



HARVARD Kennedy School

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## **A Strategic Analysis of the Strengths, Weaknesses, Opportunities, and Threats Confronting Vietnam**

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### **Introduction**

Barring further unforeseen shocks, Vietnam and the world economy have seen the worst of the 2008-09 recession. Many countries are now adjusting policies to withdraw stimulus measures as self-sustaining growth closer to normal levels re-emerges. As global markets stabilize, Vietnam's exports should eventually start to grow again and inward investment will regain some of its earlier momentum. Smaller fiscal deficits and tighter monetary policy will be used to avoid large trade deficits, asset bubbles and inflation. As "emergency" macro-management issues recede, Vietnam can once again focus attention on the country's long-run development strategy.

There are other good reasons to shift away from immediate tactical concerns and towards the country's strategic development framework. The next party congress expected in 2011 will approve a ten year development strategy and a five year plan. These documents will guide Vietnam's socio-economic policy during the period when the country is expected to consolidate its middle income country status. At the same time, Vietnam will need to implement the country's World Trade Organization commitments, which will reduce the scope for protection of strategic industries such as telecommunications, distribution and retail from foreign competition.

This paper identifies some of the key strategic issues facing Vietnam as the country enters a period of reflection on its development strategy in 2010. In certain respects it builds upon an earlier policy study, *Choosing Success: The Lessons of East and Southeast Asia and Vietnam's Future*, a paper that was written at the request of the Vietnamese government and presented to the Prime Minister in January 2008. The present document is structured as a "SWOT" analysis, setting out the country's strengths, weaknesses, opportunities and threats over the medium to long period. While significant attention is devoted to economic policy, it also addresses other aspects of public policy that influence development outcomes including governance and social policy. Our analysis relies solely on publicly available information; our comments on matters of policy and politics is informed by the vibrant public discourse in the Vietnamese press. Rather than itemize all of the challenges and opportunities facing Vietnam, we have

emphasized issues that we believe deserve special attention. *The purpose of this paper is to provide a framework for a series of policy discussions to be held at the Vietnam Policy Update 2010 Program, and as such it is not a policy analysis paper and it is not intended for wider distribution.*

The subsequent analysis is summarized in the matrix in Appendix 1.

## **PART I. STRENGTHS**

We believe that Vietnam possesses the capacity to achieve and sustain a high level of economic growth for many years into the future. Vietnam enjoys a number of strengths not shared by its competitors in the region or elsewhere. Capitalizing on these strengths—and taking advantage of the opportunities identified in part three—will require that the Vietnamese state become much more effective than it has been to date.

### ***Political and Social Stability***

Vietnam is a politically stable country in which most people—Vietnamese and foreigners alike—feel physically safe and secure.<sup>1</sup> This gives Vietnam an advantage over some neighboring countries that are struggling with the problems of political violence or high levels of criminality.

### ***Favorable geographic situation and international linkages***

Another important strength is Vietnam's favorable geographic position alongside some of the world's busiest sea lanes and close to the region's major industrialized countries. The country's economy has grown in response to opportunities presented by domestic and international trade, and the natural endowments of the Mekong and Red River Deltas. As a result, most of the population lives near the coast, a major river, or both. As discussed below, Vietnam's geography can potentially boost the country's competitiveness by efforts to lower transport costs and transport times. The geography also simplifies the provision of power and telecommunications to most areas, as it can focus on the axis of the major north-south highway. Compared to nations consisting of hundreds or thousands of islands, such as Indonesia or the Philippines, infrastructure provision should be cheaper and easier in Vietnam.

Vietnam is geographically and culturally close to major investors from China, Korea, Taiwan, Japan and Singapore. At least some of these economies are likely to emerge quickly from the current global recession. They will look to Vietnam as an investment destination and export platform, and as a source of raw materials and semi-finished manufactures. Partly because of geography and cultural heritage, Vietnamese people are open to trade, inward investment and new ideas from abroad. This openness to the outside world is also evident in the rapid growth of internet usage in Vietnam.

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<sup>1</sup> The 2008 World Bank's Governance indicators place Vietnam in the top half of safe and stable nations while others are mostly in the bottom quarter of all nations.

Vietnam also benefits from a large diaspora. The community of overseas Vietnamese, likely to number more than three million, has long provided Vietnam with foreign exchange and investment through remittances. As a source of skilled human capital, however, the overseas Vietnamese community represents a largely untapped resource.

### ***Multilateral foreign policy***

Vietnam's foreign policy is also conducive to building international economic relationships. The country has pursued a consistent policy of multilateralism through membership in the United Nations, World Bank, International Monetary Fund and other world bodies. Vietnam's performance as a nonpermanent member of the United Nations Security Council has been widely praised as constructive and responsible and is a credit to the country's talented and dedicated diplomatic corps. At the same time, Vietnam has taken on more responsibility within regional groupings such as the Association of Southeast Asian Nations (ASEAN) and APEC and has worked to expand bilateral relationships. In the third section we consider how Vietnam can build upon this strength.

### ***Favorable demographic structure***

Vietnam has a population of nearly 90 million people, half of whom are under the age of 25. Literacy rates are high. Vietnamese workers are appreciated for their willingness to work hard and ability to learn quickly. Multinational companies report that training times in Vietnam are shorter than in many competing countries. While critical skill shortages are an obstacle for some higher value-added investments, the youth, mobility and strong basic skills of the workers make Vietnam an attractive destination for many investors.

### ***High-level of domestic and foreign resource mobilization***

Vietnam has enjoyed considerable success in mobilizing resources for development, including foreign portfolio investment, overseas development assistance (ODA), and domestic revenue. In particular, Vietnam has attracted high levels of foreign direct investment (FDI). Vietnam's stock of FDI was 56% of GDP in 2007, with half of that in manufacturing. This put it well above neighboring economies in terms of relative total FDI and fairly high even on an absolute per capita basis, as shown in Table 1.

**Table 1. FDI Stocks in 2007 in Selected Asian Nations<sup>2</sup>**

Country	FDI/	FDI	Manufacturing FDI/	Per Capita (rank)
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<sup>2</sup> FDI stocks are taken from the UNCTAD database. GDP and population is taken from *2009 World Development Indicators*. The share of manufacturing to total FDI is estimated from various sources. China's FDI includes an unknown fraction of "round tripping," in which domestic investment funds are sent to Hong Kong and then re-enter China as FDI. This could have been as high as 50% prior to 2008 when regulations were changed. India's FDI data exclude reinvested profits by subsidiaries and some other items.

	<b>GDP</b>	<b>Per Capita</b>	<b>Total FDI (%)</b>	<b>Manufacturing FDI</b>
<b>Vietnam</b>	<b>56%</b>	<b>\$ 473</b>	<b>52%</b>	<b>\$245 (3)</b>
Malaysia	41%	\$2840	60%	\$1704 (1)
Thailand	35%	\$1340	35%	\$469 (2)
Indonesia	14%	\$ 260	34%	\$88 (5)
Philippines	13%	\$ 216	27%	\$58 (6)
China*	10%	\$ 248	60%	\$149 (4)
India	7%	\$ 68	25%	\$17 (7)

This table suggests that if Vietnam continues to build on its success in attracting FDI, especially FDI oriented towards efficient manufacturing, it would more nearly emulate the industrial trajectory of the fast growing “dragons” of Taiwan and South Korea. (It is true that these two did not much use FDI, but they did rapidly increase manufactured exports.) By absorbing its growing labor force in factories producing these exports as Taiwan and Korea did, and by taking workers out of low-productivity agriculture and petty services, rapid growth can be sustained for decades. Of course, many modern services in trade, transport, finance, law and marketing also grow up around manufactured exports.

Past successes in export growth from both domestic and foreign producers have already made Vietnam a significant source of some raw materials and labor-intensive exports. Total exports have soared from \$4 billion in 1994 to over \$60 billion in 2008. Vietnam is now a major exporter of rice, coffee and seafood and a significant player in garments, shoes, electronics and furniture. Oil and coal exports also play a minor but still multi-billion dollar role. To have exports equal to two-thirds of GDP indicates that a large portion of the economy is already able to compete in global markets. Past decisions to enter into the WTO, AFTA and other bilateral and multilateral trade pacts have made this growth possible. Further substantial growth should be possible since manufactured imports by rich nations amount to over \$7000 billion and Vietnam’s \$40 billion of manufactured exports could grow rapidly by taking market share, even in a slow growth environment.

