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Vietnam as a New Manufacturing Powerhouse: Key Lessons

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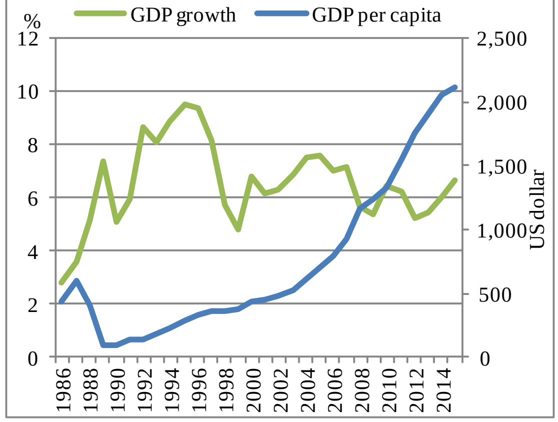
1. Introduction

Vietnam's journey towards a regional manufacturing powerhouse has not been a very long one. Till mid-1980s, Vietnam – with a centrally controlled economic policy structure – was counted amongst the laggards. It then entered a growth spurt in the late 1980s, and continued on this trajectory almost continuously since then, except for some years of late 1990s when economic growth declined due to Asian crisis **(Figure 1)**. However, the country resumed its high growth journey and outpaced the ASEAN peers in terms of economic performance.[1] Also, the country emerged as a new manufacturing powerhouse in Asia; in fact, it is now the biggest ASEAN exporter to the US – Vietnam's exports to USA stood at US$33.5 billion during 2015, compared to Korea (US$8.9 billion), Singapore (US$3.3 billion), Thailand (US$3.2 billion) during the same period[2].

Figure 1: Vietnam's Economic Growth



The country also performed well on other important economic fronts. For example, poverty head count in Vietnam fell rapidly, from 77.1 percent in 1992 to only 12.02 percent in 2014. The literacy rate further improved, especially in female workers; female participation in the labour force also increased. The current account balance as percent of GDP remained low. The external debt as percent of GDP reduced. The development expenditure remained high which augmented the growth process. The purchasing power of the masses strengthened, per capita income reached US$2,111.1 in 2015, up from US$437.1 in 1986 (**Table 1**).

Table 1: Vietnam: Key Macroeconomic Indicators

	1986	1996	2006	2015
Per Capita Income (US$)	437.1	337.1	796.7	2,111.1
Real GDP (bln US$)	24.0	47.8	91.3	154.5
Exports (bln US$)	0.8	7.3	39.8	162.1
Imports (bln US$)	2.2	11.1	45.0	166.1
Total Trade as % of GDP	23.2	92.7	138.3	178.8
Current account balance (bln US$)	n.a	-2.0	-0.2	0.9
Exchange rate(Dong/US$)	22.7	11,032.6	15,994.3	21,697.6
Lending rates (%)	n.a	20.1	11.2	7.1
Deposit rate (%)	n.a	8.51 (1997)	7.6	4.8
as percent of GDP				
Gross capital formation	14.4	28.1	34.5	27.7
Current account balance	n.a	-8.2	-0.2	0.5
Fiscal balance		-0.1 (1998)	0.3	-5.9
External Debt	0.7	55.0	20.4	49.6 (2014)
Growth rates (averages)		**1986-1995**	**1996-2005**	**2006-2015**
Real GDP		6.5	6.9	6.12
CPI		n.a	4.12	9.38

Source: World Bank and Havor Analytics

[1] During 2000-07, Vietnam's economy grew at, on average, 7.8 percent while the ASEAN-10 economies exhibited an average growth of 5.6 percent.

[2] Source: ITC.

How has this country – which is smaller than Pakistan's Balochistan province and has less than half of Pakistan's population – been able to achieve this turnaround in less than 30 years? Moreover, what key lessons can other aspiring export powerhouses draw from its experience? This note will attempt to answer these questions. It is divided into four parts: the next section gives an overview of the strucutral changes occurred overtime, and section 3 presents drivers of these changes. The section 4 outlines some lessons to be learned from Vietnam's experiences. References are given in section 5.

