deficit was below 5 percent, and foreign exchange reserves were sufficient for nearly 4 months of imports.

[8]MOF defines that public debt includes money owed or borrowing guaranteed by the government at all levels.

[9]According to the "External debt bulletin" of the Ministry of Finance, if measured by the definition of the UNCTAD's Debt Management Financial Analysis System (DMFAS), by which public debt also includes liabilities of the central bank and government agencies (including SOEs) at all levels, Vietnam's public debt level would be larger, e.g. EIU estimates Vietnam's public debt by the end of 2009 was 51 percent of GDP, as contrast with 44.7 percent announced by the MOF.

[10]Some gigantic planned projects in the next two decades like the North-South express rail (USD 56 billion), namely Hanoi's construction projects (USD 90 billion), nuclear power plants in Ninh Thuan province (USD 10 billion) etc., mainly funded by the budget and public debt, would certainly result in a rapidly increasing public debt in the coming years.

[11]Besides GDP growth, inflation and interest rates, the risk level of public debt also depends on a number of other macro variables, such as the current account deficit and foreign exchange reserves. In these respect, Vietnam is also in a significantly disadvantageous position compared with competitors in the region.

[12]Malaysia comes second with fiscal revenue equivalent s to 22 percent of GDP.

[13]The capital inflows during 2007-2008 period are estimated to be around USD 45 billion, including USD 13 billion of remittances, USD 23 billion of private capital (FDI, FPI, commercial credits,) USD 3 billion of ODA, and USD 6 billion of foreign tourists' spending.

[14]Other consequences of expansionary credit growth include bubble asset markets and skyrocketing trade deficit.

[15]In the mean time, the government also sharply cut public expenditure and tightly controlled SOEs' investment to reduce fiscal deficit. This policy helped reduce public investment in 2008 by 16.4 percent compared with that in 2007. The inflation, after about 6 months of lags, returned to single digit in early 2009.

[16]Even after several devaluations (5.0 percent in November 2009, 3.3 percent in February 2010, and another 2.1 percent in August 2010), the dong is still overvalued 13 percent against the dollar compared to the base year of 2000, (see Lê Xuân Nghĩa, 2010).

[17]In end of July 2010, Fitch Ratings downgraded Vietnam creditworthiness from "BB– " to "B+" (i.e., four steps lower than the "investment grade"). The main cause is due to the very high budget deficit of Vietnam is funded primarily through the issuance of debt denominated in foreign currency, while foreign exchange reserves are being depleted and current balance continued to deteriorate.

[18]It should be noted, however, that these devaluations were conducted in a reactive, unpredictable and abrupt way which may erode confidence of the market.

[19]This sub-section used some analyses and data from the DFID's Paper "Measuring the Economic Impact of Competition: Findings From Vietnam", 2010, p16.

[20]This sub-section follows the analysis of Suiwah Leung (2009) with updates and edits, "Banking and Financial Sector Reforms in Vietnam", ASEAN Economic Bulletin, Volume 26, Number 1, April 2009, pp. 44-57.

[21]Analyses and data in this sub-section were drawn from the National Assembly's Standing Committee's Report on University Education Quality, National Assembly 7th Plenary (May – June, 2010)

[22]"Legal documents" means both legal normative documents (LNDs) as defined in the 2008 Law on Promulgation of LNDs ("Law on Laws" or the "Law") and official letters and other documents that are not LNDs, but contain legal norms – i.e., rules and procedures of general application.

[23]The Law on Laws does not include the requirements for impact analysis and public consultation for non-normative documents. Also the formal requirement for impact analysis is for laws, ordinances and decrees only, while other LNDs have similar but less formal requirements.

[24]By end 2005, Ministry of Finance, for the first time on behalf of the Government, issued USD 750 million international sovereign bond which was later on re-lended to Vinashin with the government's guarantee. In the following year, Vinashin itself borrowed another USD 600 million from the international market with arrangements of some foreign banks. This year, the group planned to issue another VND 400 billion (USD 20 million) international bond just before its crisis was revealed. The debt/equity ratio of the group was 11 at that point of time, with the total debt amounting up to VND 86,000 billion (USD 4.3 billion) while its total asset is VND 104,000 billion (USD 5.2 billion. Its debts include USD 750 million government-guaranteed sovereign bond, and debts to contractors and financial institutions.

[25]Capital intensity per worker for the state sector in 2007 is VND 1.11 billion, three times of that for non-state sector (VND 0.35 billion) and 2.5 times of that for FIS (VND 0.45 billion). To create one unit of profit, an SOE needs 1.8 units of capital, non-state enterprise 1.13 units and FIE 1.03 units (GSO data).

[26]Estimated by the Industrial Development Strategy Institute, Ministry of Industry and Trade

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Chapter 4

Vietnam's Competitiveness Agenda: From Analysis to Action

Vietnam's Competitiveness Agenda: From Analysis to Action

It is much easier to describe and assess a country's competitiveness than to improve it. Yet improving competitiveness is the only way in which the assessment has an impact on the standard of living that the people of Vietnam will be able to enjoy. This chapter therefore aims to provide guidance on the policy recommendations to be drawn from the assessment in chapters 2 and 3.

Competitiveness is, as was discussed in the introduction, the result of a large number of factors, actions, and policies. An exhaustive list of recommendations that address all of these areas is neither feasible, nor effective. What is needed – and what is lacking in many countries that fail to make sustained economic gains - is a clear prioritization that helps policy makers to identify those specific action areas that at this point of time are the most powerful levers to improve their country's competitiveness.

Action priorities are not simply the result of an identification of strengths and weaknesses as in chapter 2 and 3; they are a reflection of the choices that a country makes about where it wants to go. Once such a strategic direction is set, an action agenda becomes the logical set of policies necessary to move a nation from where it is to where it aims to get to.

Where does Vietnam want to go? Ultimately, this is a question that only the Vietnamese can answer. The Ten-year strategy currently under discussion defines the ambition for Vietnam to become a middle-income country by 2020. The strategy identifies human resources, infrastructure, and institutions as three critical action areas that government policy has to focus on to reach this target.

The Ten-year strategy is, in its structure of ambitions and actions, quite typical for similar documents in other countries. While this structure provides some useful orientation, a complete national strategy would need to identify the specific value that Vietnam aims to offer to companies that operate in the country, rather than simply set ambitions and indicators. It would need to define more specifically the type of activities for which this offer would be most attractive. For example, the specific sectors/clusters or operations targeted at specific markets. In turn, it would then be able to deduce from this value proposition the action priorities to guide implementation.

The Vietnam competitiveness agenda outlined in this chapter does not describe such a complete strategy. This would go far beyond the mandate of an external academic analysis. Instead, the report in its entirety aims to make a contribution in two ways that are important steps towards a strategy. First, it provides – especially in the previous chapters 2 and 3 - many of the facts that are necessary to have an informed debate about a national economic strategy for Vietnam that is both feasible and in line with the country's ambitions and nature. Second, it identifies – here in chapter 4 – a set of principles and actions that are fully consistent with the long term strategic ambitions for Vietnam outlined in the ten year strategy. Any value proposition that Vietnam decides to adopt would most likely be consistent with the ten-year strategy but there will be a need to specify the strategy further. The competitiveness agenda outlined here is thus a foundation that can be further specified once a national value proposition is in place.

The competitiveness agenda developed in this chapter contains three parts: First, three critical tasks that require the focused attention of policy makers in Vietnam are identified based on the analysis in chapters 2 and 3. The ability of Vietnam to come to grips with these three tasks is going to be fundamental to its ability to deal with the opportunities and threats ahead. Second, action recommendations on what Vietnam should do to approach these tasks are identified. General principles are discussed that should guide policy making across the three tasks as well as for economic policy making in general. Specific sets of actions are then identified within each of the three tasks. Third, an implementation strategy is outlined that can provide orientation for how Vietnam can turn these action plans into reality. This strategy covers both an approach for the sequencing of different types of actions and the organization of a governance structure that can oversee and manage progress.

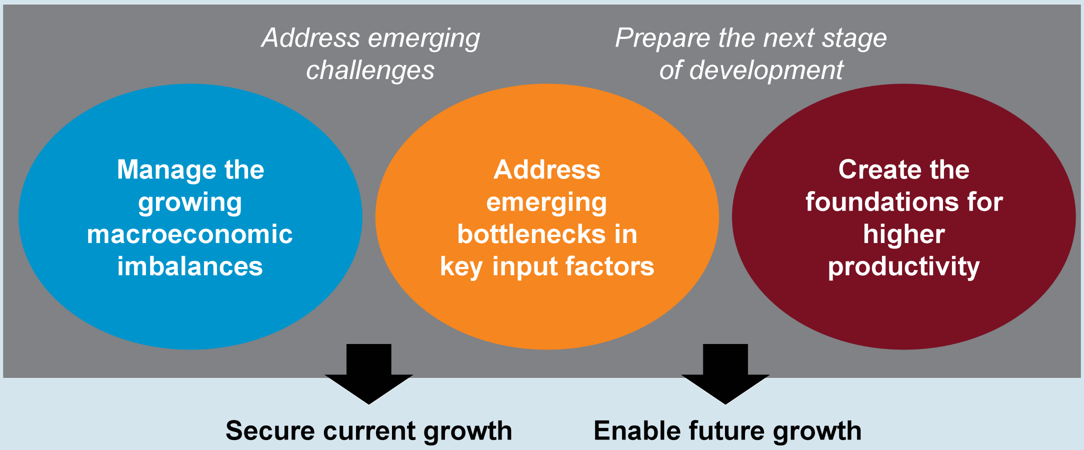
The competitiveness agenda outlined in this chapter has the ambition to be a useful starting point for Vietnamese leaders to discuss the actions to take. In this process, many of the details proposed here will inevitably be changed. The Vietnamese will have to design an action agenda that reflects their own values, objectives, and preferences. The structure and specific action recommendations presented here will hopefully make this task easier and enable the Vietnamese to engage in a more informed discussion about their competitiveness priorities. At the end of this discussion, Vietnam will have more than a clear action agenda. It will also be able to elevate its strategy to the next level and define a clear value proposition in terms of what Vietnam is offering as a place to do business.

Critical tasks facing Vietnam

Vietnam has – as chapter 2 has documented – achieved one of the most impressive global growth stories of the last twenty-five years. The analysis also indicates that the fundamental drivers of this growth continue to be in place: Vietnam has the opportunity to stay on its current growth path for the next few years. This positive outlook

Critical Tasks for Vietnam

- Vietnam can remain on a robust growth path for the next few years, if it avoids **emerging challenges** ahead
- Vietnam can move to the **next stage** of development, if it creates the foundations now to move beyond middle income status



and the complacency it can easily foster is the most difficult challenge facing Vietnam.