### ***Dynamic agricultural sector***

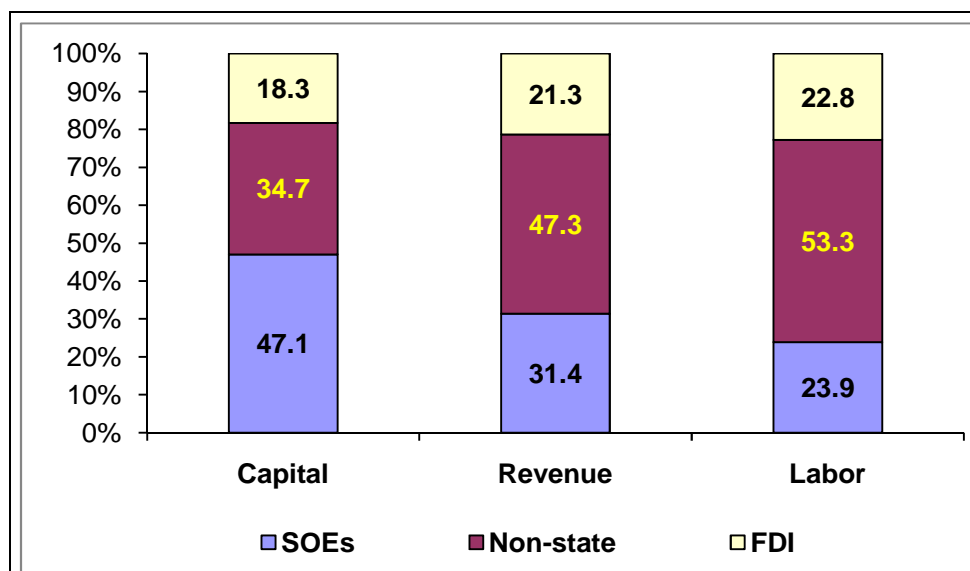
One of the lessons from Vietnam’s economic success over the past two decades is that agricultural growth is important even as agriculture’s share of GDP declines during the process of industrial development. Real growth of agricultural output averaged nearly four percent per annum for the period 1990-2007. Although industry grew at an average rate of more than ten percent over the same period, agricultural growth performed a vital role during the reform period. A dynamic agricultural sector created millions of jobs and raised incomes in the rural sector, creating a market for domestically produced goods and savings for domestic investment. Vietnam went from a food importing country to a major exporter of rice, coffee, tea, pepper, cacao, rubber, cashew and a range of other crops. Fish and shellfish are now among the country’s largest export earners. Taken together, agricultural exports increased nine-fold in the fifteen year period after 1990, earning precious foreign exchange needed to import technology, capital goods and intermediates

to build the industrial sector. As we discuss in section three, much more can be done both to increase the value of agricultural exports and the profits enjoyed by farmers.

### ***Sharp reduction in poverty***

Success in agriculture and labor intensive industries is the main factor behind the sharp fall in recorded poverty in Vietnam since 1993. Government policy has supported poverty reduction through trade and investment liberalization efforts and infrastructure including irrigation and drainage and rural roads. Private businesses have also generated millions of jobs since private enterprise was legalized under the 1992 Constitution and subsequent versions of the Enterprise Law. The emergence of the domestic private sector as a generator of employment has been an important driver of poverty reduction. Figure 1 shows that, despite disadvantages in access to capital, the domestic private sector accounts for the largest share of employment in Vietnam today.

**Figure 1. Capital, revenue, and labor shares of state, non-state and FDI sectors in 2008**



Source: General Statistics Office (2009)

As important as poverty reduction is, it is also necessary to improve the lives of those who are already above the poverty line. This has been done in part by strategic investments and sound policies in certain key areas of infrastructure. Electricity production has doubled every five or six years since the early 1990's and power has been widely extended, even to remote regions. Prices are close to levels needed to maintain growth. Telecommunication and internet policy has allowed for competition and resulted in very rapid growth in public use, helped by reasonable but not subsidized prices. This kind of provision of critical infrastructure allows for faster growth in middle-class groups while also providing many opportunities for the poor. It sets Vietnam apart from some of its neighbors who have failed to invest adequately or whose policies have effectively stifled growth in these critical supports to economic growth.

## PART II. WEAKNESSES

The Vietnamese government's oft-stated goal is to achieve a high level of economic and social development. It follows that all government policies should be evaluated based on whether they advance or hinder the attainment of these objectives. This section presents critical, policy-induced disadvantages that Vietnam must overcome if the country is to make full use of the strengths described in the previous section.

### ***Endemic lack of transparency***

The most serious weakness facing Vietnam is the absence of transparency and accountability in the public sector, including state owned enterprises. The role of the government is to maintain security and law and order, to produce public goods, to reduce some negative outcomes associated with market activity (like pollution), to encourage socially productive activities like private spending on education, and to maintain a socially acceptable income distribution. With the exception of national security, none of these functions requires secrecy and all, including security and law and order, are performed better when government agencies are held accountable for their actions.

Public information on the economic activities of government agencies and companies is severely limited. The absence of reliable information reduces accountability and creates opportunities for corrupt or otherwise unproductive behavior. For example, we know of no state-owned general corporations or economic groups that make independent audits of their activities available to the public in any form. This is a violation of the most basic principles of corporate governance. It also makes it impossible for the appropriate authorities, such as the Ministry of Finance and the National Assembly, to fulfill their legal obligation to exercise oversight over these important state institutions. An excellent example of what happens when firms are not subject to effective regulatory oversight is the recently exposed activities of the state-owned food company Vinafood 2. While the extent of the company's malfeasance is not yet known, it is clear that the company has advanced its own interests at the expense of Vietnamese farmers and consumers. Notably, it was a Vietnamese newspaper, not a government watchdog, that uncovered this case.<sup>3</sup>

### ***Continued favoritism of inefficient state sector***

The failure of public sector accountability mechanisms results in poor performance. What is most worrying is that the problem appears to be getting worse at an alarming rate. According to the government's Enterprise Surveys, from 2000 to 2004 sales growth in the central-state sector was nearly the same as the rate of capital growth. The sector also recorded modest job gains. Things changed from 2004 to 2007: the state sector had negative job growth and much slower sales growth than other sectors, *but absorbed over*

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<sup>3</sup> See a series of articles about Vinafood in *Tiền Phong* newspaper available at: <http://www.tienphong.vn/Tianyon/Index.aspx?ArticleID=173527&ChannelID=3>. Accessed on October 18, 2009.

*half of the growth in capital* (Table 2). Given that labor force growth plus transfers out of agriculture amount to about 1.5 million people per year, the decision to put so much capital into a sector that is shedding jobs and producing less output per worker and per unit of investment makes little economic sense. It is certainly not in the interests of Vietnamese workers, who benefit most from the creation of stable, productive and therefore well-paying jobs. If the government persists in putting capital into enterprises that are really making losses, they will slow down growth of output and jobs, increase debt and diminish competitiveness, pushing the state's ambitious development goals ever further away.

Nearly a decade ago Vietnam's leadership stated the primary objective of turning Vietnam into a "modern-oriented industrialized country" by the year 2020.<sup>4</sup> There is no widely accepted theoretical definition for modern-oriented industrial economy. Quantitatively, based on international experience, a modern-oriented industrial economy can be defined as one where manufacturing value added (MVA) per capita is at least US\$2,000. South Korea reached this level in the early 1990s. China today is not even halfway to that level but Vietnam in 2007 had only US\$ 172 per capita of MVA. This implies that for Vietnam to approach modern-oriented industrial status by the year 2020, its MVA in real terms would have to grow at nearly 30% per year over the next 11 years, or it will take Vietnam another 20 years to reach the US\$ 2,000 MVA per capita level if the currently high MVA growth rate can be maintained.

There is perhaps no better example of the waste and inefficiency of the state's industrialization strategy than Vinashin, the national shipbuilding company. Over the past five years the state has lavished resources on Vinashin but thus far the company has proven that it lacks basic competence in its core business.<sup>5</sup> Vinashin's latest financial reports show a low net interest cost of only 1.5% of debt. If the group was forced to pay even the below market rate of 5% a year on its debt, it would be making large losses.<sup>6</sup> Recently, for the very first time, Vinashin publicly admit that it faces financial difficulty.<sup>7</sup> The government immediately came to the rescue with a large amount of subsidy taken from the US\$ 500 million loan offered by the ADB to Vietnam's government to overcome the global economic crisis and help sustain longer-term growth. Evidence of industrial development around the world proves that competition and hard budget

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<sup>4</sup> This objective was indeed mentioned for the first time during the 8th Party Congress (1996). The objective said, by 2020, Vietnam would become "*an industrial country which has modern material and technological foundation, appropriate economic structure, advanced production relations suitable to the development standard of the productive forces, better-off material and spiritual life, solid defense and security, wealthy people, strong country, equitable and civilized society*"

<sup>5</sup> See "What's Happening at Vinashin?" in *Sài Gòn Tiếp Thị*. Available at: <http://www.sgtt.com.vn/Detail23.aspx?ColumnId=23&newsid=58087&fld=HTMG/2009/1011/58087>. Accessed on October 18, 2009. Or "Vinashin: A ship under construction forever," in *Tuổi Trẻ*. Available at: <http://www.tuoiitre.com.vn/Tianyon/Index.aspx?ArticleID=342104&ChannelID=11>. Accessed on October 18, 2009.

<sup>6</sup> See "Vietnam Shipbuilding Industry Group: financial statements for the year ended 31 December 2008," KPMG.