2. Structural Changes in the Economy

Historical perspective

At the time of its independence in 1945, Vietnam was politically divided into two parts: North, which adopted communism; and South, which followed capitalism. While South part is best suited for agriculture due to favorable agro-climatic conditions, the North one is considered fit for manufacturing production, as it is bestowed with mineral resources.

After Indochina war during 1954-75, which severely inflicted both parts of the country, Vietnam was reunified in 1975, under a socialistic economic structure. The country was facing a number of economic problems during those years, such as: (i) inefficiency of state-owned entrepreneurs (SOEs); (ii) heavy reliance on agricultural performance; (iii) non-existence of FDI due to restrictions on entry of foreign investors; (iv) dependence on donors' assistance and external borrowings[3]; and (v) absence of private ownership due to communist ideology.[4]

In this backdrop, Vietnam pursued a multi-pronged strategy in 1986 that included reforms and policy measures, which focused on removing key bottlenecks to growth, addressing supply side structural issues, improving governance of SOEs, strengthening resilience of the economy to exogenous shocks, expanding foreign trade, and liberalizing investment regime to attract FDI. Moreover, high rates on foreign currency deposits made Vietnam an attractive destination for investors looking for advantages of currency arbitrage.

As a result, the Vietnamese economy changed significantly. Its agriculture sector shifted towards an export-oriented commodity production. The manufacturing, information technology, and high-tech industries emerged as major contributor to the fast-growing economy. A new and dynamic services sector now seems to provide an adequate spurt to the economy.

Some of the salient features of the Vietnamese economy's journey towards a manufacturing powerhouse are given below:

A synthesis between central planning and free market economy

In order to recuperate after devastating war, the country started economic planning with the traditional tool of 5-year plans. However, it immediately adopted a pragmatic approach of switching from centralized to a decentralized planning structure. The third 5-year plan (1981-85) was, especially important in this regard, which afforded a compromise between ideological and pragmatic elements of economic policies. It addressed some key issues like capitalist structure of South verses communism in North, and development of both small-scale and heavy industries.

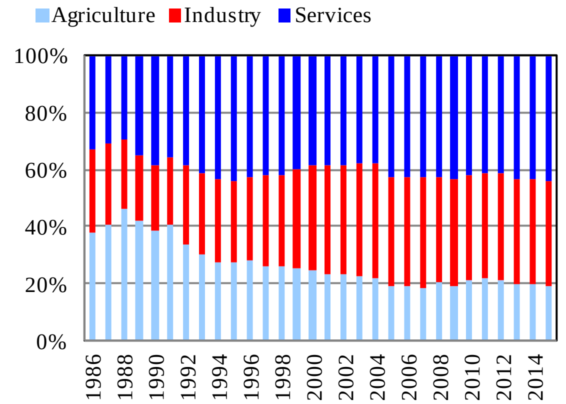
In 1986, Vietnam launched *Doi Moi* reforms to facilitate convergence of the economies of North and South parts to a *socialist-oriented market structure*.[5] Particularly, the economic policy adopted a hybrid approach by

[3] External debt was around 49 percent of GDP, on average, during 1986-95.
[4] Under the socialist party rule, Vietnam also suffered from the post-war trade embargo imposed by USA and most of the European countries.
[5] Doi Moi is the name given to these reforms for opening up the Vietnamese economy.

combining the central planning features with free-market incentives. The country also introduced governance reforms for SOEs, liberalized trade and investment regimes, and developed infrastructure facilities which provided an enabling business environment to potential investors.

As a result of these reforms, the share of industrial value added increased from about 25 percent in mid eighties to more than 30 percent in 2015 (**Figure 2**). Although the share of agriculture declined, but in absolute terms it maintained its contribution; and more importantly, the agricultural productivity doubled during this period.[6] Moreover, investment to GDP ratio also increased from 14.4 percent in 1986 to 27.7 percent in 2015.