The tasks that Vietnam is facing fall into two categories: First, there are two groups of emerging challenges that threaten to undermine the current growth dynamics if they remain unchecked. Second, there is a group of fundamental changes in Vietnamese competitiveness that are necessary for the country to move beyond the limitations of the current growth model. While different in nature, these two groups are connected and in part overlapping: The threats to current growth are, at their core, symptomatic of the growing fragilities of the current growth model. These fragilities are an important impetus for the need to enter a new stage of development. In turn, all progress on creating the foundations for higher productivity growth will also provide relief to the macro- and microeconomic pressure visible today.

Macroeconomic imbalances

Vietnam has registered impressive GDP growth over the last few years and decades, enabling a rise in standards of living and lifting millions of Vietnamese out of poverty. However, beneath this surface of strong overall GDP growth, Vietnam faces significant macroeconomic imbalances:

- Trade and current account balances; Vietnam is facing an increasing deficit in its trade balance. While widely perceived as a typical export-led economy, Vietnam is systematically importing more than it is exporting. If imports contribute towards the upgrading of the capital stock and therefore create opportunities for future exports, a trade deficit is temporary and justified; the data is not conclusive but suggests that fuels, raw materials, components and supplies for exports, and increasingly also consumption goods dominate.
- The flip side is a growing savings-investment imbalance; while such an imbalance is again normal for a country with a low capital stock on a fast catch-up path, the low efficiency of the investment is worrying. The external deficit has to be covered through capital inflows, from foreign investment, remittances, development aid, or through other sources. The increasing concerns about Vietnam's ability to finance the external deficit, fuelled by rising external debt[1] and a significant drop in foreign reserves[2], create uncertainty about the country's future economic outlook.
- Inflation and exchange rate; Vietnam's inflation rate has in the last few years become increasingly volatile, with the trend rate of inflation ratcheting upwards. Large unsterilized capital inflows and rapid growth in domestic credit have created inflationary pressure. Under an exchange rate policy that is oriented towards stable nominal rates, this has led to increasing real exchange rates and has forced Vietnam into repeated devaluations. The high level of dollarization in the economy adds to difficulties in managing inflation and exchange rate fluctuations.

The analysis in chapter 3 has revealed that the current policy approach plays a crucial role for these imbalances. The public sector accounts for a disproportional share of investment and is financing it through public sector deficits that increased quickly from 2.8% of GDP in 2001 to 8.9% of GDP in 2009 (IMF). Despite a relatively high tax to GDP ratio[3], public sector revenues are not only insufficient to cover expenditures but also overly reliant on revenue sources that are either highly volatile (oil and gas taxes) or bound to fall due to policy commitments in the AFTA and WTO context (import tariffs). Given the still shallow local capital markets, the government is forced to finance its budget through donor assistance or the global capital market.

These imbalances are costly and could turn out to become seriously dangerous. At the minimum, they lead investors to require a higher risk premium to invest in Vietnam. This slows down the rate of growth. And it reduces the benefits that the Vietnamese can derive from foreign capital that is naturally needed in an economy on a rapid catch-up path. But the consequences could be much more painful. Vietnam's macroeconomic imbalances could culminate in a crisis should sentiments shift so that Vietnam loses access to external financing. This would require a painful adjustment process with severe exchange rate changes, public expenditure cuts, and possibly years of lost growth.

The current policy response has recently received international praise, which noted that the Vietnamese government had responded to the concerns about macroeconomic imbalances. While Vietnam has taken such positive steps, the policy response falls short of a coherent strategy to address these challenges in a more comprehensive way. There is virtually no publicly announced strategy for reducing external and government financing deficit. Recent price controls in response to inflation have addressed the symptoms but not the root causes. Changes in the nominal exchange rate have been reactive and failed to outline a clear future path that financial markets can rely on. The government's pressure exerted on commercial banks to reduce interest rates doesn't take into account the market situation. In particular, interest rates have remained high because the public does not want to hold Dong balances at lower rates. The emerging imbalances described above will continue to grow, or even become chronic, unless the government changes course.

Vietnam needs a more prudent macroeconomic policy approach that addresses the root causes of the emerging imbalances. Monetary policy should be more transparent and forward looking. Fiscal policy should be more prudent in managing budget deficit, public investment, and public debt. In addition, monetary and fiscal policies will need to be well-coordinated to achieve macroeconomic stability.

Microeconomic bottlenecks

Vietnam's current growth trajectory is driven by the nature of its microeconomic fundamentals, essentially the presence of a large pool of low cost labor that has become more and more accessible for integration into the global economy. While these factors continue to hold, there are increasing signs that the microeconomic growth model is hitting bottlenecks:

- Skill and infrastructure shortages; Investors are increasingly reporting problems in getting sufficiently skilled employees, especially middle managers and technicians. There are also growing concerns about the capacity of the logistical and electricity infrastructure. These problems are locally concentrated in regions that have received the lion's share of export-oriented investment inflows, especially in the Ho Chi Minh City region.
- Profile and implementation rate of FDI; foreign investment is increasingly focused on real estate projects and labor-intensive activities. There is less upgrading from the induced imports of capital goods; already before, there was little, if any, evidence of positive spillovers from foreign owned activities to local companies. FDI firms use cheap labor in Vietnam to produce for their own global value chains and have shallow roots in the local economy. While the announced FDI projects continue to be strong, there is an increasing gap between these announcements and actual investments. While part of the gap might be explained by an interest to "over-report" FDI attraction at the regional level, part of it is likely to be driven by increasing problems in implementing FDI projects in line with initial plans or by speculative behavior of some investors who register projects to "reserve a seat" and later resell their licenses for profit.
- Deteriorating ratio of investment to growth; as an accounting measure, the incremental capital to output ratio (ICOR) gives a sense of how investment relates to GDP growth. Notwithstanding the fact that ICOR is often criticized for its conceptual validity, it is still notable that relative to its investment, Vietnam achieves lower GDP growth than China and India. State-owned enterprises account for the lion's share of capital investment, accentuating the low overall investment efficiency.

These emerging bottlenecks are signs of the gradually decreasing level of dynamism that the current growth model is able to generate. While they are unlikely to result in any immediate crisis, they will slow down growth and with it, the rate of improvement in the standard of living of the Vietnamese people. And these bottlenecks are likely to become more cumbersome as the economy expands.

The policy response so far has been based on a largely accurate identification of the bottlenecks – all three main elements of the ten-year strategy are highly relevant. However, the impact of the steps taken in response, has so far, been clearly insufficient.

In the area of workforce skills, the educational system is in a transition. Relative to its GDP, Vietnam is spending more on education than many of its peers: According to the World Bank, Vietnam's public spending on education as a percentage of GDP in 2009 was about 5.2% - higher than most of its ASEAN peers (Malaysia – less than 5%; Thailand – 4%; Indonesia – 3.5%). But the education system is inadequate in responding to the needs of companies, in terms of quality, quantity, and content of education.

Private institutions have entered the market to fill some of this gap, but providers vary highly in their quality. Their effectiveness is hampered by the lack of a modern regulatory framework as current government oversight tends to impose administrative and operational control, but has been ineffective in implementing transparent quality standards. Barriers still exist and restrict competent, especially foreign, education providers from entering the market.

In physical infrastructure, the government has – with the strong support of foreign donors - made significant investments over the last few years. However, here too, spending has been less effective than in peer countries: The average cost of building one km of railroad between Hanoi and Vinh (200km/h) is double than that of the road between Beijing and Shanghai (300 – 350km/h) (Fulbright Economics Teaching Program 2008). Foreign donors provide much needed financing, but their financing is conditional and is tied to their interest. Regional governments request projects that in sum lead to an inefficient duplication of infrastructure assets. National government allocates funding for such projects as compensation for regions with lower growth, not with a view to achieve the highest possible overall development impact. Private sector infrastructure investment remains limited due to the lack of regulatory framework and commercially viable mechanism for profit sharing. These challenges will only get more complex as Vietnam moves from a stage where the most pressing infrastructure needs were obvious to a situation where the prioritization of projects becomes more intricate.

In regulatory processes, the government and foreign donors have, through Project 30[4], engaged in a wide-ranging effort to simplify administrative procedures. The many simplifications that were successfully identified by Project 30 now need to be implemented. A critical challenge that will need to be addressed is the highly heterogeneous application of rules and regulations across the country and across different government agencies. Many foreign companies report that while the national laws are solid given Vietnam's overall state of development, their application across the country creates high levels of uncertainty and costs.

Vietnam needs microeconomic policies that can effectively address these emerging bottlenecks. In the short term, ways need to be found in which the government can ensure such action without having to wait for a fundamental reform of government institutions.

Foundations for middle-income status and beyond

Vietnam's current growth is based on an economic logic that ultimately has limited potential. At its core, it raises prosperity by moving Vietnamese workers from agriculture into more capital-intensive manufacturing activities. This structural change then induces further growth as an emerging middle class starts to demand a broader range of consumption goods and services. The highest level of prosperity that Vietnam can reach given this approach is defined by the level of productivity that unskilled workers can reach in manufacturing. If Vietnam is not able to move beyond this model, it will be stuck at lower middle income level, with poorer economies threatening its position. There are many signs that Vietnam currently remains trapped in this dangerous position:

- Low value added exports; export-oriented manufacturing activities in Vietnam rely almost exclusively on imported supplies. The only local content provided is the work of low- or semi-skilled Vietnamese employees, using machinery and materials imported from abroad. The only exceptions are exports of natural resources and agricultural produces, where local endowments rather than imports provide the critical inputs.
- Eroding cost competitiveness of Vietnam; the high growth in Vietnam has fuelled inflation and raised cost levels. While productivity has improved only marginally as infrastructure has been upgraded, costs have gone up. Vietnam's cost position is gradually eroding relative to other countries that either also provide a large pool of low-cost labor or have increased their productivity more dynamically.
- Low productivity of Vietnamese products versus imports; as Vietnam is opening up to the global economy and as its domestic market is growing, it is also becoming a more attractive market for foreign exporters. In a number of industries, there are clear signs that these companies, for example from China, are able to out-compete local producers. While foreign companies generally face higher cost levels, they more than compensate for this with higher productivity levels and better logistical networks.

These observations are typical for an economy that is growing quickly based on the combination of domestic low-cost labor and foreign capital. While they do not signal an imminent crisis, they provide clear evidence that unless Vietnam moves to a new economic policy approach, it will be stuck at the current level of prosperity and might even lose some ground to new competitors. This task is getting more urgent given rapid changes in the international economic environment.

The current policy response is based on the widely shared view that Vietnam needs to move beyond the current economic growth model, which is based on low labor cost and intensive capital investment rather than on productivity and competitiveness. But there is no clarity or consensus on the policy implications to draw and on the new strategy and growth model to implement. The challenge is that moving to a new model requires interrelated changes in many policy areas. Such a fundamental transition is challenging for any administration and is particularly daunting for Vietnam given its widely acknowledged institutional weaknesses. The only way to deal with these weaknesses is a competitiveness strategy that sets clear priorities and focuses the government's limited institutional capacities at a few truly critical tasks

Three Guiding Principles

*From a **broad-based** shift towards **market-oriented** economic activity to a **targeted** approach of upgrading **productivity***

*From a Government **Controlling** a Transition Economy to a Government **Creating** Competitive Advantages in a Market Economy*

*From **Dominance** of SOEs and Foreign MNCs to a **Market-driven Mix** of private firms, SOEs, and Foreign MNCs*

at any point in time. At the moment, Vietnam is trying to upgrade too many things at the same time, without a clear strategy that could align and sequence these activities towards a coherent new goal. The lackluster success in many if not most of the initiatives to fundamentally upgrade Vietnam's competitiveness is the logical consequence.