<sup>7</sup> See "General Director of Investment at Vinashin: 'If we borrow we must repay'" in *Tuổi Trẻ*. Available at <http://www.tuoiitre.com.vn/Tianyon/Index.aspx?ArticleID=342649&ChannelID=11>. Accessed on October 19, 2009.



constraint are essential for any successful development effort; unfortunately it seems that Vietnam is moving in the opposite direction. Equally fundamental, Vinashin (as well as many other state corporations) has used access to state resources to build a typical Southeast Asian horizontally diversified and highly leveraged conglomerate—a model that has proved to be highly vulnerable to financial shocks. According to the KPMG audit, Vinashin's debt/equity ratio in 2008 is 12, nearly triple the debt/equity ratio of an average Korean chaebol before the 1997 financial crisis. Meanwhile, Vinashin has used its access to capital and state land to establish at least 445 subsidiaries in businesses ranging from finance to winemaking. As a result, it is hardly possible for Vinashin to have an effective internal control system, and also for supervisory organizations to effectively put a check on the company activities.<sup>8</sup>

**Table 2. Sales, Investment and Employment in the State Sector 2000-2007**

	Trillion Dong or Thousand Workers			Annual Growth Rate	
	2000	2004	2007	2000-2004	2004-2007
<b>Sales:</b>					
Central-State	317	533	876	13.9%	18.0%
Other	493	1187	2584	24.6%	29.6%
Total	810	1720	3460	20.7%	26.2%
Central/Total	39%	31%	25%		
<b>Fixed Assets:</b>					
Central-State	186	283	796	11.1%	<b>41.1%(!)</b>
Other	226	669	1086	31.1%	17.5%
Total	412	952	1882	23.3%	25.5%
Central/Total	45%	30%	42%		
<b>Number of Employees:</b>					
State-Central	1301	1518	1299	3.9%	-5.1%
Other	2236	4253	6083	17.4%	12.7%
Total	3537	5771	7382	13.0%	8.6%
Central/Total	37%	26%	18%		

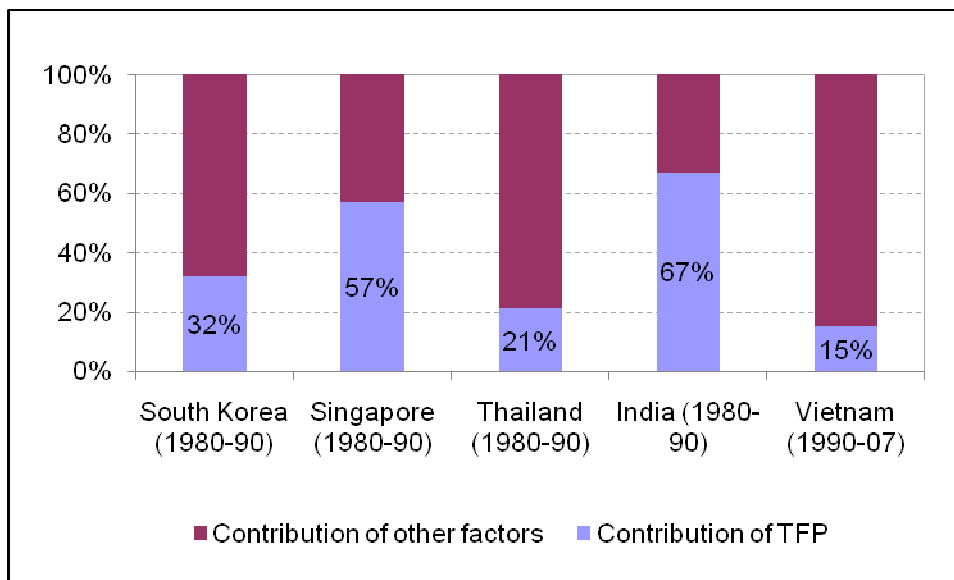
Source: Enterprise Surveys, various years, General Statistics Office

<sup>8</sup> The policy of investing heavily in state conglomerates sometimes explained as an effort to guarantee Vietnam's sovereignty and "economic independence." However, if firms such as Vinashin can only operate with massive subsidies while accumulating large debts, it is difficult to see how they further these objectives. In September it was announced that the Export-Import Bank of China was offering soft loans to Vinashin and Vinacomin. See "Chinese bank to fund shipyard expansion, power plant." In *Thanh Niên*. Available at <http://www.thanhniennews.com/business/?catid=2&newsid=52538>. Accessed on October 18, 2009.



There are three basic sources for total output of an economy to grow: increases in labor, increases in capital, and increases in the efficiency of these factors. Total Factor Productivity (TFP) measures the efficiency with which labor and capital are used. A modest contribution of TFP to Vietnam's total output implies that at least part of the existing labor and capital resources of the country have not been realized to their fullest potential. Figure 2 compares TFP in Vietnam with other countries at similar levels of development. This can be seen as a current weakness, but also a future opportunity for technological innovations of all kinds.

**Figure 2. Comparison of Total Factor Productivity**



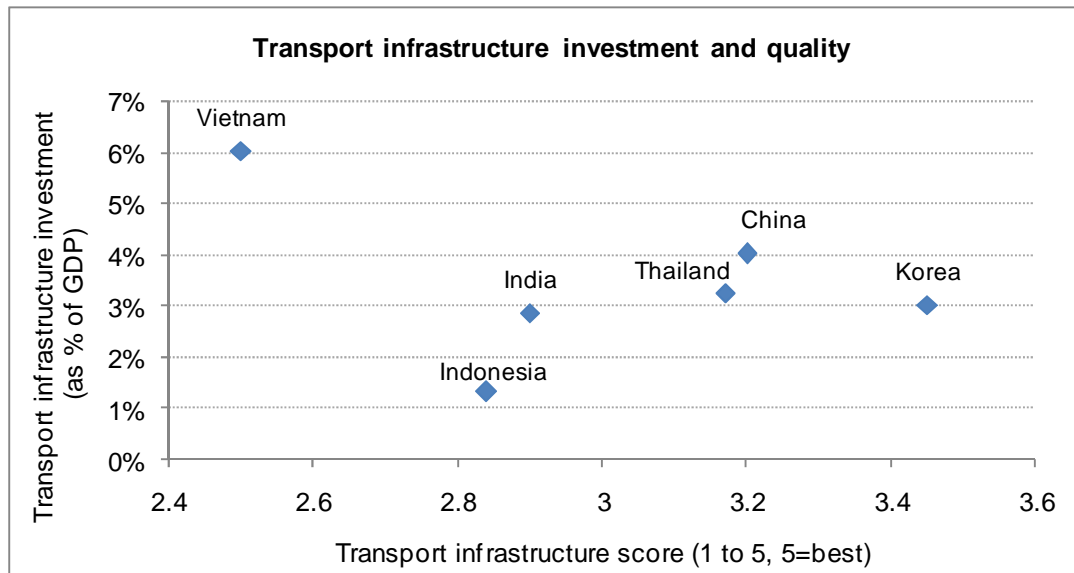
Source: Central Institute for Economic Management, Ministry of Planning and Investment

#### ***Inefficient and ineffective public investment program***

The negative effects of weak accountability mechanisms are also seen in the public investment program. Domestic and foreign investors alike note that despite relatively high rates of public investment, Vietnam's infrastructure is falling behind its major competitors.<sup>9</sup> Figure 3 presents investment to GDP levels in transport infrastructure and independent ratings of the adequacy of infrastructure in recent years. Vietnam invests more of its national income in transport and has worse outcomes than other major Asian economies, including countries with notoriously poor transport infrastructure like India and Indonesia. This in part reflects a process of catching up from years of war and underinvestment under central planning. Yet twenty years into the reform process this explanation is no longer as convincing as it once was.

<sup>9</sup> Government spending in Vietnam averaged 26.4% of GDP over the period 2000-2008, as compared to 18.9% in Thailand, 18.4% in China and 18.8% in Indonesia. In the East Asia region only Malaysia comes close to Vietnamese levels, with public spending equal to 25.6% of GDP.

**Figure 3. Investment and Outcomes in Transport Infrastructure, Selected Asian Countries**



Source: Share of GDP invested in transport is taken from “Trade and Logistics: An East Asian Perspective”, ESCAP, 2006 and uses 2003 data; Transport Infrastructure Index is from the World Bank’s Logistics Performance Index, 2007.

Figure 3 indicates that state management is inefficient and that simply adding more funding to a broken system will not improve outcomes. While the example in the graph is transport infrastructure, the problem applies more widely.

Part of the problem is the inability of the system to prioritize public investment projects on the basis of economic criteria. Although Vietnam still lacks an international standard highway linking the north, center and south of the country, serious consideration is being given to an expensive high-speed rail link. Deep water ports are springing up along the coast at an alarming rate—including an “international transshipment port” in Khanh Hoa that makes no economic sense whatsoever<sup>10</sup>—yet the country’s busiest port is still located in the center of the country’s largest commercial city.<sup>11</sup> Vietnam is planning its third oil

<sup>10</sup> See “Construction of Van Phong Port is About to Start.” Available at <http://vneconomy.vn/20091014110958942P0C10/sap-khoi-cong-cang-van-phong.htm>. Accessed on October 18, 2009.

<sup>11</sup> An important factor in developing port facilities is proximity to economic activity. Van Phong port is far from Vietnam’s primary economic centers. Northern Cambodia, southern Laos, and Northeast Thailand are hardly dynamic economic areas either. The presence of Saigon Port in the middle of Ho Chi Minh City

refinery yet cannot produce enough electricity to power the country's major cities and industries without seasonal rolling blackouts and other interruptions. Similar examples of lack of prioritization are numerous and do not need to be repeated here. Vietnam does not have the luxury of wasting scarce public resources on economically unviable prestige projects and political favors.