Figure 2: Sectoral Share in Vietnam's GDP

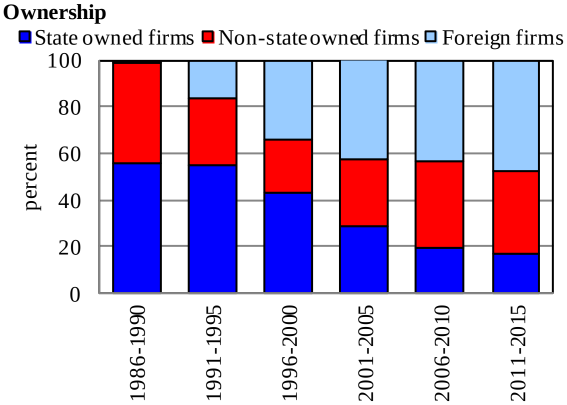


Source: General Statistics Office of Vietnam

Declining role of public sector enterprise

As the country moved up the development ladder, the contribution of state owned enterprises (SOEs) declined and the role of private non-state firms (especially small-scale) and FDI-led foreign firms increased (**Figure 3)**. This process, however, took place gradually. In order to do away with inefficient SOEs and encourage the private sector, an Enterprise Law was enacted in 1995, which aimed at defining the rights, obligations, operating mechanisms, financial management and other key features of the SOEs. Further, the merger or dissolution of small-scale or unprofitable SOEs was allowed which led to the reduction in the number of SOEs from 12000 in 1996 to half in 2000.

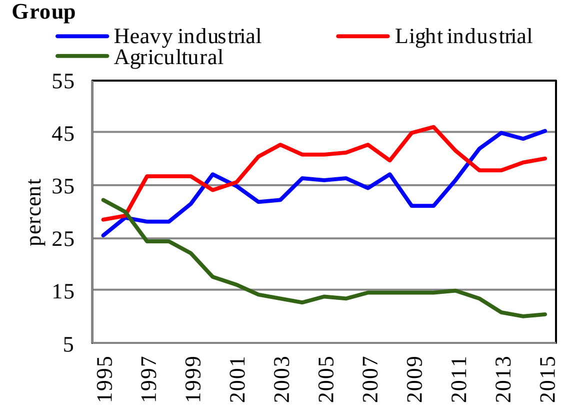
Figure 3: Contribution to GDP in Vietnam, by Type of Ownership



Source: General Statistics Office of Vietnam

In this consolidation process, Vietnam also encouraged merger of big SOEs into conglomerates, which helped them develop their own brands and produce goods with economies of scale.[7] This action played a key role in transforming the industrial sector of Vietnam into a high-tech sector with enhanced role of the private sector.

Figure 4: Share in Total Exports of Goods by Commodity Group



Source: General Statistics Office of Vietnam

Industrial activities leaning towards exports

The country adopted two pronged industrial policy: encouraging export oriented manufacturing activities and attracting foreign investment by relaxing foreign exchange regulations.

[6] The real value added per worker in agriculture sector increased to US$ 805.7 in 2015, up from US$434.1 in 1985.

[7] In order to monitor these conglomerates, the State Enterprise Groups (SEGs) were formed under the direct supervision of the Prime Minster, which helped these big firms to convert into internationally competitive companies.

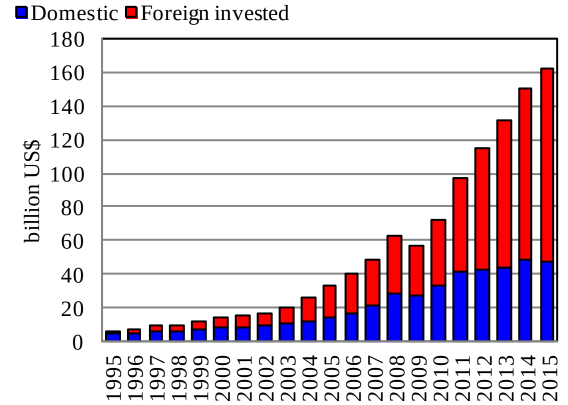
The influx of foreign direct investment not only contributed to the productivity enhancement in high-tech manufacturing sector, it also boosted activities in other sectors of the economy due to backward and forward linkages. The foreign firms benefited from the Vietnamese low-wage labor and produced the competitive products to export across the globe.