Improving Vietnamese competitiveness: What to do?

Vietnam needs an action agenda that accomplishes the three main tasks identified in the preceding section. Vietnamese leaders have to design the many specific policy programs and activities required in this context. Companies, local and foreign, international donors, and others will also have to be involved. The dialogue between these important stakeholders will provide the basis for future work on defining a comprehensive national economic strategy.

This section contributes to their work in three steps. First, it outlines some general principles on how the nature of Vietnamese economic policy will have to evolve in this new stage of the country's development. Second, it will identify specific actions recommended for early implementation in each of the task areas discussed. Third, it will define important general rules for how to align ongoing government policy changes with the overall competitiveness agenda.

Guiding principles: How does Vietnamese policy action need to change

Vietnam's economic policy approach since 1986 has, in many ways, been an enormous success. Standards of living have gone up and many people in Vietnam have seen their livelihoods transformed. This is a source of well deserved pride. Changing the policy approach now is by no means an indication that the policies of the past were mistaken. It is a sign that both Vietnam and the international economic environment in which the country operates have been dramatically transformed over the last two decades: what worked well in the past is not necessarily what will work best in the future.

Moving from one policy approach to another is not just a matter of refining current policies. It is driven by the need to adopt a new set of principles that can then guide the multitude of individual changes that are required. These principles describe the direction and underlying logic of change. Clarity on these principles enables the many individual policy makers and implementers to align their actions with an overall strategy. While this happens naturally in a steady-state economy within a given growth paradigm, it becomes a critical condition for effective action when many things need to be changed in parallel.

The following three principles outline critical dimensions of the Vietnamese economic transition- the economic policy goals, the role of government and the private sector profile

Growth drivers

Vietnam's growth since the mid-1980s has been driven by transition and structural change. Transition has transformed the governance of the economy from plan to market, opening up Vietnam for integration with the global economy. Structural change has transformed the composition of the economy, moving millions from subsistence agriculture into manufacturing and services. These macroeconomic "systemic" changes have enabled underlying competitiveness, essentially the presence of low cost labor, to be revealed.

Vietnam's future growth has to move beyond providing access to and leveraging existing economic fundamentals. It needs to be based on a consistent upgrading of these fundamentals. This will require changes on a wide range of macroeconomic and microeconomic conditions driving productivity.

The current policy debate in Vietnam has not quite made the transition to this new vision. Much of the focus is on short-term growth rates rather than on sustainable productivity growth. While these objectives do not need to be in conflict, they easily can be. Many macroeconomic policies that fuel short-term growth have no or even negative impact on the longer-term productivity potential of the economy. This is particularly true for attempts to provide SOEs with easy access to capital in order to keep up their investment activities.

Government role

Vietnam has experienced a significant transformation in the role of government in the economy since the mid-1980s. The basic institutions of a market economy, including free price setting, making decisions on buying, producing, and selling, and so forth, have been created. Government remains an important factor in the economy, but the nature of its involvement has clearly changed. Government is now reeling under the strains of finding its new role within the more complex market economy that has developed. The government's instinctive reaction remains, too often, one of control. But the public sector's ability to exercise this control is not keeping pace with the changes in the environment. This breeds an environment in which inefficiency, corruption, and weaknesses in the rule of law develop almost naturally.

Vietnam's government needs to define a new role, in line with the demands of an emerging, dynamic market economy. This role is defined by the roles that government needs to play to allow the market to function. Government needs to provide a transparent and effective regulatory environment in which companies can compete on equal terms. Government needs to have an effective approach towards providing public goods, including infrastructure, education, and regulation, in ways that reflects both its political will and the needs of companies and the broader public. In short, it needs a plan for how government actions are contributing towards the emergence of a business location with clear and distinct competitive advantages.

The current policy debate in Vietnam is too often focused on the size and the direct power of government, rather than on its ability to provide the functions needed. But size and effectiveness do not necessarily go hand in hand. Government that aims to directly control many actions is findings itself overburdened, even if it is large. Government that focuses on setting and implementing clear rules of the game can have much stronger impact, even if it is smaller.

Structure of the economy

Vietnam has in the process of transition moved from an economy in government ownership to an economy dominated by SOEs and foreign companies, with the local private sector playing a significant but overall still small role. The process of "equitization" has been challenging, and the financing of SOEs remains non-transparent. Efforts to create national champions have not met with much success and in some cases, like Vinashin, seems to have provided an environment where leading executives exploited their position for private gain. Foreign companies have been able to grow and operate successfully in Vietnam despite these challenges. Yet the local private sector has for the most part been relegated to small companies, largely serving local demand.

Vietnam needs to provide an environment in which a more balanced mix of state-owned, private, and foreign companies characterizes the economy. Competition between these groups needs to be on equal terms, enabling those that make the strongest contribution to Vietnamese prosperity to gain ground.

The current policy debate in Vietnam too often gets hung up on political views about ownership. Academic research clearly indicates that market structure, i.e. the exposure to competition, is more critical than ownership per se in determining productivity levels within companies. Vietnam can combine SOEs with a market economy and rising levels of prosperity. However, it can only do so if the governance of the SOEs is transparent, the role of the government as an owner clearly separated from its role as a regulator, and SOEs are exposed to the same market rules and incentives as their foreign and local rivals.

Specific action proposals: Addressing the three critical tasks

Guiding principles for economic policy need to be translated into specific actions. Ultimately these actions need to be designed and implemented by Vietnamese institutions and individuals to gain real traction. The remainder of this section provides examples of key actions to take, organized by the three key tasks defined earlier, for upgrading Vietnamese competitiveness. These actions are meant to provide useful input for Vietnamese policy makers, not to constitute a fully comprehensive list or a readily implementable action plan.

Macroeconomic imbalances

As a small-open economy with a quasi-fixed exchange regime, Vietnam's ability to stimulate growth through macroeconomic policy is limited. Monetary policy relaxation doesn't guarantee higher economic growth since a large portion of the increased demand (i.e., investment and consumption) will be satisfied by imports. It may also cause inflation, asset bubbles, and dollarization as Vietnam experienced during 2009 as the result of the stimulus package[5]. Fiscal policy, too, faces significant limitations in Vietnam: The budget deficit is very high and has become almost chronic. And any fiscal stimulus will attract more capital inflows that under the quasi-fixed exchange regime will force the central bank to increase money supply and thus push up inflation. Instead of using expansionary fiscal and monetary policy to stimulate the economy, the government should follow a prudent long-term policy approach and improve its macroeconomic management capability to maintain sound macroeconomic foundations[6].

The overall macroeconomic policy mix has to achieve a number of objectives: Monetary policy needs to create an environment in which inflation, interest rates, and nominal exchange rates develop in a transparent, market-driven process that sends clear signals to market participants. Fiscal policy needs to ensure transparency and discipline in balancing government revenues and expenditures in a way that is consistent with the public sector's long-term budget constraint. Macroeconomic management needs to align short-term monetary and fiscal policies with these long-term goals while reducing short-term cyclical fluctuations of the economy. Macroeconomic management also needs to monitor and if necessary manage the build-up of unsustainable bubbles in the economy, for example in the real estate, credit or equity markets, and to strengthen the soundness of financial market institutions.

The following policy actions are examples of the steps Vietnam needs to take to move towards a macroeconomic policy environment in which imbalances are less likely to occur and can be mitigated:

- Transparency of fiscal position of the government and SOEs; uncertainty about the economy's fiscal conditions, such as budget deficit, public debt (including debt of SOEs), foreign reserve holdings, etc. undermines the trust of market participants. Vietnam should establish an effective and independent reporting body in charge of providing transparent and robust data in line with international norms on the state of the economy. SOEs need to be subject to stringent information disclosure requirements, especially on their economic efficiency, financial performance and financial relations with the government.

- Strengthen budget discipline; Transparency and discipline in state budget management need to be enforced to minimize off-budget spending items and maintain a sustainable fiscal balance. Quality and effectiveness in public debt management need to be enhanced. Public debt management should be considered as an organic part of the overall macroeconomic management and should be coordinated among Ministry of Finance and other policy agencies. Transparency and independent monitoring in public investment need to be enforced.

- Consistent and predictable monetary policy; Monetary policy needs to be driven by a transparent policy objective and has to be consistent and predictable over time. According to Vietnamese laws, monetary policy decisions involve the National Assembly, the government, and the SBV. We recommended a clear assignment of roles among these three entities: The National Assembly could set the ultimate objective for monetary policy (for instance, an inflation target rate), the government together with the SBV set the intermediate targets (for example, money supply and/or credit growth), and the SBV is given complete autonomy in setting the operational targets. SBV then needs to send clear signals on its main monetary target, namely inflation, and the corresponding money supply and credit growth targets. Over time, it is critical that the central bank's independence, competence, and capability are strengthened.

- Financial market regulation; weak regulatory frameworks and immature financial markets are a recipe for speculative bubbles and overheating. Vietnam needs to develop a robust regulatory framework in which the room for speculation is reduced while the financial system is gradually deepened. SBV needs to prudentially oversee the financial system to ensure the soundness of financial markets and institutions. Transparency and fair competition should be enforced to ensure that credit is allocated to the firms and the areas where it can be used most efficiently. Regulatory framework should also support effective surveillance of financial institutions and risk management to ensure soundness of the system and reduce systemic risks.

- Coordination of overall macroeconomic policy over time; a short-term focus and a lack of coordination among different macroeconomic policy instruments undermine the effectiveness of policy. The Central Committee for Financial and Monetary Policies can play an important coordinating role to enhance alignment of efforts across different ministries. Its operation and mandate should be upgraded and formalized to manage a medium- to long-term agenda rather than to seek ad-hoc solutions to immediate crises and problems.

Microeconomic bottlenecks

Vietnam needs microeconomic policies that can effectively and quickly react to bottlenecks in the regions and clusters where they are most pressing. As discussed previously, these bottlenecks are related to workforce skills, physical infrastructure (including electricity) and administrative procedures.

While a fundamental solution to these challenges requires broader-based changes in policies and institutions, there is a need to find effective answers more quickly. This can happen in public - private partnerships where the companies affected by the bottlenecks, the government agencies in charge of the respective issues, and – where relevant – the institutions that provide relevant products and services, launch target activities together. Such partnerships will provide useful learning and experimental experience to convince people to embark on broader national-level policy measures.