### ***Decreasing competitiveness***

The absence of transparency and weak accountability mechanisms in the public sector affect private as well as state-owned businesses. The World Bank's "Doing Business" surveys of regulatory structures and enforcement show that Vietnam falls into the group of low ranked countries that are losing ground against the competition (see Table 3 below). While China and India are unique cases due to their size, the remainder of the countries consists of either reformers (Thailand and Malaysia) or decliners (Vietnam, Indonesia and the Philippines).

**Table 3. Doing Business Rankings in 2008 to 2010: Selected Asian Nations (Best = 1)**

	2008	2009	2010	Change 2008 vs. 2010
Thailand	19	13	12	↑7
Malaysia	25	20	23	↑2
China	90	83	89	↑1
<b>Vietnam</b>	<b>87</b>	<b>92</b>	<b>93</b>	<b>↓6</b>
India	120	122	133	↓13
Indonesia	127	129	122	↓5
Philippines	136	140	144	↓8

Source: World Bank

Vietnam's rankings are particularly low in four areas: protecting investors, paying taxes, employing workers, and closing a business. Lax corporate disclosure rules, inadequate protection of minority shareholders and the absence of rules to hold directors accountable for their actions means that Vietnam ranks lowest in this group in terms of protection of investors. Businesses also report that it takes a remarkable 1,050 hours per year to comply with Vietnam's tax laws. Only three countries *in the world* performed worse on this indicator.<sup>12</sup> The corresponding figure for Malaysia was 145 hours, and for Thailand 264. The amount of time required to complete tax procedures in Vietnam is partly a consequence of overly complicated and inconsistent rules. Uneven enforcement and corruption also increase the amount of time that companies must spend on their taxes.

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increases traffic congestion and pollution, reduces the efficiency of the port, increases loading and unloading times and prevents the city from developing its waterfront as a hub for commerce and tourism.

<sup>12</sup> These countries are Bolivia, Cameroon and Brazil.

Vietnamese regulations also make it difficult to fire workers, mostly because of the large payments owed to workers who are made redundant. While it is important to protect workers from the personal costs of unemployment, the costs of achieving this desirable social objective cannot be entirely shifted to enterprises. Doing so simply makes it more expensive to open new businesses, and therefore reduces the total level of employment. Increasing the costs of doing business is not an adequate substitute for well-designed and comprehensive social policies. The recent establishment of the unemployment insurance program is certainly an important move in the right direction.

Why does the high cost of doing business in Vietnam matter if the country is getting so much FDI? First, Vietnam cannot rely on cheap labor forever. As wages rise, Vietnam will have to compete with forerunners like Thailand and Malaysia. Second, other countries are not standing still. If Thailand resolves its political stalemate it will become more attractive to investors. Investors are already closely watching Indonesia, given the size of the country's workforce and internal market. Third, it is not just the value but also the quality of investment that is relevant to development. A good business environment attracts higher quality investments that generate more domestic value added and are less speculative in nature. In contrast, investors would accept a higher cost of doing business only if they can take advantage of cheap labor, low environmental standard compliance, or easy access to scarce land and natural resources – all of which Vietnam doesn't really want.

#### ***Unstable macroeconomic architecture***

Another major weakness is a tendency towards macroeconomic imbalances leading to persistent bouts of instability. In the last three expansions, including this one, Vietnam has run into either inflationary pressures and/or severe trade deficits. In 1990, after growth had been sparked by early *Doi Moi* reforms, inflation soared to 70% in both 1990 and 1991. In the middle 1990's, after a few years of brisk growth, the trade deficit soared to 18% of GDP and required quantitative controls to reduce it. These controls discouraged investment and resulted in a sharp slowdown in the growth rate. The boom of 2006 to 2007 led to the inflation and asset bubbles of 2008. The global crisis reduced demand and therefore inflationary pressure in the first half of this year, but inflation is now returning as a result of the large fiscal deficit (10.5% of GDP according to ADB<sup>13</sup>) and loose monetary policy. The market expects a devaluation of the Vietnam dong despite massive SBV intervention and a sharp decline in international reserves. The boom-bust cycle that has characterized Vietnam's reform period continues.

Macroeconomic instability imposes high risk premiums on investors, who in turn demand a higher rate of return to justify investments in Vietnam. One negative consequence of high risk premiums is that Vietnam attracts riskier ventures (high risk/high reward) rather than long-term investments that generate more modest returns. Most of the costs of boom-bust cycles fall on the poor, who lose jobs in bad times and who are unable to protect themselves from price inflation in good times.

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<sup>13</sup> Source: "Report and Recommendation of the President to the Board of Directors", ADB Project Number 43315: Proposed Loan to Socialist Republic of Viet Nam: Countercyclical Support, September 2009.

An important cause of macroeconomic instability in Vietnam is the tendency towards pro-cyclical fiscal and monetary policies. During good times, the responsibility of government is to reduce inflationary pressure by balancing public sector budgets and keeping a close eye on credit growth. Vietnam has increased public investment and lending during periods of rapid growth in an attempt to accelerate growth or because planners are unable to resist political pressure for more spending. This breakdown of fiscal and monetary discipline has produced a boom-bust cycle that is exacerbated by the pro-cyclical nature of many kinds of international capital flows.

Macroeconomic imbalances are also attributable to the absence of transparency and accountability in public sector management. It is not at all clear where and how money is spent. Realistic loan loss ratios and foreign currency reserves are not reported. This discourages investors, domestic and foreign, from holding local currency or making long-term investments. Recent moves to crack down on those who report on corruption magnify this problem. A modern economy requires more, not less transparency. In this regard, Vietnam is moving in the wrong direction.

***Lack of internationally competitive firms***

Vietnam lacks competitive domestic firms. This might seem wrong or irrelevant given the rapid growth of exports over the past two decades. Yet much of the export success has either come from foreign firms or from exports of agricultural commodities and raw materials. While both are desirable, it is not the same thing as having domestic firms that grow in capability and sophistication. Some state firms, such as Viettel, have done well in a semi-competitive market. This is hopeful and underlines the need for competition to produce better management. Vinatex has a good reputation as a garment producer but has not moved upstream into textiles and thus remains a low-skill and lower-tier contractor to others. Vietnam will continue to run up huge trade deficits when exports and growth accelerate unless Vietnamese manufacturers can capture more value added within the country and move up the production value chain. The reasons for this lack of capable domestic firms needs to be understood and remedied.

In theory, there is no barrier to the emergence of competitive state-owned firms. China has succeeded in forcing some of its state firms to be globally competitive, but it has done so by adopting very different policies than Vietnam. First, virtually all SOEs in China faced stiff competition, both among themselves and with foreign firms. With the partial exception of the petroleum sector, there were few national monopolies either in the consumer goods or the producer goods sectors. By contrast, in Vietnam sectors such as power generation, mineral extraction, and aviation are dominated by single firms. Second, China encouraged its state firms to compete with foreign firms in the Chinese market. Beginning in the 1990s, foreign and private construction firms were allowed to bid against state firms for publicly funded infrastructure projects. The pressure of competition forced firms to improve their management systems and upgrade their technical capacity. By contrast, the construction sector in Vietnam has been characterized by collusion, not competition, with state firms largely shielded from international

competition. The result is long delays in project implementation, limited technical capacity, and low quality of work.

Many large private firms in Vietnam exhibit behavior that is little different from state firms. They too depend on privileged access to resources such as land. Export oriented firms are important because they introduce international standards of quality and performance into the domestic market. Even with government subsidies, export-oriented firms would fail if they could not acquire up to date technologies and reliably deliver products of the highest quality. *Vietnam must therefore attach the highest possible priority to removing barriers to the development of these firms.*

#### ***Weak, ineffective business associations***

Vibrant and effective business associations are a common feature of the region's most successful economies. In economies such as Taiwan's, business associations have enabled small private firms to become globally competitive by generating information about export markets, providing marketing services, and supporting research and development. Vietnam's dynamic but small companies would be much more competitive if they were served by business associations that acted in their interest. To date, however, business associations are effectively state agencies and are dominated by state-owned firms. An excellent example of the ineffectiveness of Vietnamese business associations is the Vietnam Food Association, the leadership of which is drawn from the ranks of the largest state-owned food corporation.<sup>14</sup> Similarly, the leadership of the Vietnam Chamber of Commerce and Industry (VCCI) as well as of most sectoral business associations is dominated by representatives of the state-owned sector. Private processors and exporters, meanwhile, lack even basic knowledge of foreign customers, putting them at a distinct disadvantage to their competitors in, for example, Thailand.

#### ***Reliance on natural resource exploitation***

Vietnam's natural resource endowments include deposits of oil, natural gas, minerals, and timber. These resources must be carefully managed to derive maximum benefit for society while minimizing the risks of environmental degradation. Oil provides the largest share of state revenue. Proven reserves are insufficient to guarantee revenue flows at current levels, and assuming that new reserves will be discovered is a risky strategy. The absence of accountability and transparency in the state sector has meant that the exploitation of the nation's mineral wealth has not benefited the Vietnamese people to the fullest extent possible. The press has reported that large amounts of the high value anthracite coal found in Quang Ninh has leaked across the border in illicit trade.<sup>15</sup> Poor enforcement and corruption have led to high-grading, in which unlicensed domestic mining companies skim off the easily reached minerals, leaving behind land and water

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<sup>14</sup>See "Special powers and big profits: Farmers helpless," in *Tiền Phong*. Available at: <http://www.tienphong.vn/Tianyon/Index.aspx?ArticleID=173527&ChannelID=3>. Accessed on October 18, 2009.