A number of downstream domestic industries also benefitted, which had upgraded their technologies to meet the high input requirements of the foreign firms. These developments gradually shifted Vietnam's production structure from resource-based to hi-tech manufacturing. The changing pattern of production was also reflected in the composition of exports. Two aspects are particularly worth noting: first the share of light and heavy machinery in the total exports increased, while that of agricultural products declined (**Figure 4**); and second the export market was mainly captured by foreign firms (**Figure 5**). It may be noted that there were almost no foreign firms in the country till 1995 due to Vietnam's protectionist policy and restricted foreign investment regime.

As the country relaxed its foreign investment regulation with the start of new millennium, foreign investment poured into export oriented industries (**Figure 6**). The majority of the foreign firms (particularly the MNCs) developed their manufacturing facilities in Vietnam. They export their manufactured products to different countries, including their home markets. Moreover, the big supply chains also benefitted from the Vietnamese manufacturing facilities.[8]

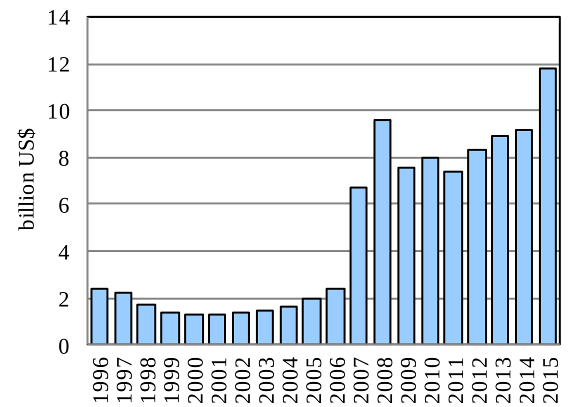
Besides industrial policy, Vietnam's commerce policy also contributed to its export performance, whereby it promoted trading companies to bring new export orders from across the globe. Vietnam also encouraged clustering and sub-contracting of firms, which opened businesses opportunities for domestic private firms to supply input material/intermediate products to foreign firms.

Figure 5: Vietnam's Total Exports by Economic Sectors



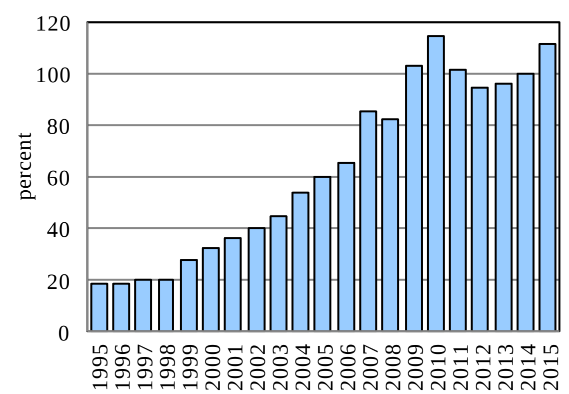
Source: General Statistics Office of Vietnam

Figure 6: Foreign Direct Investment Flows in Vietnam



Source: Havor Analytics

Figure 7: Domestic Credit to Private Sector (% of GDP)



Source: World Bank

Booming services sector

As the activities of foreign firms gathered pace, the services sector of the country also flourished. A wide range of services including, personal services, tourism, hoteling, food and beverage, transport, and trade activities witnessed boost along with the banking services. With the start of financial liberalization in 1990s, the private sector was encouraged to avail bank credit, which resulted into a substantial expansion in the credit to the private sector (**Figure 7).**

[8] For this purpose, Vietnam opened an export promotion office in Hong Kong, which allowed suppliers to benefit from their manufacturing facilities.

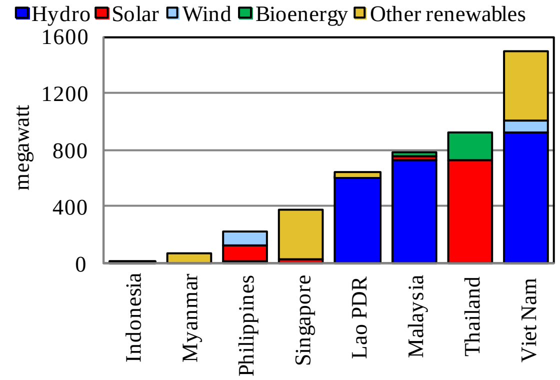
Before 1990, the State Bank of Vietnam (SBV) used to perform both the functions of a central bank as well as a commercial bank. However, the 1990 Ordinance on Banks, Credit Cooperatives and Financial Companies allowed SBV to separate the central banking functions from commercial banking activities. Accordingly, the commercial banking functions were entrusted to the four newly established state-owned commercial banks (SOCBs). At the same time foreign banks were allowed to operate in the country. Currently, Vietnam's banking industry consists of 33 joint stock commercial banks (JSCBs), 5 joint venture banks and 5 foreign-owned banks.