BOX 4.1:
EXAMPLES OF CLUSTER-BASED INITIATIVES

- Garment and textile cluster in Ho Chi Minh City's surrounding area (Ho Chi Minh City, Binh Duong, Dong Nai provinces); the garment sector is facing a serious challenge of low value-added and low productivity. The project will roll out a study and some action initiatives to enhance the competitiveness of the cluster. For example, skills training programs for technicians, engineers and line managers; capacity building for design and branding; facilitating linkages among garment factories and local textile suppliers and developing material supply zones in collaboration with industry players.
- Electronics and engineering cluster in the Red River Delta (Hanoi, Vinh Phuc, Bac Ninh, Hai Duong); building up the local supplier base (supporting industries) is critical to increasing the value-added of this cluster. The initiative will collaborate with flagship FDI companies to map out a database of potential local suppliers; identify areas of potential linkages and promote partnership; build capacity and provide incentives for local suppliers to meet the requirements of FDI clients. Any generalizable lessons could assist government in formulating policy on developing supporting industries in other clusters.
- Logistics cluster in the neighborhood of Ho Chi Minh City; an efficient logistics sector is critical for all firms regardless of whether they are serving a domestic or foreign clientele. An industry assessment could be launched to identify factors impeding the sector. This can be followed up with focus group discussions with all stakeholders – public, private and institutions for collaboration so as to seek workable solutions and formulate coherent policies which remove bottlenecks and enhance both the quality and efficiency of the provision of multi-modal logistics services.
- Tourism cluster in the Central region (Da Nang, Hue and Quang Nam province); of late there has been an influx of FDI in tourism-related real estate projects in the region however, there is a lack of coordination among provinces to develop a sustainable tourism cluster. The initiative will develop an integrated concept and strategy for the region; prioritize and attract investment in supporting industries such as transportation, recreation and healthcare; facilitate linkages and coordination among cluster participants.
- Agro-processing cluster in the Mekong Delta region; most agricultural exports comprise unprocessed or semi-processed goods which have low value-added. The initiative will connect the relevant stakeholders such as farmers, traders, processing factories, supermarkets and exporters, quality standard regulators, agricultural extension service providers and conduct focus groups to promote business linkages and find ways to improve both the quality and value-added of agricultural products.

- Cluster-based action initiatives; the lack of dialogue between the government agencies regulating workforce skills or providing infrastructure and the companies using these services is one of the most critical barriers towards removing the bottlenecks for growth. A range of targeted pilot initiatives can be launched in clusters where there is sufficient critical mass for actions to affect a meaningful number of companies and willingness of both companies and the relevant public sector agencies to collaborate. Central government could provide special authority to such efforts, where needed. Such initiatives will showcase how different stakeholders – public and private, central and local, industries and academia – can work together to address issues of common concern. Issues could be picked and initiatives could be designed in a way so that the government and business people could learn how to formulate a holistic policy mix to address not only individual issues but also a complex set of inter-related problems which is often the case in reality. International agencies with relevant experience could provide technical support. Success will ultimately depend on the willingness of the Vietnamese stakeholders to take ownership and translate such experimental experience into broad-based policy actions.

New competitiveness strategy

Vietnam needs an overall economic strategy that provides a coherent approach for upgrading competitiveness and moving the country to the next level of development and competitive advantage. This strategy is also dependent on how Vietnam intends to position itself in the global economy. To achieve this, Vietnam will need to change many of its policies as well as the way policies are designed and implemented. While, the task of repositioning Vietnam in the global economy is beyond the scope of this report, the following are key policy areas and policy processes where change is most critical.

Policies

1. Education and workforce skills

Skills are critical to enable the emergence of a higher value-added economy in Vietnam. While education alone is not sufficient, there is no way forward that does not require a work force that is better trained and educated for the tasks required in a more sophisticated modern economy. There is little if any controversy about this fact in Vietnam; the question is how to get it done.

The current approach is not delivering. It fails on quantity, quality, and relevance of education and workforce skills. Public sector institutions have proven unable to provide the right skills and to extend their capacity in line with the growing needs of the Vietnamese economy. This is the result of ideological and state centric governance system in education combined with the lack of collaboration between educational institutions and the business community. Few foreign institutions have entered the market under the watchful and often constraining oversight of government agencies. There is a recent rapid expansion of local private sector institutions which has added to capacity but their track record in terms of the quality of education has been highly heterogeneous. The market is not transparent enough to provide guidance to customers seeking high-quality and relevant educational programs. Regulators focus on entry barriers and administrative control of operational issues (e.g. how many students to enroll, how much instructors are paid, etc.) rather than on strategic control of quality. The policy focus on expanding access to basic education has come at the cost of lower quality and less relevant education.

A new approach towards education and in particular workforce skills development needs to focus on the role of education as a central enabling condition for higher productivity. Entry of private sector training providers, especially of competent foreign players, needs to be simplified. Government should focus on its role as a regulator for public and private training providers that implements quality standards and enforces transparency through a combination of incentives, controls, and investments.

The collaboration between companies, training providers, and regulators at the level of clusters needs to be actively encouraged to align education content with market needs. Government investments should be directed to areas where, based on the dialogue in clusters, the potential for increasing value-added is the highest.

Specific actions and mechanisms can build on the efforts previously mentioned as a response to local bottlenecks, and provide a pathway towards rolling them out nationally. Examples to consider include:

– Develop a national workforce strategy with rigorous studies on the type of skills and competencies required for future growth. This strategy should be developed in close consultation and implemented in coordination with industry and educational institutions rather than solely by the government. It is necessary to have a central government body to champion and oversee the strategy and all efforts related to human capital upgrading. This body will coordinate various issues which are currently being split among different ministries, namely the education portfolio of the Ministry of Education and Training, the vocational training and labour issues of the Ministry of Labor, Invalids and Social Affairs and industry-specific skill issues of line ministries. A Central Taskforce on Education Reform under a broader competitiveness watchdog agency can help coordinate and streamline efforts. Another institutional example is the Workforce Development Agency (WDA) in Singapore.

– Reform the regulatory framework for the education sector. Instead of focusing on administrative control, the regulator needs to develop effective quality standards to control the quality, not quantity, of instructors, students and curriculum. Entry barriers need to be simplified towards smarter regulation to allow most competent players to enter the market. Educational institutions need to have more autonomy to decide their own operational and organizational issues. A merit-based system needs to be strengthened to encourage most talented instructors and students, and also to alleviate corruption and fraud. Funding allocation should be tied to performance rather than size of the institutions. Transparency needs to be enforced to provide clear guidance for the customers who are seeking education services. Government needs to mobilize the dynamics of the market process in order to enhance the quality of education supply, instead of working against market forces.

– Promote vocational training: The social preference for university education (especially business and management education) over vocational and technical training has led to a serious shortage of capable engineers and technicians in the market. The government's administration in this area need to be streamlined into a single focal agency (instead of divided among three different ministries as currently). Vocational training programs needs to be developed and managed in close coordination of educational institutions, local government, and the business sector, including foreign investors. An interesting foreign example is the WIRED program in the US, where groups of regional government agencies, educational institutions, and companies proposed joint workforce skills development plans for specific clusters for funding to the federal government.

– Set up a National Productivity Fund to support cluster-based initiatives in improving productivity through upgrading workforce skills, technology, production management system, etc. The Fund should embrace a much broader portfolio than the current Vietnam Productivity Centre (under the Ministry of Science and Technology) which is merely an ISO accreditation agency. A national productivity fund needs to be put at the centre of the system to coordinate productivity upgrading efforts in different sectors and to have deep industry-specific knowledge and expertise. Examples of structure and operation of such a fund can be found in Korea, Singapore and Hong Kong.

2. Physical infrastructure

Transportation, communication, and energy infrastructure are another critical condition for emergence of a higher value-added economy in Vietnam. Again, there is little if any controversy about this fact in Vietnam; the question is how to get it done.

The current approach has delivered a significant upgrading of the absolute level of physical infrastructure available in Vietnam. But the costs of these investments have been high compared to similar projects in peer countries, and their impact on competitiveness is not visible. Corruption and inefficiencies have been a significant burden. And the demands of the economy have grown even faster than infrastructure capacity has been added. In many cases, infrastructure projects have been used as a tool of regional policy, compensating regions not fully benefiting from the brisk growth in, especially, Ho Chi Minh-City and its surroundings. The Vietnamese government has now plans to massively upgrade infrastructure nationwide. Foreign donors have provided capital, but in many cases such projects are tied to their conditions or interests. Serious concerns have, for example, been voiced about the plans to build a high-speed rail link between Hanoi and Ho Chi Minh City.

A new approach for infrastructure investment needs to systematically evaluate public infrastructure projects by their contribution to competitiveness, not by their roles as demand drivers or compensation to regions. The overall budget control should be centralized, with decision making on national projects centralized and other budgets for regional projects allocated to region. PPP should be used as an instrument to enhance the effectiveness of investments, not just to mobilize private capital. Relevant proposals have been discussed in the recent past, for example at the Vietnam Business Forum. It is now time to move beyond the pilot phase and start a larger scale roll out.

The major part of infrastructure investment is currently financed and implemented by the public sector. Enhancement of transparency, efficiency and accountability in public procurement and construction is critical not only to reduce costs and enhance quality, but also to strengthen the country's creditworthiness with creditors.

Policies need to focus not only on building "hardware" infrastructure like roads, ports, airports, etc. but also on developing the complementary "software" solutions and services, e.g. logistical networks and services to ensure seamless and efficient connection of infrastructure hardware. As an export economy, Vietnam should place great importance on improving logistical and custom service efficiency where it is currently underperforming other regional peers. Electricity shortage is also emerging as a serious impediment for growth.

Specific actions and mechanisms can build on the efforts previously mentioned as a response to local bottlenecks, and provide a pathway towards rolling them out nationally. Examples to consider include:

– Create a centralized planning mechanism to coordinate, oversee and evaluate infrastructure development. A transparent and enforceable system for prioritizing, selecting, managing and evaluating projects (e.g. set of criteria, procurement system for public infrastructure projects) is critical. Investment decisions need to be based on rigorous assessments of public benefits and costs. The planning mechanism does not necessarily centralize all decision making, but should play a central role in developing and overseeing the implementation of the master plan for infrastructure investment, monitoring the alignment of individual projects with the master plan and evaluating the projects' efficiency and impact. It would provide a framework and transparent rules and processes for other agencies and lower levels of government to follow. An example for such a mechanism is Singapore's Ministry of National Development, which is the country's lead agency that oversees physical infrastructure development (MND 2010).

– Strengthen the system for managing public procurement, including streamlining procurement procedures with those of international agencies, development of an e-procurement system and creation of an independent supervisory agency which reports to the National Assembly and which has power and authority to monitor, inspect and evaluate major projects. In Singapore all infrastructure tenders, other public sector opportunities, and awards can be readily accessed online through GeBIZ, the government's one-stop-shop e-procurement portal. The Government e-Procurement System (GePS) is a similar initiative in South Korea that centralizes public sector procurement through a dedicated portal.

