Vietnam
Competitiveness
Report

2010

Executive Summary

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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.