3. Drivers of the Structural Change

The key to the successful transformation of the economy was a proper sequencing of the reforms with strong political will. Further, a prolonged period of one-party government in the country also helped ensure continuity and consistency in economic policies. Some of the main policy measures adopted by the government are described below.

Improving energy supplies: With a special focus on the energy sector, the country's electricity production increased from 4,824.93 Gigawatt hours (GWh) in 1990 to 16,300 GWh in 2016. The country also outpaced other ASEAN countries in terms of new installed capacity of renewable energy during 2015, which contributed in reducing its power shortage over time (**Figure 8**).

Figure 8: New Installed Capacity of Renewable Energy by Energy Source in ASEAN in 2015



Source: General Statistics Office of Vietnam

The improved power supply in the country helped the manufacturing units run smoothly. Also, this provided an edge to manufacturers in Vietnam over their potential competitors, which suffered from power supply shortages.

Infrastructure development: Vietnam developed an extensive network of roads, ports, and navigable waterways, which spread over 17,700 kilometers.[9] In 2009, Vietnam also signed a deal with Japan for the construction of a high-speed railway, which would serve a total of 26 stations, including Hanoi and Ho Chi Minh City. The trains travel on these tracks at a maximum speed of 360 kilometers per hour. Besides, expansion of railway lines will continue to other cities.

Special economic zones: The country also establised different types of special economic zones, including industrial, export processing, and hi-tech zones. These zones offer foreign enterprises all important facilities. Further, the land to investors is allotted through lease or sub-lease agreements. The zones are also in close proximity to main roads, ports and airports. In addition, the usual intensive administrative processes are significantly reduced in these zones. These zones have attracted foreign investors, particularly those in the manufacturing and export producing sectors.

[9] A Vietnam rejser - February 2014 report provides detailed description of Vietnam's network of roads, ports, and navigable waterways (source: http://www.smedebol.dk/Rejser/Afsluttede/pdf/119_Vietnamrejsen%20-%20februar%202014.pdf).

Development of human capital: Vietnam extensively invested in education to fulfill industries' demand for skilled labour force.[10] While a large number of public schools were constructed across the country, the multinational firms also participated in this drive by launching training programs for their workers.[11] This addressed, to a large extent, the concerns regarding skill gap of qualified engineers and middle managers.[12]

Trade liberalization: The trade liberalization remained a key driving force behind the country's performance. It may be noted that Vietnam was a part of Comecon – a communist alliance of trading partners – from late 1970s to mid 1990s. However, as the Comecon was dissolved in 1995, the country was forced to look afresh to other trading partners. Thus it signed the trade agreement with ASEAN countries in 1995; joined APEC in 1998; and signed an important bilateral trade agreement with USA in 2000. The FTAs were also signed with the Eurasian Economic Union, the European Union, and South Korea. Vietnam also became part of the Trans-Pacific Partnership agreement.[13] It also updated its intellectual property legislation in July 2006 mainly to comply with the agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). Vietnam joined WTO in 2007, which freed the country from textile quotas enacted worldwide as part of the Multi Fiber Arrangement (MFA).

Supportive exchange rate regime: The exchange rate policy remained supportive of the country's quest for export promotion. The value of Dong against US dollar continued to depreciate in nominal terms during 1980s onward.[14] However, as the domestic export firms (especially those using local input materials) benefitted more from this devaluation, the FDI led – foreign industries have to face higher cost of imported intermediate goods.[15] Nonetheless, these firms were more than compensated by low cost Vietnamese labor and infrastructure facilities to produce and export their goods. In fact, the foreign firms remained almost insulated from the impact of the Dong's devaluation, as their manufacturing cycle mainly involved foreign currency, i.e., their receipts and payments were in foreign currency.