<sup>15</sup> See a series of articles in *Tiền Phong* and *Người Lao Động* newspapers on Vinacomin. Available at <http://nld.com.vn/20090904031050696P0C1002/tkv-tiep-tay-cho-trum-than-lau.htm> and <http://www.tienphong.vn/Tianyon/Index.aspx?ArticleID=171120&ChannelID=2>.

pollution and uneconomical mines. Vietnam will not exploit its natural wealth in a way that benefits the people until the government insists on complete public disclosure and accountability in the mining sector.

### ***Education system in crisis***

It is difficult to exaggerate the enormity of the problems afflicting Vietnamese education at all levels. Vietnam has earned justifiable accolades for its high literacy rates and near-universal primary education enrollment. However, the quality of primary and secondary education is difficult to assess. One reason for this is that, unlike Thailand, the Philippines, or Indonesia, Vietnam does not participate in tests used to determine international benchmarks. The data derived from these examinations provide educational policymakers a valuable diagnostic tool for policymakers to identify curricular weaknesses and learn from international experience. There are other causes for concern with the quality of primary and secondary education. For one, outside major urban areas, Vietnamese primary students only attend school for a few hours every day. This pressures teachers to hurry through curricula and leaves little time for classroom learning.

International comparisons become easier at the tertiary level, and here the situation is undeniably bleak: Vietnamese universities lag behind their counterparts in the region in commonly used metrics such as faculty publishing in peer-reviewed journals. Vietnamese and international investors point to a dearth of skilled workers as among the largest barriers they face to expansion. Even in priority sectors such as information technology, Vietnam is not producing enough qualified workers. The difficulties encountered by Intel in staffing its assembly and testing plant in Ho Chi Minh City are well known. Less well known is that in recent years leading technology companies such as Microsoft, Google and Infosys have considered Vietnam as a destination for research and development centers, only to conclude that the human capital is insufficient.

The moribund state of Vietnamese higher education constitutes a mortal threat to the country's future. It is an axiom of economic development that without a sufficient stock of highly skilled labor Vietnam will fail to develop the competitive domestic firms that are critical drivers of prosperity.

### ***Limited science and innovation capacity***

There is a strong correlation between national science capacity and levels of economic and human development. An ability to innovate is an important requisite for the emergence of competitive domestic firms. Science capacity is also important to analyze and address the myriad challenges—in the spheres of health, public safety, and the environment to name a few—that 21<sup>st</sup> century societies must confront. At present Vietnamese science is not capable of providing economic or social benefits.

The distinguished physicist Pham Duy Hien of the Vietnam Agency for Radiation and Nuclear Safety recently conducted a comparative analysis of scientific output in Vietnam and Thailand using publications in peer-reviewed journals as a proxy for scientific



capacity.<sup>16</sup> His findings are alarming. In 2008 Vietnam's entire publication output was less than that of two universities in Bangkok. Dr. Hien found that many publications were primarily the result of research conducted overseas and thus should not be regarded as the result of domestic capacity. Research "made in Vietnam" was concentrated overwhelmingly in a few theoretical fields such as mathematics and theoretical physics. In contrast with Thailand, Vietnam generates very little research in applied areas of economic and social importance such as medicine and agriculture. Vietnam is facing and will face public health threats in the form of pandemic diseases, yet its research capacity in medical sciences is weak. Dr. Hien found that Vietnamese research output was particularly meager in the atmospheric and oceanic sciences, a field that is critical to understanding the impact of climate change and sea-level rise. This is a compelling illustration of the degree to which Vietnamese science is disconnected from the socioeconomic needs to the country.

### ***Ineffective local government***

The quality and effectiveness of local government in Vietnam is extremely weak. In the economic sphere, the ability of local governments to fashion supportive environments for growth is highly uneven. Most local governments appear to confuse public investment with economic development, leading to an obsession with high-profile projects such as sea ports and industrial zones that too often amount to little more than white elephants.<sup>17</sup> Moreover, the conversion of land from agriculture to commercial or industrial uses is a main source of social tension, particularly in the countryside. It's estimated that more than 80% of citizen complaints received by legislature bodies are land-related.<sup>18</sup> In urban areas, while Vietnam faces critical challenges in developing infrastructure and housing to meet the demand for the explosive urbanization, a large area of land is either wasted or held up by state corporations.<sup>19</sup> This, together with poor urban planning and the lack of effective land taxation, has pushed up real estate prices to very high levels, making land less affordable for businesses, households, and public infrastructure development. In the sphere of environment and natural resource conservation, the inability of local governments to oversee the responsible exploitation of minerals (Quang Ninh), forestland (the Central Highlands), titan (central coast), and sand (the Mekong Delta) is well documented.<sup>20</sup> In the sphere of social policy as well, local capacity is limited. Local

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<sup>16</sup> See Pham Duy Hien, "Vietnamese Science Capacity and Higher Education in Comparative Perspective: A survey of publications in international journals." This article is included in VELP background readings.

<sup>17</sup> See "The Hanging of US\$ Billion Projects." Available at <http://diaoc.tuoiitre.com.vn/Tianyon/Index.aspx?ArticleID=318046&ChannelID=204>. Accessed on October 15, 2009

<sup>18</sup> See Pham Duy Nghia, "Countryside and Farmers from the Property Rights Perspectives." Available at <http://www.tiasang.com.vn/Default.aspx?tabid=76&News=26&CategoryID=3>. Accessed on October 15, 2009.

<sup>19</sup> See "The Anguish of Public Land Waste." Available at <http://www.sggp.org.vn/xahoi/2009/7/197807/>. Accessed on October 15, 2009.

<sup>20</sup> On titan, see "Exploitation of Titan in the central coast: To the powerful go the spoils," in *Lao Động* newspaper. Available at: <http://www.tuoiitre.com.vn/tianyon/Index.aspx?ArticleID=193724&ChannelID=3>. Accessed on October 18, 2009. On illegal timber, see "Flooding reveals illegal timber," in *Tuổi Trẻ*. Available at <http://www.tuoiitre.com.vn/Tianyon/Index.aspx?ArticleID=340888&ChannelID=3>. Accessed on October 18, 2009. On sand and gravel exports from the Mekong Delta, see "Exploiting Sand is Out of

healthcare infrastructure has degraded to the point that patients and their families seek to bypass the county-level health facilities in favor of hospitals in urban areas.<sup>21</sup> According to data presented at a recent conference, fewer than half of provinces are capable of conducting the most basic tests on food products, leading to a number of scandals regarding food safety and hygiene.<sup>22</sup>

Compounding the problem of limited capacity is an inability or unwillingness to work together. The lack of coordination in the development of infrastructure exemplifies this pattern. Under the current plan, almost each and every coastal province has a deep sea port and many provinces will have new airports. This is due partly to active engagement of provinces in infrastructure lobbying and partly to the political pressure in reducing the gap between the urban centers and rural areas. On the surface, this seems to be a healthy change of direction. However, the allocation of funds for infrastructure development suffers from two problems. The first is perverse incentive: tax revenue is taken from fast growing provinces like HCMC and its surrounding provinces to be reallocated to provinces that perform poorly in private investment attraction and job creation. The second problem is that expensive infrastructures are then largely under-utilized, therefore requiring subsidies on continual basis. Allowing every coastal province to have an expensive deep sea port while Vietnam desperately needs a port facilities that can accommodate “mother ships” is a wasteful and unproductive investment strategy that will not lead to rapid industrialization. This story is repeated in many other sectors as well.

The present political and administrative structure of the state creates little or no incentive for intraprovincial cooperation. For provinces, the key political relationship is with the center, which is a source of investment, rather than with their neighbors. Given the absence of a meaningful land and property tax, neither the fiscal nor administrative capacity of the provinces is adequate to deal with the challenges they are facing. Moving forward, the need for regional cooperation and coordination will only increase. Many of the threats identified below cannot be addressed by individual provinces. Responding to pandemic diseases and sea level rise, and ecological and hydrological changes wrought by changes to the flow of the Mekong Delta will demand coherent, coordinated policy responses that at present appear impossible.

Could it be that there are too many provinces in Vietnam? Given the complexity of the policy problems Vietnam will confront in the years to come and the lack of skilled technocrats to confront them, it makes little sense to retain the current structure. It is interesting to note that China, with a population of 1.3 billion, has 34 provinces and province equivalents; Vietnam, with a population roughly equal to a Chinese province,

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Control,” in *Tuổi Trẻ*. Available at <http://www.tuoitre.com.vn/Tianyon/Index.aspx?ArticleID=335716&ChannelID=3>. Accessed on October 15, 2009. The government recently announced a moratorium on sand exports from the delta.

<sup>21</sup> See “Patients Bypassing Local-Level Health Facilities, Flooding into Central-Level Hospitals” in *VietnamNet*. Available at <http://www.vietnamnet.vn/xahoi/doi-song/2009/09/869167/>. Accessed on October 15, 2009.