– Provide viable market-based financing options for infrastructure investment (i.e. greater private sector participation, financially viable, more efficient, etc.). The PPP model for infrastructure investment is an option, but scrutiny is required to ensure that it is not abused as a tool to provide privileges for some well-connected private groups in getting access to land (as a return for their co-investment) and cheap ODA credit or in overcharging the end-users of infrastructure. Besides a transparent legal framework, an effective and enforceable competitive bidding system with a monitoring and evaluation mechanism is key to ensuring the impact of the PPP model.

– Address electricity shortages through a combination of investment, market regulation and technological measures. Gradually liberalize electricity prices to attract investment in the sector. Create a competitive market and put EVN subject to market disciplines.

Enforce quality control and technology standards and measures to reduce electricity consumption ratios of key industries, especially steel, cement and chemicals. Develop and gradually commercialize new and more sustainable energy sources.

3. SOE Governance

State-owned enterprises remain are an important part of the Vietnamese economy and are likely to remain so in the near future. Enhancing the capabilities of SOEs is critical to increase value-added, to remove the drain on public sector resources their financing needs impose, and to create opportunities for competitive private companies to emerge.

The current approach of SOE governance is not delivering the strong, competitive Vietnam-based companies that are the objective of policy makers. The hope was to achieve high performance through creating economies of scale. SOEs receive special treatments and privileges in forms of access to land, subsidized and preferential credit through state-owned banks or government guarantees, etc. They also enjoy monopoly positions and strong connections to the sectoral regulators who are also their direct reporting line in most cases. The SOEs are also not required to adhere to the governance standards which apply to almost all public companies such as information disclosure, independent audit, recruitment of professional management, competitive bidding, etc. It is getting increasingly obvious that low efficiency persists in large SOEs, growth is achieved by entering into other fields, and corruption and personal enrichment remain difficult problems. While it is tempting to see such failings as the result of individual misbehavior, the experience of many other countries suggests that it is systemic. The current policy approach not only fails to provide an environment in which SOEs improve their competitiveness and productivity. It also crowds out more productive players and erodes confidence in a transparent and equal playing field.

A new approach needs to separate the roles of government as an owner from that as a regulator. Government needs to define a clear owner policy in terms of what it expects as returns from its SOEs. Government's measures to improve SOEs' performance need to focus on enhancing productivity rather than increasing short-term profitability. SOEs need to be subject to the same competitive pressure as their foreign and local private sector rivals. It is crucial to ensure that SOEs compete on equal terms to other companies on all markets, including those for capital, and are subject to full market discipline. While equitization needs to remain on the policy agenda, it is more pressing to enforce modern corporate governance standards in SOEs, especially standards related to information transparency, risk management, and the transparent operation of the Board of Directors and management team.

Specific actions and mechanisms to consider include:

- Separate the role of the government as an owner from that as a regulator. This requires the government to delegate its ownership to an independent, strong body which operates purely as a commercial corporate and independently from any political agenda. All major state-owned conglomerates are still reporting either directly to the Prime Minister or to the line ministries that ultimately also regulate their markets. Ownership of smaller SOEs is managed through the Vietnamese State Capital Investment Corporation (SCIC). But SCIC has an unclear mandate, ownership policy, and does not effectively separate regulation and control. Singapore's Temasek is an example of clear separation between the government and its linked companies.

- Define and enforce modern governance standards for SOEs, especially those related to information disclosure, risk management, independent financial audit, and appointment and operation of the Board of Directors (BOD) and the management team. The BOD and the management team of the SOEs have to be accountable for the enterprise's performance. At the minimum, SOEs need to be subject to the same governance standards and regulations as other public companies. An interesting foreign example is the initiative of the Baltic Institute of Corporate Governance. In collaboration with the Lithuanian government, it has developed governance principles for SOEs that have now been implemented.

- Ensure competition and market discipline in the markets in which SOEs operate. All the current non-market subsidies and special treatments for the SOEs need to be removed. The government can still support the SOEs but only under the same rule as it provides support to privately-owned companies. The support needs to go to those who can use it most efficiently and contribute the most to competitiveness and it needs to focus on sustainable upgrading of productivity rather than increasing short-term profitability. SOEs, therefore, should be discouraged from expanding into non-core areas, especially into speculative financial and real estate ones as this is creating systemic risks for the economy. State resources (land and real estate, equipment, credit, etc.) which have been and will be allocated to SOEs need to be duly revaluated by independent, competent agencies to protect those from leaking to individual pockets. Competition framework and disciplines need to be strengthened, e.g. strengthening the capacity and separating the operation of Vietnam Competition Administration Department (VCAD) from sectoral regulators; enforcing competitive bidding in government contracts, allowing private sector players to enter the currently monopolized markets, etc.

- Improve the equitization process and define policy for effective management of divestment proceedings. Equitization needs to be used as a tool for adopting technology and know-how transfer, applying good governance and creating exposure pressures, rather than just for mobilizing private capital. As major state conglomerates and enterprises will be equitized over the next few years, the amount of divestment proceedings may be huge which requires careful and effective management of the money.

4. FDI attraction

The attraction for foreign direct investment, especially Greenfield investments, has been a critical driver of recent Vietnamese growth. Given the weakness of the local company base, FDI will continue to be a critical driver of growth. It will possibly start to include more takeovers of Vietnamese companies, including SOEs, alongside further Greenfield investments.

The current approach towards FDI attraction is reactive and oriented towards high announcements of FDI inflows. The value that this generates for Vietnam is insufficient. FDI attraction is essentially focused on the process of dealing administratively with investors that have already decided to come to Vietnam. This process is distributed across a number of national and regional agencies, with little coordination or alignment between them. Regions tend to race for FDI by offering excessively preferential incentives in terms of land or tax, rather than by positioning themselves to offer unique factors and advantages to investors. There is no proactive approach towards contacting those investors that might have the most to offer in terms of adding towards Vietnamese competitiveness. There is no systematic work to integrate the foreign investments with the local economy once they have materialized. There is also little if any follow-up in working with investors to attract their suppliers and service providers to Vietnam. There is little linkage and coordination between FDI policy and other policy areas to work out what to offer for investors as a package of solutions, and then provide feedback from investors about what needs to be developed as new competitive advantages for Vietnam. As a result, Vietnam gets mostly investments that create a very short-term return but are highly mobile in terms of moving to other locations. Luckily, Vietnam also gets investments from long-term oriented companies like Intel or recently Boeing, that are looking at the future outlook of the region and the country. But these investments are the result of economic fundamentals, not of a successful FDI attraction policy.

A new approach needs to focus on actual FDI, not announcement and more effective monitoring and follow up. FDI attraction needs to be separated from regulation and permitting. Investment attraction needs to evaluate FDI projects as tools to strengthen Vietnam's competitiveness. The needs of MNCs to improve business environment conditions need to be leveraged to enhance the environment for all companies. Clusters need to be developed around MNCs, attracting/developing other MNCs, SOEs, and local private sector companies and creating incentives for encouraging FDI spill-overs. The roles and responsibilities of regional and national agencies in attracting and regulating FDI need to be clarified and coordinated.

Specific actions and mechanisms to consider include:

- Develop a new FDI attraction strategy for Vietnam which needs to build on Vietnam's strategic positioning and its strategy for the local economy. The strategy should identify and prioritize what sorts of FDI Vietnam wants to attract; how it will add value to the local economy; what can be done next to it to move up the value chain. It should also discuss who Vietnam has to compete with to attract such FDI and so what it can offer to get the deal. The current FDI management system needs to be reformed, from target prioritization, attraction, coordination to follow-up, oversight and evaluation. This includes strengthening of the current mechanism of delegating authority to provincial governments. A centralized coordinating and supervisory mechanism needs to be put in place to ensure that provinces do not "fence-break" to attract any type of FDI at any price and the licensed projects are in line with the overall master plan of each sector or industry.

- Strengthen the capacity of the Foreign Investment Agency (FIA) under the MPI as the central coordinating agency for attracting and managing FDI. FIA needs to be transformed from a purely policy making agency to become an active gateway agency who provides "one-stop" innovative package of investment solutions and services for investors. In this role, FIA will not only deal with new coming investors but also follow up closely with existing ones to attract their suppliers or subcontractors to Vietnam and also to get their feedback on strengthening Vietnam's competitive advantages as a business destination. FIA should be well-equipped and empowered to undertake the strategic and central coordinating tasks as mentioned above.

- Set up outreach initiatives with foreign MNCs to build local supplier base and clusters and to create incentive system to encourage technological spillovers and linkages between FDI and local economy. In order to successfully leverage the MNCs as anchor firms to build local supplier base around and improve overall productivity, it is neither sufficient nor effective to merely use financial incentives or impose local-content requirements. Policy measures need to tackle a number of important issues, such as: (i) absorption capacity of the local economy, e.g. technology level of local firms, workforce skills, quality standard system, linkages with research institutes, etc. (ii) a strong and enforceable IPR protection system to eliminate the risk of appropriation when MNCs share their technology secrets with local suppliers; (iii) level of competition among firms and sophistication of customers in the local market – when such factors encourage firms to compete by innovation and adopting new technology rather than by reducing costs; (iv) characteristics of sectors, etc. Especially in a small and newly emerging market, when the risks are too high for both the FDI and the local firms to invest in creating forward and backward linkages, there is a role for the Government to match the risk gap by providing appropriate incentives, e.g. credit risk sharing, labor training or land provision, etc.

A new FDI policy needs to be put in the context of broader competitiveness policy framework and connect to other policy areas. Land management policy is important to redirect FDI from real estate into more fundamental value-creation manufacturing areas. Provision of workforce skills and infrastructure also need to be targeted towards serving the sorts of FDI which contribute the most to competitiveness.

An interesting foreign example is Singapore's Economic Development Board (EDB). Creating jobs through labor-intensive industries was once the top priority of the government when the city-state gained independence from British rule. The EDB was then formed to take on the challenge of attracting investors to do business in Singapore. EDB strategically charted the direction of policies that are coherent with the nation's overall development goals and it set-up overseas offices to spearhead FDI attraction initiatives (EDB 2010).

5. Cluster development/Industrial policy

Higher competitiveness requires specialization in areas where the presence of related and supporting activities can support a level of productivity that any individual company finds hard to achieve. The actual specialization is the result of the specific assets and capabilities available in a location, shaped by the way comparative and competitive advantages have dynamically evolved over time. Government does not create specialization that drives higher productivity but it controls many policies that have a significant impact on the specialization dynamics.

The current approach of the Vietnamese government towards specialization and industrial policy is based on creating national champions from SOEs, providing cheap credit to individual companies, and creating dedicated infrastructure (industrial parks). There is a plethora of sectoral and industry plans at different levels, but no integration and no effective follow-up or implementation. A systematic dialogue with the clusters that have emerged in the Vietnamese economy is lacking. There are little if any linkages between the narrow attempts of industrial policy based on intervention and subsidies with related policies like FDI attraction, skill development, or infrastructure investment.