Macroeconomic stability: Initially, Vietnam pursued a growth-led model which paid attention on quantum only. Later on, the country diverted attention towards macroeconomic stability, especially when the economy severely hit by financial crisis of 2008. Consequently, the country was able to maintain a single digit low inflation, high growth (although lower than 1986-2007 period), stability in exchange rate, reduction in deposit and lending rates, contained money supply and brought more discipline in its fiscal policy.

Favorable business environment: Vietnam's business environment has also improved, which is reflected by its international ranking in a number of indicators. The improved ranking, in turn also helped the country to

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[10] According to the Dtinews, "the literacy rate among people age 15 to 35 is 98.5 percent, with 43.7 percent of laborers having basic knowledge about computers and foreign languages". The news report is available at: http://dtinews.vn/en/news/020/43462/vietnam-s-literacy-rate-reaches-97-3-percent.html

[11] In September 2008, Vietnam established NSCTSD with the mandate to make/implement training policies mainly to meet demand of local and foreign companies.

[12] Some relevant policies issued by the country in this regard included: i) the Strategy for Human Resources Development in Vietnam (issued by the 11th National Congress of the Communist Party); ii) Strategy for Education Development in Viet Nam 2011-2020; and iii) the Master Plan for Vocational Training 2011-2020.

[13] In January 2017, USA has discarded TPP.

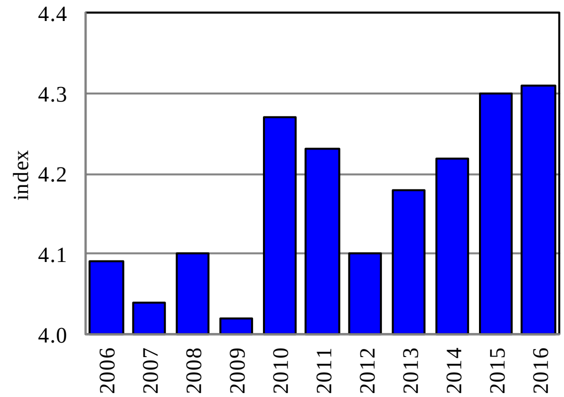
[14] During 1983-1992, on average the devaluation of Dong against US dollar stood high (53 percent). Excluding the period of Asian crisis and global financial crisis, the Dong on average devalued on 1.4 percent against US dollar.

[15] Vietnamese imports from China accounted for 49.4 percent of its total imports in 2015. Korea has emerged as the second largest importer, with 27.6 percent share in total imports in the same year. Similarly, Japan is the third biggest importer (with 14.2% share). All these countries have established many industries in Vietnam, which are manly carrying out manufacturing of goods for exports and involved in the product assembly business.

perk up the perceptions about the economy among global investors. Some of the key indicators to show the standing of Vietnam on the global performance scale are given below:

i. Vietnam significantly improved on the scale of **competitiveness** over the past decade. The country's overall score on the Global Competitiveness Index (GCI) has risen from 4.1 to 4.3 (out of 7) between 2006 and 2016 (**Figure 9**).

Figure 9: Vietnam's Competitiveness Index



Source: World Bank

ii. It also improved its ranking on the **ease of doing business metrics.** For instance, the time required to open a new business in the country declined from 41 days to 24 during 2006 to 2016.[16] Similarly, the time required for a firm to get an electricity connection went down from 115 days to 46 during this period. Improvements were also noted in indicators related to registration of property and payment of taxes.[17] This indicates that Vietnam has taken important steps in improving and simplifying its regulatory environment, which have helped make business operations in the country more conducive.

iii. Vietnam has also made progress in **reducing corruption**. Between 2005 and 2016, the country's score on the Transparency International's Corruption Perception Index (CPI) improved from 26 to 33; its rank stood at 113 (out of 176) in the year 2016.[18] This improvement came about as the country developed a robust legal framework for tackling corruption: it established a new anti-corruption body and issued National Strategy for Preventing and Combating Corruption towards 2020. In fact, Vietnam's Anti-Corruption Law 2005 is considered by the World Bank to be among the best anti-corruption legal frameworks in Asia.[19] In 2006, Vietnam developed the Business Anti-Corruption Portal – a one-stop shop offering tools to companies to mitigate risks and costs associated with corruption when doing business abroad. The portal is supported by the European Commission, OECD, UN and the World Bank.