<sup>22</sup> See “Food Safety and Quality Testing: an Alarming Reality” in *Sài Gòn Giải Phóng*. Available at <http://www.sggp.org.vn/ytesuckhoe/2009/8/201085/>. Accessed on October 15, 2009.

has nearly twice as many province equivalents. South Korea is comprised of 9 provinces. The absence of an overly diffuse allocation of power explains in part why China and South Korea have had considerably more success than Vietnam in implementing their development agendas. Indeed, in this respect, Vietnam looks much more like its less successful Southeast Asian neighbors: Thailand (population 60 million) has 75 provinces, the Philippines (population 70 million) has 80.

### **PART III. OPPORTUNITIES**

#### ***Attractiveness as a destination for FDI***

The biggest opportunity has already been identified. Vietnam is well placed to attract larger amounts of more sophisticated and efficiency-seeking FDI. If the country can develop a domestic industrial supplier network to support it, FDI will continue to boost exports, good jobs, and skills. Taking advantage of this would require moving up on the “Doing Business” scale to compete with other nations so as to attract better-quality FDI. It would require fundamental educational reform and much more thoughtful and effective infrastructure investments, along with a more modern financial system to support local supplier firms. Sporadic explosions of credit and fiscal deficits would have to be curtailed. But there is no doubt that Vietnam is on the short list of places to go when investors wish to move beyond a China-only strategy.

#### ***Prospect of reduced transport costs***

A second opportunity is that Vietnam has a favorable geography and *could* make road and rail freight investments so that goods produced at any point along its coast could be transported cheaply to major domestic and international markets. The cheapest way to carry containers on land is by train, and the cheapest way to ship containers by sea is to put them directly on “mother ships” that carry thousands of containers directly to major markets. Only Ho Chi Minh City (really Ba Ria-Vung Tau) and Haiphong have any chance of hosting frequent services of large container ships. The current strategy of investing in high-speed passenger rail and many ocean ports is not cost-effective. Only by studying the physical and financial realities and investing efficiently but aggressively to lower costs will the poor central coastal regions of Vietnam be fully opened up to world trade and manufactured exports.

#### ***Educational attainment highly valued***

The commitment of the Vietnamese people to education creates numerous economic opportunities. Vietnamese families, partly in recognition of the weaknesses of domestic universities, invest heavily in international education for their children. Vietnam is a major source of international students in US, UK, Australian and Singaporean universities. While many of these young people will acquire world-class knowledge and skills, too few of them will return to Vietnam. This is in part related to the weakness of domestic private firms and the slow rate of job creation, but it also reflects the undervaluation of knowledge and skills in the state sector. Hiring within the state sector

is insufficiently merit based and too heavily skewed by personalistic ties and nepotism.<sup>23</sup> Firms, whether state or private, domestic or foreign, cannot compete if they are not willing and able to hire the best people.

#### ***Global demand for commodities***

A fourth opportunity comes from Vietnam's natural resource endowments. Growth in India and China continue to support world commodity prices. As discussed earlier, Vietnam's farmers have proven their competitiveness by increasing their market share in a wide range of commodities. The government can help by removing remaining obstacles to competitive behavior in input supply and output markets. Infrastructure spending should focus on reducing transport times to port from the Mekong Delta, which is a productive and export-oriented agricultural region but which is under-served by basic infrastructure. Transparency and accountability in the energy and mining sectors would attract investment and give Vietnam access to up to date technologies.

#### ***Expanded role in international arena***

Vietnam is well-positioned to assume a larger role in regional and global affairs. Vietnam is widely regarded as a committed and constructive member of the United Nations. For several years Vietnam has stated its intention to participate in international peacekeeping operations; its well trained and highly disciplined military would certainly contribute greatly to the UN's overstretched (and often professionally challenged) peacekeeping forces. In the region, Vietnam can do more to bring about a resolution to the ongoing political stalemate in Myanmar and among the international community. It is well known that the military junta respects Vietnam's economic success and is keen to understand it better; Vietnam may be able to persuade the generals of the necessity of economic liberalization and reform. Like it or not, it is likely that Vietnam will be forced to take on a larger role in Myanmar when it assumes the chairmanship of ASEAN in 2010, particularly if the collapse of Myanmar's agricultural economy precipitates another humanitarian disaster. The threat that climate change poses to Vietnam lends it a moral authority that should empower it to speak out in the various international fora that have emerged to debate responses to the threat. If Vietnam is to take advantage of these opportunities, it must be prepared to depart from its preferred modus operandi of avoiding comment on the internal affairs of other countries.<sup>24</sup>

#### ***Strengthened representative political institutions***

Over the past two decades the National Assembly has gradually assumed a greater role in the governance process. Whereas Vietnamese people once cynically dismissed the institution as a rubber stamp, it is now a forum for increasingly critical policy debates,

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<sup>23</sup> See "Neglecting talents" in *Tuổi Trẻ*. Available at: <http://www.tuoitre.com.vn/Tianyon/Index.aspx?ArticleID=342621&ChannelID=7>. Accessed on October 16, 2009.

<sup>24</sup> Vietnam would also be well served by dispelling the widely held view in Western capitals that it unwilling to take a position at odds with Beijing. Normalizing relations with the Vatican would be a good way to demonstrate that there is daylight between the two countries on matters of foreign policy.

even if votes are rarely in doubt. A strengthened National Assembly, coupled with a more independent press, represents Vietnam's best hope to impose more transparency and accountability on the bureaucracy. To accomplish this, however, the National Assembly must become more independent. The election of delegates must be made more competitive. Critically, the number of non-party delegates must be increased dramatically from the current nine percent.<sup>25</sup> Increasing the number of fulltime delegates will also encourage critical debate. More professional support for delegates, including travel budgets and, critically, a research service, will also enhance their effectiveness. A robust National Assembly also provides a constructive outlet for Vietnam's increasingly sophisticated and well educated citizenry to participate in public affairs.

### ***Greater press freedom***

An autonomous press plays an important role in a modern society. It is one of the most effective weapons against corruption and the abuse of state power. As Vietnamese officials have remarked, despite the proliferation of state anti-corruption bodies in recent years, these entities have proven far less effective than the press which has initially exposed all of the largest corruption cases.<sup>26</sup> The press also provides a forum for healthy and informed debate of public problems. Sadly, over the past two years the state has instead opted to restrict press freedom. Ironically, this push has often been justified by the need for a "high level of social consensus." In fact, a refusal to allow constructively critical debate and dissenting views on policy issues is almost certain to exacerbate popular and elite resentment towards unpopular policies.

## **PART IV. THREATS**

The main known dangers facing Vietnam over the medium term are economic and environmental. However, the social progress and political stability that Vietnam has enjoyed in recent years should not blind us to the threats posed by public dissatisfaction with the unequal distribution of the gains from development and the unresponsiveness of state institutions.

### ***"The Middle Income Trap"***

Productivity is the key to economic growth. Poor countries that succeed in shifting at least part of the workforce from subsistence agriculture and other very low productivity occupations to jobs that produce a bit more per hour or working day can grow at rapid rates. Vietnam allowed its farmers to produce higher value added commodities for the market and to keep the proceeds, which created incentives for productivity-enhancing

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<sup>25</sup> The late Võ Văn Kiệt forcefully articulated the importance of increasing non-party representation in the National Assembly. See "The people's right to choose," in *Tuổi Trẻ*. Available at: <http://www.tuoitre.com.vn/tianyon/Index.aspx?ArticleID=193724&ChannelID=3>. In China in 2000, roughly thirty percent of delegates to the National People's Congress are not party members. See Tony Saich, *Governance and Politics of China* (London: Palgrave, 2001) 114.

<sup>26</sup> See the recent interview in *Sài Gòn Giải Phóng* with Chief Government Inspector Trần Văn Truyền. Available at <http://www.sggp.org.vn/xahoi/2008/10/170195/> Accessed on October 15, 2009.

investments and greater efficiency. Trade and investment liberalization opened the way for the growth of labor-intensive manufactured exports.

The problem that low income countries face is that once most of the workforce has left very low productivity occupations for slightly more productive jobs growth will slow down unless new jobs are created in higher productivity industries. But this often proves difficult. Higher productivity jobs require a skilled workforce, and thus improvements to the education system. These industries also require larger, slower gestating investments, and thus more secure property rights and a developed financial system. Developing education, legal and financial systems is not easy, and many countries fail to do so. A quick glance around Southeast Asia provides a number of examples of countries that have not been able to sustain the rate of growth once they have achieved middle income status.

Vietnam has recently achieved lower middle income status. This is an important milestone, not only because it signals how far the economy has come, but also as a reminder of the challenges ahead. Vietnam must accelerate institutional change, particularly in the spheres of education, law and finance if the country is to maintain even the present rate of economic growth over the medium term.