A new approach needs to focus on clusters and value chains, not individual companies or narrow industries. The objective needs to be improving productivity, not private profitability. For existing clusters, collaboration and cluster dynamics have to be enhanced to move them beyond the current state of mere co-location. Alongside with strengthening linkages within clusters, it is necessary to build beyond-cluster external linkages along the value chains in which firms are participating. Clusters which are built around MNCs could serve as the platform for local firms to participate in the global value chains. Policy priorities should focus on creating an environment in which meaningful linkages and positive spill-overs can emerge in a market process. Modern cluster policies are fundamentally different from traditional interventionist policies targeting specific companies or industries through subsidies or protection: they are open to all existing clusters that have the ability and willingness to upgrade, and are based on enabling companies in clusters to compete on a higher level, not shelter them from competition. Several government policies (regional development, workforce skills, infrastructure spending, FDI attraction, regulatory reform, etc.) can be organized around clusters to provide more coherent policy packages aligned with the specific needs of an individual cluster. The orientation towards clusters provides higher effectiveness of government spending while minimizing distortions.

Specific actions and mechanisms to consider include:

- Re-organize existing policies around clusters, especially in areas linked to investment attraction, workforce skill development, industrial parks, and SME/private sector-development. In these areas cluster-based efforts can raise the level of effectiveness and play a crucial role in implementing strategic plans in public-private collaboration. Pilot efforts to develop clusters/supplier networks around large foreign investors and/or large SOEs could be among the first of these projects. Taiwan's Hsinchu Science Park (HSP) is a good example of how cluster thinking can be used to enhance the effectiveness of an industrial park. The government built the park in close proximity with leading academic institutions (Chiaotung and Tsinghua) and Taiwan's Industrial Technology Research Institute (ITRI), offered attractive financial terms, and focused investment attraction on a set of related industries with high potential linkages.
- Conduct a national cluster mapping project to identify and assess clusters across the country. The resulting database of clusters can then be matched with instruments like a Vietnam Regional Competitiveness Index (RCI) to provide a strong factual basis for the design of cluster- and region-specific policies. Such an RCI can be designed to assess comprehensively macroeconomic and microeconomic competitiveness fundamentals of provinces in the contex of regional linkages. This would complement the current Provincial Competitiveness Index (PCI) which focuses on assessing governance quality and proactivity of provincial governments in creating a conducive business environment for private sector businesses. Over time, the knowledge infrastructure created through the cluster mapping effort should be matched by a training initiative focused on education for cluster initiative managers. The European Cluster Observatory[7] and Harvard's course on Microeconomics of Competitiveness[8] are international examples.

- Encourage the launch of pilot cluster initiatives through the creation of a Vietnamese Cluster Initiative Fund that would allocate funds for strategy development to cluster initiatives based on a competitive process with an international review committee. Cluster efforts should be evaluated on their current abilities and on their willingness to improve. Initial funding would cover only the analysis and strategy design, with implementation of efforts to be covered through existing government programs opened up for clusters.

Institutional architecture

1. Policy process

More effective policies, in the specific areas mentioned above as well as in others that will rise in importance over time, are more likely to emerge, if a robust process of policy design and implementation is in place. Competitiveness is not achieved through the one-time creation of a good policy. It requires an inherent ability to systematically upgrade and improve policies over time.

The current policy design and implementation process in Vietnam has significant flaws. Policy design is often based on limited if any data. While the policy quality at higher levels (Central Government, National Assembly) has been improved, especially after WTO accession, the quality and application of policies at lower levels (rules and regulations issued by ministries or provincial governments) are highly heterogeneous. The inclusion of experts or affected groups from outside of government is often insufficient. The Vietnam Business Forum has been rated as one of the most effective public-private dialogue structures internationally (World Bank 2009). But even here there are concerns about systematic follow-up and the integration of this structure into policy planning. In general, there is no lack of policy plans in Vietnam, but these plans are often set up in isolation, leading to a multitude of conflicting guidelines. The presence of many aid organizations with their individual focus areas and objectives might contribute to this situation. Long-term plans exist in separation from short-term action agendas, leaving the long-term "strategic" plans without real impact. There is little systematic follow-up on whether policies were implemented and had their desired impact.

A new approach needs to provide data for fact-driven policy making and clear procedures to monitor the relevance and quality of policy. Planning efforts have to be consolidated and connected. Policy planning needs to be connected to budgeting and implementation; short-term budgets/plans need to be integrated in rolling updates of long-term plans. There has to be an institutionalized impact assessment for policies. The coordination among different government agencies in design and implementation needs to be strengthened. Dialogue between government and external stakeholders in the policy design process needs to be systematized. In its work with donors, the government needs to be driven by a clear national economic strategy, leveraging the specific capabilities of individual donors where they can contribute the most to the overall objectives set by the Vietnamese.

Specific actions and mechanisms to consider include:

- Creation of a central Regulatory Impact Assessment (RIA) unit to constantly review existing laws and assess new laws and regulations based on effectiveness, clarity, consistency, relevance, etc. Project 30 on the Simplification of Administrative Procedures has achieved significant momentum in reviewing the existing stock of rules and regulations in term of their administrative efficiency. The Law on Promulgation of Normative Legal Documents (Law on Laws) was issued to require all the new laws and regulations to go through a systematic RIA process. This is a major movement in the legal reform process and is compliant with international practices. However, the Law doesn't provide for a central RIA agency to be established and for the RIA process to be applied to lower level laws and regulations, leading to a loophole for new regulations to skip the requirements. The Law should also legalize the requirements for laws and regulations to be developed based on clear facts and data. The new centralized RIA Agency will need to streamline and coordinate different portfolios of laws and regulations currently divided among different agencies (Ministry of Justice, Office of the Government and Ministry of Home Affairs, etc.). Placing it under the National Assembly like the Congressional Budget Office (CBO) in the United States might be an option.
- Establishment of an automatic formal review process that invites relevant government agencies and other stakeholders, including private sector associations, to comment on draft laws and regulations within a given time frame. There need to be a clear mechanism and scorecards to follow-up and evaluate how the comments were integrated in the new policies. An administrative appeal mechanism also needs to be set up to allow businesses and citizens to appeal improper or illegal policies and regulations.
- Development of a medium-term budget planning process with rolling updates. The planning process needs to integrate annual budgets into medium-term planning. The current budget needs to be design with a view towards longer-term fiscal policy objectives, especially over the business cycle. Medium-term budget plans need to reflect changes made in current budgets. One option would be to invite the OECD's Working Party of Senior Budget Officials (SBO) to undertake a review of Vietnam's budgeting system; similar reviews have been conducted for Thailand and the Philippines.

2. Capacity

More effective policies require a more capable public sector. Well trained public officials and an effective organization and management structure of public agencies are crucial to enable government to operate more effectively.

The current approach in Vietnam reflects a very traditional public sector organization. There are numerous training and capacity building initiatives being offered, but the lack of a merit-based and performance-driven system has limited their impact. There is a lack of appropriate incentive system to encourage good performance (salaries are well below market levels, advancement and remuneration are not driven by performance, individual accountability is not enforced, etc.). Leadership is often dispersed and coordination mechanisms across government agencies are weak. Good governance principles and code of conduct system are not in place, giving way to corruption and misbehavior. Government officials are often over-occupied with administrative and operational work, leaving little time for strategic management and professional work.

A new approach needs to be based on an integrated efforts providing modern solution in leadership, training, incentives, and organizational structures.

Specific actions and mechanisms to consider include:

- Establishment of the Prime Minister's Policy Unit with high-quality staff and sufficient resource to provide action oriented analysis and to develop implementable policy proposals. The Unit should have significant powers to draw on data and collaboration from all parts of government. It could be charged with following up on the implementation of tasks allocated to individual ministries, and provide a central role in coordinating activities across different ministries and agencies. Several countries, like the Strategy Unit in the Prime Minister's Office in the UK, provide useful examples.

- Launch anti-corruption campaign; corruption is a systematic problem, not a case of individual misbehavior. Effective action against corruption requires an integrated set of activities, and a long-term perspective. Reducing the benefits of corruption by both stricter punishment and higher, more market- and merit-based wages for public employees are important elements of the strategy. Strong examples in behavior and rhetoric from the political leadership are another. Reducing the number of situations in which corruption can occur, for example through the simplification and transparency of administrative procedures and the use of e-government tools, is a further element. There needs to be an effective institutionalized mechanism like an independent agency under the National Assembly to lead anti-corruption programs. Interesting foreign examples of successfully implemented anti-corruption mechanisms include Hong Kong's Independent Commission Against Corruption (ICAC) and Singapore's Corrupt Practices Investigation Bureau (CPIB). ICAC has investigative, preventive, and communicative functions while CPIB focuses on the investigative functions complemented with rigorous use of deterrent measures (Heilbrunn 2004, 3-6). Both agencies have gained recognition for successfully combating corruption both in the public and private spheres.

- Review of the current training system for public officials, starting with a number of pilot agencies. Regulatory Impact Assessment (RIA) is a good example; numerous technical training courses are available on law making techniques, but little training is offered on the approach and process of developing and implementing demand-driven and market-oriented rules and regulations. Apart from designing appropriate courses, a key issue is the selection of staff for training. This needs to be based on ability and the profile of the position; training is not primarily a benefit. Singapore's experience in improving the public sector's human resources is another interesting case. Every year the government awards several scholarships to top-notch students transitioning to higher education level. This initiative ensures that the government is able to absorb potential leaders of the public service. Meritocracy and performance-based evaluation are considered key principles in human resources development. The Public Service Division under the Prime Minister's Office has a specialized research and strategic planning unit to plan scenarios as well as generate, test and realize ideas on improving the civil service system. They also conduct researches on new skills needed in the civil system and launch policy venture projects to seek innovative approaches in delivering public services.

- A comprehensive civil service reform program is crucial to ensure success of all other reform efforts. A strategy for public service reform needs to be developed, specifying measures to build up elements of a modern civil service system. Performance and transparency need to be key principles for recruitment, salary, and advancement in the organization.

3. National – regional structure

Given Vietnam's size and geographic profile, the effective allocation of roles and responsibilities between national, regional, and local authorities is particularly important. Companies always locate in specific regions within a country, so the cumulative effect of government from all levels as it materializes in a specific place is what matters for their performance.

The current structures in Vietnam suffer from significant weaknesses. The lack of coordination between national and regional agencies leads to high variability in the way that rules and regulations are being implemented. Regional governments often follow me-too economic strategies that copy the plans of other regions instead of developing a unique strategy based on local circumstances. Regions also compete by "fence-breaking" central rules or offering inherited endowments like land to attract investment. Provincial strategies and plans are not put in the context of inter-regional linkages. Regional policy from the central government is often taking the form of large infrastructure investments "compensating" those regions not growing at the same level as Ho Chi Minh City and Hanoi.