iv. After enduring almost two decades of a devastating war, Vietnam has been relatively spared from violent incidents since then. According to data compiled by the **Global Terrorism Database**, the country recorded only 10 incidents of terrorist violence between 1992 and 2001; these events cumulatively left one person dead and 27 injured.[20] The Global Terrorism Index 2016 ranked Vietnam last on its list of countries affected by terrorism (at 130, among many other countries), indicating that it was least impacted by extremist violence. This long spell of stable law and order situation undoubtedly complemented the economic reforms undertaken by the country and contributed to its perception as an attractive destination for foreign investors.

[16] Source: Doing Business database, World Bank.
[17] For instance, Vietnam reduced the number of VAT filings for companies with an annual turnover of 50 billion dong (about $2.3 million) or less, from monthly to quarterly basis (source: Ease of Doing Business Report 2016, World Bank).
[18] A country's CPI score ranges between 0 to 100; the higher the number, the less corrupt it is perceived to be.
[19] www.globalsecurity.org
[20] The Global Terrorism Database did not have any record of terrorist violence in the country after 2001.

4. Key Lessons

The Doi Moi economic reforms of the late 1980s helped the country move away from its centrally planned economy towards globally market oriented economy. This contributed to a stunning growth rate of about 7 percent for three decades. This experience provides some important lessons which can be helpful for other aspiring export powerhouses, including Pakistan:

- ***Continuity in economic policies with strong political will can help change economic outlook:*** The consistency and continuity in policies helped Vietnam give a strong positive signal to stakeholders, who benefited from a stable business environment. With a democratic governing structure, Pakistan can also achieve consistency in its economic and financial policies by involving all democratic partners and giving them due ownership of the policymaking process, so that critical policies and development plans could not be reversed in case of a change in the government.

- ***Removing energy shortages:*** One of the key enablers of Vietnam's economic transformation was the increase in the country's power generation capacity. Vietnam initiated a number of traditional as well as alternate energy projects, which proved critical in ensuring that its industrial units had constant access to power supply. Pakistan has been facing sever energy shortages which had virtually crippled the country's manufacturing sector – before the power sector received a sharp policy focus quite recently. Encouragingly, the recent energy projects under the CPEC are likely to ease energy constraints in the country in near future.

- ***Dealing with public sector enterprises:*** Vietnam successfully handled the inefficiencies of its state enterprises (SOEs) by their restructuring and putting them into competition with the domestic and foreign private firms. Pakistan also needs to effectively implement its plans for restructuring and privatization of ailing public sector enterprises.

- ***Institutional strengthening:*** Vietnam showed substantial progress in strengthening its regulatory regime. Regulations were issued to protect ownership rights of firms, facilitate ease of doing business, and strengthened corporate governance of public institutions. It also took appropriate measures to improve governance and transparency of regulatory bodies, and upgraded the financial-reporting standards and risk-management framework for banks. As a result, business sentiments improved, which, in turn, encouraged private firms (both local and foreign) to invest in the country.

- ***Investment in export oriented sectors:*** This is very important lesson drawn from Vietnamese experience; as it adopted a deliberate and well thought policy to attract foreign investment in its export oriented sectors. With this, despite the pressure of profit repatriation by foreign firms, the country's overall balance of payments remained comfortable with the help of booming exports. Pakistan can also offer incentives foreign firms (also to domestic firms) to invest in export oriented sectors.

- ***Skilled workers can lead an economy towards high standards:*** Vietnam paid substantial attention towards skill development of its labor force and incentivized corporate-sponsored training programs for the workers. This helped improved productivity of their workers. In case of Pakistan, as CPEC related investments are picking up pace, the demand for highly skilled labor force is expected to increase; this not only requires policy focus and investment by the public sector, but also is an opportunity for private sector educational institutions to design tailor made skill improvement programs.

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