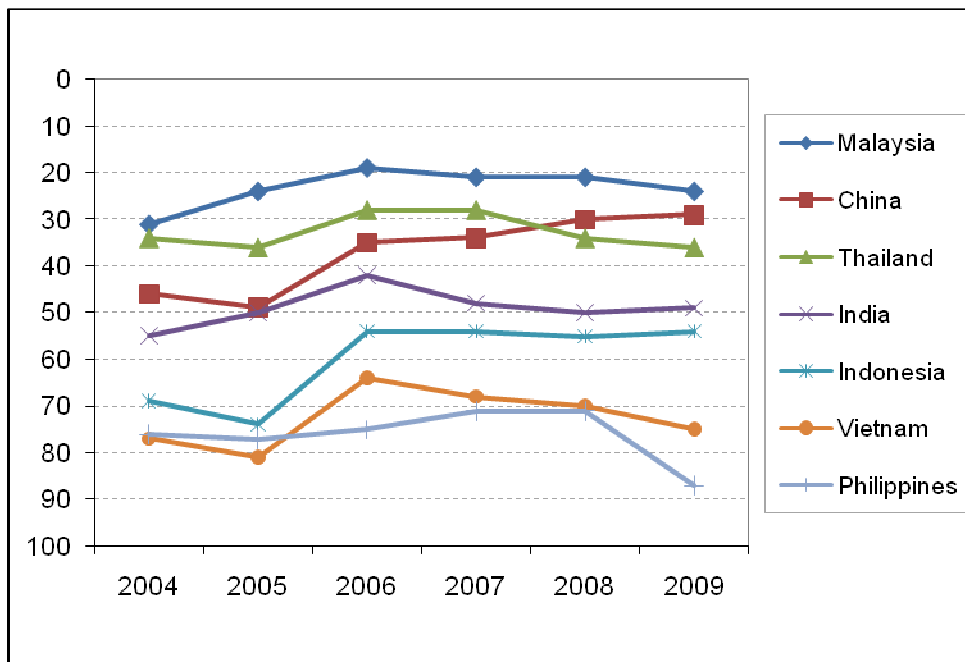
### ***Global competition***

A looming threat to Vietnam's continued development is that its economy becomes less competitive relative to other economies. The aforementioned World Bank survey "Doing Business" suggests that Vietnam is losing ground relative to its neighbors. This is reinforced by the results of the World Economic Forum's Global Competitiveness Report (see Figure 4 below).<sup>27</sup> In recent years Vietnam and the Philippines have consistently ranked lower than the other major developing economies in the region. Moreover, the gap between the two bottom countries and Indonesia appears to be widening over time as the latter country consolidates reforms initiated by the government elected in 2004. Meanwhile, China's performance continues to improve. Although rankings of this sort contain a subjective element, they are a useful tool for policymakers interested in comparing the quality of the business environment at home against the performance of close competitors.

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<sup>27</sup> See "Stabilizing the macroeconomy to strengthen competitiveness," in Tuổi Trẻ. Available at: <http://www.tuoitre.com.vn/tianyon/Index.aspx?ArticleID=337719&ChannelID=119>. Accessed on 23 October, 2009.

**Figure 4. WEF Global Competitiveness Rankings 2004-2009**



Source: World Economic Forum

### **Environmental change**

The world is taking increasing cognizance of environmental threats, and Vietnam is no exception. Sea level rise associated with climate change will result in a significant loss of arable land and saltwater intrusion into Vietnam's deltaic regions. Already saline intrusion is at record levels.<sup>28</sup> The most immediate environmental threat is in the Mekong Delta where a combination of fast-falling groundwater (which causes the soil to sink), large Chinese dams and rising sea levels may reduce output in as little as five years. The Chinese dams will definitely change the hydrology of the Mekong River, and could result in salt water intrusion past the Vietnam-Cambodia border during much of the year. The number of rice crops, the rice yield and the amount of fish or shrimp raised could suffer and many of the nearly 18 million people, most of whom are poorly educated, would be

<sup>28</sup> See " 'Salty flood' Threatens the Mekong Delta" in *Thanh Niên*. Available at: <http://www.thanhnien.com.vn/News/Pages/200942/20091015235843.aspx>.



hard pressed to find other jobs for which they are suited. Major reductions in rice and fish exports would also hurt the overall economy.<sup>29</sup>

### ***Rapid increase in public sector international debt***

Vietnam's public sector international debt is modest and mostly on concessional terms. But the pace of borrowing has accelerated in recent years. Borrowing is useful if the money invested generates a high rate of return and export revenues. However, Vietnam has a poor track record in selecting public sector projects and big borrowers like Vinashin are unprofitable.<sup>30</sup> Only one major project, the high-speed rail, could result in over \$100 billion of debt if current plausible estimates are correct about costs, ODA terms, and likely rail revenues.<sup>31</sup> High levels of indebtedness increase the risk of financial instability and force the government to allocate government revenues to debt servicing rather than public services and other necessary expenditures.

### ***Increase in poverty and inequality***

Vietnam has made tremendous progress in reducing measured poverty but a majority of households are still clustered around the poverty line. This means that even a small rise in the cost of living, an increase in necessary expenditures or a fall in incomes could throw millions of people back below the poverty line. Price inflation is a real risk given the size of the fiscal deficit, the rate of credit growth and the instability of the currency. The main threat of burdensome household expenditures among the poor comes in the form of out of pocket health and education costs, particularly in rural areas. As illustrated in Figure 5, out of pocket spending on health care is very high; in the region, only Indonesia is higher. Hanoi and HCMC have seen an increase in "health migration" – rural families moving to the city to bring family members to hospitals because adequate care is not available in towns or even smaller cities. If more capital goes to firms that do not create new jobs, unemployment will rise and poverty along with it. Removing obstacles to private firms and further facilitating their growth, especially if they create jobs, would be desirable. But this would require rethinking priorities in public and state enterprise investments. If priorities remain as they are, recurring bouts of macroeconomic instability could further add to poverty as people are periodically thrown out of work with little help from the state to adjust.

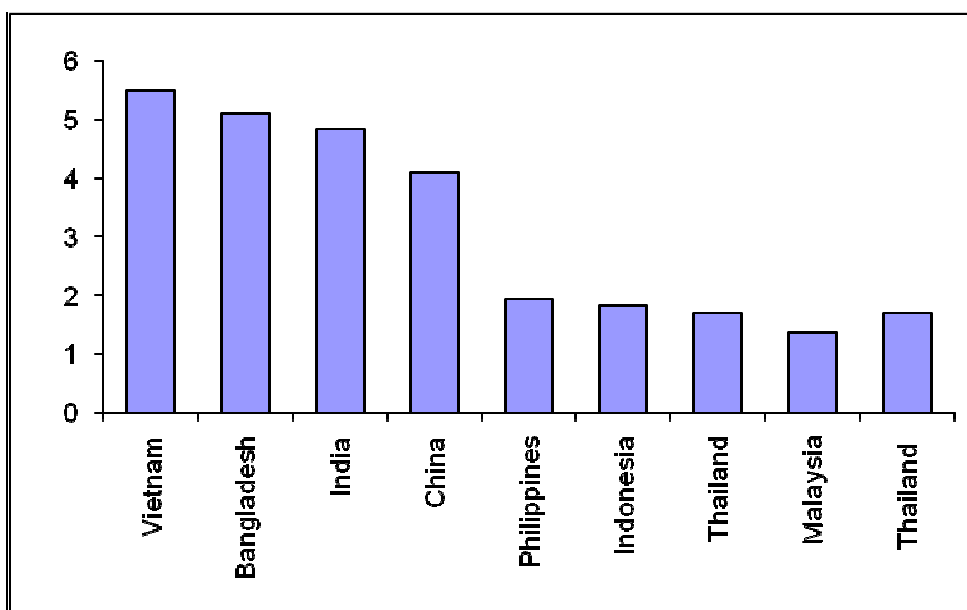
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<sup>29</sup> See "World's River Deltas Sinking Due to Human Activity," *Science Daily*, September 21, 2009. This refers to a longer paper appearing in *Nature Geoscience*. It notes that flooding will be worse and occur sooner if deltas lose sediment additions. This seems likely to happen in the Mekong Delta.

<sup>30</sup> On October 9 it was announced that Vinashin would receive approximately half of the \$500 million Vietnam will borrow from the ADB's crisis recovery fund. This is a stunning example of the sacrifice of national interests for the sake of a single, grossly inefficient, firm.

<sup>31</sup> Some argue that this rail project is so expensive it will not be completed for many years, if ever. The trouble with this line of argument, which is correct, is that it ignores the tactic of completing segments (Hanoi to Vinh or HCMC to Nha Trang) as a compromise costing many billions of dollars each and providing almost no additional economic benefits. After the segments are built, there is a constant effort to "complete" the project since so much money has been already spent. Vietnam needs a modern "regular" dual track rail line that would handle freight and fairly speedy (150 to 200 kilometer per hour) passenger trains. This would cost a small fraction of the high speed rail and produce significant economic benefits. In any case, there are *many* other examples of poorly chosen projects – airports, ports, roads and bridges.

**Figure 5. Out of Pocket Payments for Health Care, Share of Total Household Resources**



Source: Vandoorslaer, et al. 2006

Vietnam is still a relatively equal country by regional standards. But this should not be a cause of complacency. China went from being the most equal country in Asia by income in 1978 to the most unequal in 2004. Inequality in China is a product of slow job growth in rural areas, rapid and chaotic urbanization, an underdeveloped legal system, rampant corruption, and a severe lack of an equitable social security system. Vietnam could suffer a similar fate. As in China, land has emerged as a major cause of inequality as state officials and people with connections to the state capitalize on rising land prices at the expense of farmers and poor urban dwellers.