A new approach needs to review the current mechanism of responsibility delegation and strengthen oversight and quality control by the central government. Regions need to be motivated to develop their competitiveness based on a unique positioning. It should encourage collaboration and leveraging through the cluster approach rather than competition among regions.

Specific actions and mechanisms to consider include:

– Funding competition for development of regional economic development strategies. Instead of compensating regions with infrastructure or financial support for poor performance, central government could incentivize regions to develop their own economic strategies. Such strategies would have to be based on the unique combination of assets each region possesses, not on copying the concept of others. Despite the significant differences in economic and political context, Denmark's Regional Growth Fora could provide an interesting example for Vietnam to review.

– The national government could support this process by developing a knowledge and skill infrastructure for regional development. This would include region-specific data – a Regional Competitiveness Index (RCI), as mentioned in the Cluster Policy section above, is clearly a key source - as well as training programs for regional decision makers.

– Review the current structure of authority delegation between the central and regional governments and strengthen the oversight and quality control by the central government. Consider centralized mechanisms in certain policy areas (e.g. regulatory review, infrastructure, etc.) to help coordinate, prioritize, monitor and evaluate regional policies and implementation. The OECD in particular has done significant work on this topic in recent years that Vietnam could draw on[9].

Policy action in other areas

The policy areas and institutional changes identified in the previous sections are critical for Vietnam to address its short- and medium-term competitiveness tasks. But government clearly has to be active in many other policy areas as well.

Policy action in these other areas needs to be informed by the overall competitiveness agenda as well. Decision makers across government need to understand the country's overall strategy. For each of their actions, they need to consider a sequence of three questions:

- Is the planned policy or program undermining efforts on the competitiveness agenda?
- Can the activity be designed in a way that it can take advantage of activities that are part of the competitiveness agenda?
- Is the activity contributing towards creating the competitive advantages that the competitiveness strategy aims to establish?

For these questions to provide effective guidance for policy makers and administrators across the public sector, it is crucial that the key elements of the competitiveness strategy are widely published and discussed. Alignment with the strategy cannot be achieved by fiat; it requires the free decision of many individuals to use their decision power in a way that is consistent where the country aims to go overall. This is easier than it sounds – individuals will find it in their and their entities interest to take decisions that leverage in the best possible way the decisions taken in other parts of government and by other private and public entities.

Improving Vietnamese competitiveness: How to get it done?

Many of the recommendations covered in the preceding parts of this report have been made in one form or another by others before. Still, as the analysis has revealed, the issues that they aimed to address persist. This lack of effective follow-through is not unique to Vietnam. What are possible reasons for it, and how can they be overcome?

- Lack of urgency; after many years of solid growth with a corresponding rise in standards of living for millions of Vietnamese, there is little pressure to change the economic policy approach.

The analysis in this report reveals that such complacency would be dangerous. The three critical tasks identified all reflect dangers ahead if left unaddressed. The first – macroeconomic imbalances – could precipitate a major crisis. The second and third will progressively lead to decreasing growth rates in the short- to medium-term. The political leadership in Vietnam needs to resist the temptation of ignoring the warning signs. These are not an indication of failure, but in many ways a natural result of the huge success that Vietnam's economic policy over the last 25 years has delivered. These warning signs should instead be used to give impetus to change.

- Limited individual incentives for change; for any particular institutional structure, there are always entrenched interest groups who would be disadvantaged by change. This is not unique to Vietnam, but a particular problem when more fundamental economic reforms are needed. It is therefore important to create incentives and willingness strong enough to sacrifice individual interests of a small number of groups for broader common interests of the whole country and its people.

This report provides no magic formula to overcome the complexities of political economy that exist. But it tries to provide data and analysis to support the reforms which are most needed for Vietnam and the Vietnamese people. And it provides in the following section some thoughts on an implementation strategy that is designed to systematically align policy initiatives with a gradually increasing impetus for reforms.

- Weak logic behind recommendations; many action proposals are made without a clear analysis of the specific challenges in Vietnam that they are designed to address. They are instead proposed as policies that are viewed as generically beneficial for any country. This reduces their ability to convince policy makers in Vietnam of their relevance to the specific situation their country is facing.

Unlike many other reports, this report provides full transparency of the data and assessments that drive the recommendations. It develops recommendations that are specific to Vietnam and mutually reinforcing in their impact. And it provides a holistic view on how targeted efforts in a specific set of policy areas can be leveraged to create a maximum combined effort. It does not purport that reform in any individual policy area alone is sufficient, nor does it argue that everything needs to change at once.

- Insufficient focus on implementation; external advisors, especially if they come from an academic institution, are naturally focused on the analytical task of identifying what is wrong or not optimal. They then identify targets for what a better situation would look like. But they are usually much less focused on (or trained) to understand how to achieve these targets. And they also usually are not experts in understanding why these steps have not been taken in the past.

This report provides some initial thoughts on how an implementation strategy might look like. The remainder of this chapter discusses first how the action recommendations developed above can be sequenced to increase the odds of their success. It then provides some thoughts about an institutional structure to govern the implementation. These recommendations are not a full implementation plan, nor are they based on a detailed analysis of the political economy of reform in Vietnam. This would be far beyond the scope of this report. But it takes the concerns about implementation serious and aims to provide a useful starting point for Vietnamese decision makers to address them.

Finally, Vietnamese policy makers have sometimes be skeptical about the motives of external advisors that they see more beholden to the institutional interests of their organizations than to Vietnam. This report has been prepared in collaboration of a Vietnamese and a Singaporean research institutions as a neutral partnership with no other interest than to achieve maximum impact for Vietnam by providing decision-relevant data, assessment, conceptual frameworks, and action ideas. Any remaining bias is related to the subjective views of the individual researchers, and not a consequence of institutional interests.

Sequencing of activities

The sequencing of activities in a competitiveness agenda is a crucial task and not just a matter of technicality. First, governments cannot upgrade all dimensions of competitiveness in parallel. This overstretches their ability to achieve change and results in most cases in failure. This challenge is even more acute when, as is the case in Vietnam, an economy needs to transition from one set of competitive advantages and policies to the next level. Second, the impact of individual reforms often depends on other policy steps taken in parallel or even before. Without the right sequencing, results will take much longer to materialize. In the meantime, the political willingness to pursue reforms can wane if there are no positive results to point towards. Getting the sequence of reforms right is thus a critical dimension of a sustainable competitiveness agenda.

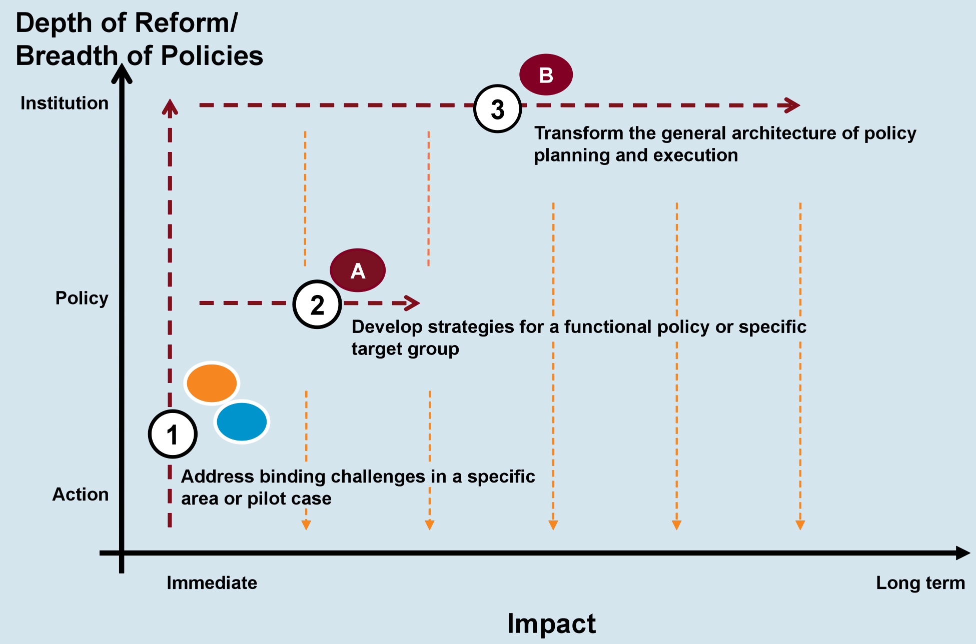
For Vietnam, we suggest an evolutionary reform process. Changes in competitiveness will initially be driven by narrow activities in well-defined pilot cases. Over time, these new solutions will then be rolled-out nationally and across a broader set of policy areas. In the last stage, the institutional architecture of policy making will be upgraded.

The only exception to this bottom-up approach is the set of activities needed to defuse the increasing risk of macroeconomic imbalances. Here an effective response will require changes at all levels – individual measures, changes in policy, reform of institutional structures – within a relatively short time frame.

There are two main reasons for taking a bottom-up approach to the overall competitiveness strategy. First, in the absence of a 'clear and present danger' to Vietnamese prosperity, it is hard to mobilize support for a wide-ranging reform agenda. Reforms are more likely to happen if the positive results of changes at a lower level can over time create the motivation to attempt changes on the next higher level, where the resistance to change will be higher. Second, given Vietnam's overall profile and political structure, a competitiveness strategy will have to convince decision makers across many different parts and levels of governments. A top-down strategy process by fiat is unlikely to be effective in such an environment. A gradual process has a better chance of over time winning support and alignment.

A bottom-up approach also has disadvantages. A national strategy in terms of a set of specific competitive advantages to position Vietnam in the global economy cannot emerge bottom-up; it requires a top-down decision that then provides guidance to the many individual policy decisions that have to be made. The recommendations in this report by-pass the lack of such an overarching national strategy. The actions suggested are consistent with a broad range of more specific strategies that seem most likely to be options for Vietnam. A national strategy process can follow once the actions suggested here have successfully come under way.

