Vietnam – Challenges for the Coming Decade

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With an estimated GDP growth of 5.3% in 2009 and a forecasted growth rate of 6.7% for 2010, Vietnam has not only survived the GFC in better shape than most other countries of comparable size in Asia, but has also joined the ranks of middle-income countries by having its per capita GDP in excess of USD1,000. This is certainly a remarkable achievement in two decades of reforms, resulting in average annual growth rates of 7.4 percent between 1991 and 2009. The leadership’s stated aim is to have Vietnam develop into a modern industrialized economy in the coming decade. This is driven in part by rapidly changing demographics. Whilst Vietnam is generally considered to be a country of young people, the projections are that it will have an ageing population by 2040. Hence, there is a strong desire (if not an imperative) to “get to the top” before “going over the hill” (Menon and Melendez 2009).

However, the macroeconomic instability in the past three years, and the underlying structural problems, have given rise to concerns that another decade of rapid growth may not be easy to achieve. The “home-grown” macroeconomic turbulence of 2007/8, as well as the instability during the GFC, should constitute a “wake up call” for the need for further reforms. This is strengthened by the fact that towards end 2009, capital flight on the part of domestic residents, as indicated by the item “errors and omissions” in Vietnam’s balance of payments account, had jumped to 13.1% of GDP.

It is perhaps not surprising that, despite having weathered the GFC so well, the dong has been under attack and has had to be devalued several times since November 2009 whilst other currencies in the region had been appreciating; the country risk premium for Vietnam as at June 2010 was higher than for Indonesia, Thailand and the Philippines, and Vietnam has been consistently falling in the Global Competitiveness index, with concerns over macroeconomic stability being the main cause for the decline. The recently-announced government intention of using price controls to tackle inflation did not help market perceptions. It is clear that strong economic
institutions capable of formulating macroeconomic policies and communicating the government’s policy stance to the market are urgently needed.

Underlying the unease about the macroeconomic situation are some structural factors. Firstly, the current account deficits in the last three years have been hitting the ‘safety threshold’ of 10% of GDP whilst the exchange rate has been close to, and at times exceeds, the lower limits of the band. Trade and current account deficits are again forecasted at 9.1% of GDP for 2010, constraining policy choices. And yet, one of the expected outcomes of export-oriented strategies is precisely the freedom from such balance of payments constraints, but this does not appear to be happening currently in Vietnam. Admittedly, the current account deficits have been financed mainly by foreign direct investment (FDI) and long-term loans (aid funds) rather than short-term borrowing and portfolio inflows, but that did not prevent the capital flight towards end-2009. Furthermore, in the context of East Asian industrialization, Vietnam’s heavy reliance on FDI stands out. In the two decades since Doi Moi (1991-2007), FDI as a percentage of GDP averaged around 5.9%. The next closest was Malaysia (4.3%) during its period of rapid growth and industrialization from 1977 to 1996. South Korea (1969-1988), Thailand (1976-1995) and Indonesia (1977-1996) all had significantly lower FDI/GDP ratios as well as lower trade deficits as a percentage of their GDPs (Harvard/Fulbright Asia Program 2008).

Such preponderance of FDI, however, did not link Vietnam to the first “rung” of the parts and components trade in electronics and IT equipment (the so-called production networks of East Asia) until 2006. This brings us to a second structural issue – the lack of domestic supporting industries. Indeed, if Vietnam were to move up these global supply chains, a much more dynamic and entrepreneurial domestic private sector is needed to undertake the necessary risks involved in the development of products and processes. For this purpose, long-term development capital and not FDI is required. Although bank credit to the domestic private sector has risen from 49% of GDP in 2006 to 80% of GDP in 2009, very little of this is in the form of long-term loans principally because the average maturity of the banks’ deposit base is relatively short-term. Vietnam’s bond market (at 15% of GDP) is very small compared with an East Asian average of 63% of GDP. It is underdeveloped, and lacking in the necessary infrastructure. These issues are supposed to be addressed through the preparation of a Public Debt Law. However, in practice, resolving these issues would require significant cooperation amongst a number of agencies, including the Ministry of Finance, the State Securities Commission, the tax office, and the State Bank of Vietnam – another instance where strengthening public institutions would be important for Vietnam’s next phase of development.

A corollary of poorly-functioning capital markets is the inefficient use of capital. This brings us to a third structural issue. The incremental capital-output ratio (ICOR), defined by the General Statistics Office as the increase in capital for an extra unit increase in output, has
been rising throughout the past decade. In the early to mid-1990s, Vietnam’s ICOR was relatively low and the contribution of total factor productivity (TFP) was high, indicating that growth came from increased productivity (compared with the years of central planning) with little additional use of capital. In more recent years, ICOR has been rising, contribution of TFP to growth falling, and contribution of capital to growth increasing. “That is an indication of investment-driven growth with low efficiency in capital use” (Ohno 2009 p.26). An implication is a tendency towards chronic inflation as increased demand from investment activities are not met by concomitant increases in the supply of output (Harvard/Fulbright Asia Program 2008).

A fourth and related structural issue is that, after two decades of reforms, the very large state-owned enterprises (conglomerates called General Corporations) still constitute a quarter share of Vietnamese industry and command over half of the country’s investible funds. The move on the part of these General Corporations into real estate and finance in 2007/8 provided another channel of funding to these corporations and also contributed to destabilizing the macroeconomy. The recent failure of Vinashin, the large state-owned shipbuilding conglomerate, is having reverberations at the highest political levels. And yet, as the country is about to implement its ninth socio-economic development plan in 2011, there seems little appetite to address directly the role of the State in the economy vis-à-vis the private sector.

Given the concerns over macroeconomic stability, the building of strong macroeconomic institutions (central bank, ministry of finance, ministry of planning and investment) is an important and necessary goal in the medium-term future. Furthermore, this is an achievable goal given that the central bank in the Philippines underwent dramatic transformation within a relatively short period of time in 1991, and that this example is being emulated in the region (by the central bank of Indonesia, for example). It is achievable also because the number of highly qualified staff needed for macroeconomic policy research and formulation can be relatively small. Admittedly, greater numbers of staff are needed for financial regulatory roles, but even these do not need to be large provided they are adequately supported by IT systems. In due course, institution-building could spread to other areas of the civil service, in conjunction with the on-going Public Administration reform. A strong set of public institutions could act as a bulwark against politically-driven and wasteful public spending, leaving more room for social spending on health and education – essential ingredients supporting a dynamic private sector. In time, this would help to re-define the catch phrase, “A market economy with socialist orientation”, that is more suited to, and indeed could help realize, the modern industrialized market economy to which Vietnam is aspiring.

References


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