#### ***Poorly managed urbanization***

Vietnam faces important challenges in managing the explosive growth of its urban areas, and nowhere more than in the Ho Chi Minh City Area. According to the recent census, Ho Chi Minh City's population grew at an average rate of 3.5 percent per year over the last decade, reaching 7.1 million by 2009. The official statistics seriously understate

HCMC's growth, however, since as many as 2 million migrants are thought not to be accurately registered with the city. This means that as many as one in ten Vietnamese people now inhabit the greater Ho Chi Minh City area. Seen in these stark terms, the current fiscal relationship between the city and the center is unsustainable, if not to say reckless. The added services that the city must provide to migrants costs more than the additional tax revenues it is allowed to retain. Hobbled by transfers of 70 percent of tax collections to the central government, the city's budget is completely inadequate to prevent severe congestion that will slow growth. While the consideration of equity will always dictate some level of subsidy from richer to poorer areas, the level of transfer should not be so high as to strangle growth in the most dynamic region.

The experiences of other countries in the region reveal the dangers of mismanaged urbanization. One common feature of developing countries that stagnate before reaching a high level of GDP per capita is a failure to manage the challenges of urbanization. In not a few cases, including Bangkok, Jakarta, and Manila in the region, inequality and poor living conditions have been catalysts for political upheaval. There is still time for Vietnam to avoid the fates suffered by these other cities. However, it must be said that the track record of municipal governments in Vietnam is not confidence building. Structural barriers to better management are well known, including a diffusion of power horizontally across agencies and vertically down to the district and ward levels when effective urban management typically demands a powerful executive. This dysfunctional structure results in inertia, inconsistent implementation, and poor coordination.

### ***Loss of state legitimacy***

Every government's legitimacy—which can be understood as popular confidence in and support for government policies—rests upon its ability to protect and improve the wellbeing of its citizens. It is a useful exercise to consider the primary sources of the Vietnamese state's legitimacy in the eyes of its citizenry.

A critically important source of state legitimacy, in Vietnam and everywhere else, is effective stewardship of the economy. Especially in underdeveloped countries such as Vietnam, citizens are willing to tolerate a great deal if they believe that their economic circumstances are improving. For much of the past two decades, Vietnam's relatively high economic growth over the past two decades appears to have ensured a general level of satisfaction with economic policies. However, as we note above, ensuring continued economic growth will not be easy. Furthermore, success breeds higher expectations. Seen through this lens, policies that do not maximize the economic wellbeing of the largest number of people must be regarded as the long-term threat to the state's legitimacy.

An equally important pillar of legitimacy is the ability of the state to deliver social goods such as education and healthcare. In the sphere of social policy, it would not seem alarmist to assert that the state is already facing a crisis of legitimacy. The healthcare system is in a shambles, with corruption ridden hospitals and declining medical ethics.<sup>32</sup>

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<sup>32</sup> See "Special subject on medical ethics: The stories of medical doctors" in *Tuổi Trẻ*. Available at: <http://tuoitre.com.vn/Tianyon/Index.aspx?ArticleID=330694&ChannelID=123>. Accessed on August 8,

The string of recent scandals relating to food safety and pollution raises serious questions about the capacity and competency of state agencies to protect people. The flight to costly overseas education reflects the previously discussed problems in higher education.

The Vietnamese state has historically derived particular legitimacy from its ability to advance the interests of farming households and other rural dwellers. Today however, the aforementioned slow growth of the agricultural sector, decaying educational and health systems, ineffective provincial development policies, and predatory behavior of local governments and politically connected firms regarding land all constitute immediate threats to the state's legitimacy as a defender of rural Vietnamese.

Another important, and related, source of legitimacy is state capacity. This paper has identified many examples of poor state effectiveness. One cause of weak government capacity is the decline in the quality of the civil service. Low pay is one reason: young, skilled officials are leaving to take up better offers in the private sector. But it is not only about pay. Qualified young people also complain that career paths and promotion depend more on who you know and politics than on performance.<sup>33</sup> No knowledgeable Vietnamese person believes that recruitment into the state system is open and transparent. Positions in government are often purchased. State agencies are increasingly "family businesses" with more senior officials ushering their relatives and clients into the agency.<sup>34</sup> The absence of meritocracy has a corrosive effect on state capacity and accountability and destroys the trust of the people in their government and ultimately its legitimacy.

State legitimacy is also undermined by the government's refusal to tolerate any forms of organization outside of the auspices of the state itself. The government views its blanket ban on civil society organizations as a policy to protect political stability. This may be true in the short term, but it is not a sustainable approach over the long period. As the economy and society develop, social interaction becomes increasingly complex and variegated. People form organizations to support their children's schools, to keep their parks clean, to enrich their spiritual lives, to promote sports and to exchange information relating to their businesses and their hobbies. Earlier we mentioned the important role of business associations in promoting domestic industry and commerce. The vast majority of these organizations have no political content or aspirations. They do not need an umbilical cord connecting them to the government and the party to conduct their business or keep out of trouble. The government's reluctance to allow these forms of organization puts tremendous pressure on the state. It draws government into areas in which it has no

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2009. The article cites a study conducted by the Hanoi Medical University during 2006-2009, finding that 73% of interviewed doctors admitted to committing medical ethics violations.

<sup>33</sup> See a series of articles about "Brain-drain" in the Vietnamese public sector in *VietnamNet*. Available at <http://www1.vietnamnet.vn/chinhtri/event/9241/>. According to these articles, during 2007 more than 100 employees of the State Bank of Vietnam quite their jobs to pursue other opportunities.

<sup>34</sup> Another indicator of the paternalistic nature of the state sector is the lack of regional diversity within the system. With the exception of the most senior levels, line ministries in Hanoi and large SOEs appear to be the exclusive purview of northern born officials. One explanation for this reality is that only individuals from Hanoi and environs are qualified for government service; a more convincing explanation is that state personnel bureaus are uninterested in casting a wide net to recruit the most capable people.

business and no competence, and distracts government agencies from their proper functions. It creates conflict with the public when conflict is not necessary. It places the Vietnamese people in a subordinate position to their government, thus draining Vietnamese citizenship of its meaning and content.

*The suppression of public discussion of important issues facing Vietnam also destroys the legitimacy of the state.* In the past Vietnam had allowed robust discussion of policy options and publication of newspapers stories critical of corruption and abuse of state power. Policy successes such as joining the WTO and the enactment of the Enterprise Law were also the subject of a robust public debate. Yet in the past few years the newspapers have been instructed to avoid “sensitive” issues. Like the suppression of civil society, this may work in the short term, but only at the expense of the legitimacy of the state over the longer period. Without the control mechanism of a vibrant press, corruption will continue to increase in frequency and scale.<sup>35</sup> In the absence of information, cynicism about state agencies and government officials will grow. Ultimately the people lose faith in the government and party, with potentially disastrous results.

## CONCLUSION

Vietnam has enjoyed considerable success over the past 20 years. It has a strong record of reducing poverty and growth in output and exports. It has many potential advantages which should allow it extend these successes. However, past success has created potential pitfalls that could result in a growth slowdown, worsening poverty and inequality and social and political instability. Institutional development is the key to avoiding these threats and capitalizing on the country’s many opportunities. Increasing transparency and accountability in the public sector is the most pressing need. Public investment must be streamlined and prioritized. State companies must be forced to compete domestically and internationally, and must pay market rates for their capital and land. The education system needs a complete overhaul at all levels. Property rights must be strengthened and business regulations rationalized and impartially enforced.

Now is also an appropriate time for the government and party to give serious thought to the relationship between Vietnamese citizens and the state. As the society and economy grow more complex, old sources of state legitimacy will attenuate. Allowing the development of civil society would reduce pressure on the government and enable the Vietnamese people to find new ways to contribute to social cohesion and progress in their own communities.

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<sup>35</sup> The World Bank’s governance indicator for “control of corruption” in Vietnam has gotten worse over the latest five and ten year periods. The same is true for “voice and accountability.” It appears that Vietnam is retreating in several important dimensions, and this suggests that internal corruption control alone will not be effective. This increase in difficulties with corruption coincides with reduced transparency.

## Appendix 1. **SWOT Matrix**

Strengths	Weaknesses
<p>Political and social stability</p> <p>Favorable geographic situation and international linkages</p> <p>Multilateral foreign policy</p> <p>Favorable demographic structure</p> <p>High-level of domestic and foreign resource mobilization</p> <p>Dynamic agricultural sector</p> <p>Sharp reduction in poverty</p>	<p>Systemic lack of transparency</p> <p>Continued favoritism of inefficient state sector</p> <p>Inefficient and ineffective public investment program</p> <p>Decreasing competitiveness</p> <p>Unstable macroeconomic architecture</p> <p>Lack of internationally competitive firms</p> <p>Weak, ineffective business associations</p> <p>Reliance on natural resource extraction</p> <p>Education system in crisis</p> <p>Limited science and technology capacity</p> <p>Ineffective local government</p>
Opportunities	Threats
<p>Attractiveness as an FDI destination</p> <p>Prospect of reduced transport costs</p> <p>Educational attainment highly valued</p> <p>Global demand for commodities</p> <p>Expanded role in international arena</p> <p>Strengthen representative political institutions</p> <p>Greater press freedom</p>	<p>“The Middle Income Trap”</p> <p>Global competition</p> <p>Environmental change</p> <p>Rapid increase in international debt</p> <p>Increase in poverty and inequality</p> <p>Poorly managed urbanization</p> <p>Loss of state legitimacy</p>