Implementation Strategy: Actions

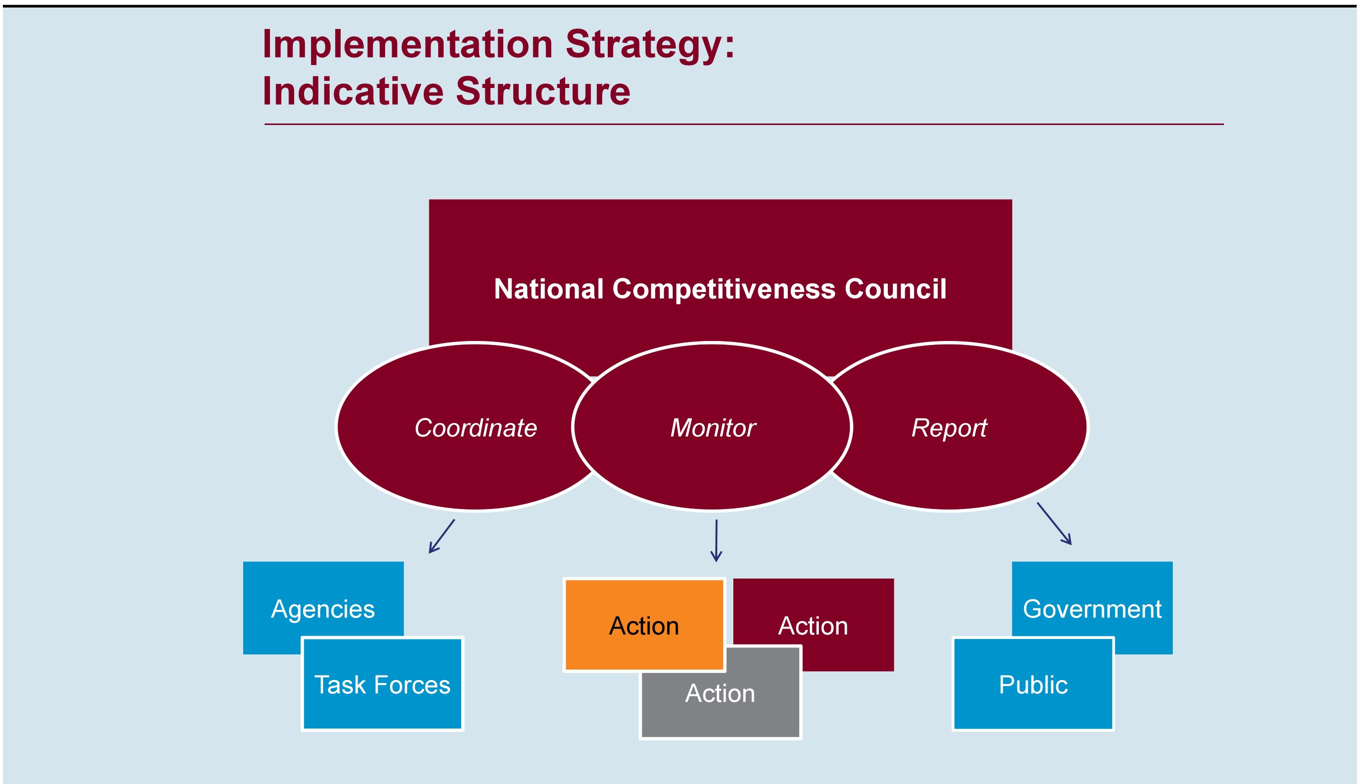


Management of the competitiveness agenda

Competitiveness upgrading is a multi-faceted, cross-sectoral process that requires coordinated efforts across different policy areas and levels of government. In many dimensions, especially in the design and implementation of microeconomic reforms, it also requires engagement with different stakeholders from outside of government. Progress on implementing the competitiveness agenda requires the assignment of clear responsibilities at two levels. First, for each specific initiative there needs to be an institution or group in charge of driving the process. Second, there needs to be an overarching structure that can manage the portfolio of activities, ensuring that the most critical efforts are being undertaken and mobilizing new efforts at the appropriate time.

Over the last few years, national competitiveness councils have been launched in many countries to deal with these challenges. Competitiveness councils differ in their mandate and in their organizational structure. Most of these councils have been charged with developing action proposals that are then submitted to government. They have a membership of public and private representatives and tend to be chaired by either a high-ranking official or by a cooperation of public and private sector leaders[10]. These councils are usually supported by a small secretariat that facilitates operations, sources analysis from government agencies and outside researchers, and integrates the findings into reports and draft action proposals.

Councils that follow this general model exist in, for example, Croatia, Egypt, Peru, and Sweden[11]. While councils of this type often have been useful in raising the quality of the national debate on competitiveness issues, their overall impact on policy tend to be limited. Other countries have implemented structures that connect their competitiveness councils more directly with the policy process. This has been achieved through a direct or indirect connection of the council with the highest level of government, or through the integration of the Council into the administrative structure. Korea has through its Presidential Council of National Competitiveness (PCNC) created a structure that reports directly to the President. This has given the Council much more political relevance and a direct entry point into the policy process. PCNC is also charged with reviewing progress on initiatives launched as a consequence of its recommendations. The National Competitiveness Council in the Philippines has also a direct link to the Presidency, but is less directly integrated in the policy design and implementation process. Conversely, the Council of National Competitiveness (CNC) in the Dominican Republic has been explicitly designed in order to oversee the country's National Competitiveness Program. Denmark's Globalization Council and Finland's Science and Technology Policy Council (renamed Research and Innovation Council in January 2009) are both chaired by their country's Prime Ministers and include all relevant ministers, alongside representatives from business, academia, and trade unions. In both countries, the Cabinet members in the councils use these fora to discuss and design policies that are then directly turned into draft laws. The Irish National Competitiveness Council is integrated into the administrative structure of the government, but also includes members from outside the public sector. It is tasked with providing the government with objective data, analysis, and advice on competitiveness issues. Singapore's more ad-hoc process of competitiveness



assessments, most recently through the Economic Strategies Committee, follows a similar approach.

Based on this international experience, Vietnam needs to choose a structure that is most aligned with its specific economic policy needs and the realities of its political process. Our analysis in this report identifies a number of key needs: Vietnam needs to improve the quality of its dialogue about policies in the design phase; Vietnam needs to make individual policy choices based on a strategic perspective on where the country wants to go, and what is critical to get there; and Vietnam needs to systematically integrate policy planning with implementation and follow-up.

We suggest creating a Vietnamese National Competitiveness Council to assume this role.

Mandate:

The Vietnamese Competitiveness Council should focus on three main tasks:

- Coordinate across the government agencies and public-private project groups that are engaged in specific activities that are launched in the context of the competitiveness agenda. While the Council would not need to control significant own budgetary resources, it should help to mobilize the necessary funds and capabilities when needed. The members of the Council would also provide mentoring and guidance to the individual project groups.

- Monitor progress on individual activities and the overall portfolio of activities. The Council should discuss where projects should be realigned, discontinued, or where new activities should be encouraged. This would require the Council to have robust competences to request information from government ministries and agencies. It would also require a solid internal monitoring capacity within the Council or its secretariat, potentially in collaboration with other government agencies in charge of auditing, policy analysis, and budget management.

- Report to the Party, the Government, and the general public on the progress of the competitiveness agenda. This would include regular updates, reviews, assessments as well as public events, including an annual Vietnamese Competitiveness Conference and dissemination of annual (or bi-annual) Vietnam Competitiveness Report.

Structure and Operational Mechanism:

To perform these tasks, the Council should be comprised of leading government and business leaders, including leaders of the Vietnamese operations of foreign companies. Given the complexity and comprehensiveness of the Council's mission, it is essential for the Council to be led by the top leader(s) of the government. We propose that the Council to be chaired by the Prime Minister, and be comprised of working groups of members interested in specific parts of the overall competitiveness agenda.

The Council would be supported by a full-time secretariat with the resources to draw on competent experts and practitioners in different policy areas as needed. The secretariat operates independently from governmental agencies but has direct link to the government leaders. It should have its own budget. The Council should collaborate closely with the Prime Minister's Policy Unit.

As a first step, the government of Vietnam could create a steering group to manage the pilot projects emerging out of the Vietnam Competitiveness Report. This group could be composed of high-level officials from the relevant ministries as well as representatives from companies and other institutions involved in the projects. The group could, for example, report to a Deputy Prime Minister, who would assign the responsibility for providing secretarial support to the group. This steering group could provide initial experience with the public-private, cross-agency format. It could become the nucleus for a Competitiveness Council with broader mandate and membership.

Conclusion

Vietnam's dynamic growth since the mid-1980s has been one of the most impressive success stories in the global economy and has transformed the livelihoods of millions of Vietnamese people. Growth has been fueled by the transition to a market economy, integration with the global system and a structural shift from subsistence agriculture to manufacturing and services. More recently, the policy response has been focusing on capital investment to maintain growth momentums. These drivers have enabled underlying competitiveness, essentially the presence of low-cost labor, to be revealed.

However, this growth trajectory ultimately has limited potential hurdled by the low level of productivity and structural imbalances facing the economy. Vietnam will need to move beyond the current model if it does not want to get stuck at lower middle income level and face stiffer competition from newly emerging economies. This will essentially require Vietnam to put competitiveness and productivity at the core of its growth. Vietnam will need to constantly upgrade existing competitiveness fundamentals and create new advantages to move up to the new stage of development.

There is currently a widely shared consensus and willingness among different stakeholder groups in Vietnam to bring these issues into serious discussion and follow up with decisive actions. The Vietnam Competitiveness Report was developed with the hope to provide comprehensive fact-based analyses and concrete action proposals to inform such an important discussion. It is unrealistic to expect that the Report could offer a panacea that could quickly remedy all the outstanding issues and challenges. The success of enhancing competitiveness will ultimately depend on the determination and efforts of the Vietnamese government, business community and the public. Yet our ambition is to provide a widely accepted foundation for policy debate and the follow-up action agenda. This is the first in its series of periodical National Competitiveness Reports for Vietnam and we intend to pursue our commitment to supporting Vietnam in this important endeavor over the course ahead.

Endnotes

[1]Vietnam's total public debt by the end of 2009 was about 44.7% of GDP (Ministry of Finance). Public debt per head rose nearly four times, from US$ 144 to US$ 548, during the 2001 – 2009 period, or 18% annually, while GDP per capita growth was only 6% during the same period (EIU).

[2]The foreign exchange reserves fell sharply from 4.6 months of imports by the end of 2007 to less than 3.0 months of imports by the end of 2009 (IMF, International Financial Statistics).

[3]Vietnam has the highest fiscal revenue as a percentage of the GDP during the 2004 – 2009 period vis-à-vis its comparators in the region (averaging 26.8%) – EIU.

[4]More information on Project 30 can be found at http://thutuchanhchinh.vn.

[5]For a more detailed discussion on the implications of the "impossible trinity" to Vietnam's fiscal and monetary policy, see Harvard/FETP (2008a, b).

[6]Important aspects of Vietnam's macroeconomic management have been discussed elsewhere. For comments on the transparency and coordination of macroeconomic policy, see Harvard/Fulbright (2008b) and IMF (2009); for the discussion of the SBV's independence, see Vu Thanh Tu Anh (2010c); for an examination of the SBV's supervision and oversight of financial institutions, see Rosengard et al (2010).

[7]See European Cluster Observatory, http://www.clusterobservatory.eu/.

[8]See Professor Porter's competitiveness course, www.isc.hbs.edu/moc.

[9]See http://www.oecd.org/department/0,3355,en_2649_34413_1_1_1_1_1,00.html.

[10]Exceptions at the Council of Competitiveness in the US and the Private Council of Competitiveness in Colombia. Both are private sector only and perceive themselves as discussion partners for the government.

[11]The Swedish Globalization Council was operational between 2007 and 2009, when it ended its operation with the presentation of its final report. See http://www.sweden.gov.se/sb/d/9299/a/84844 (accessed October 13, 2010).

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