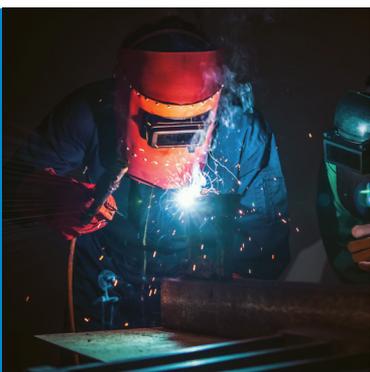




ECONOMIC RECOVERY AND PROGRESS TOWARD THE SDGS:



VIET NAM IN MULTIPLE TRANSFORMATIONS

Ha Noi, April 2021



Economic Recovery and Progress Toward the SDGs: Viet Nam in Multiple Transformations

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FOREWORD

The Government of Viet Nam acted early and decisively to safeguard the country from the worst effects of the Covid-19 pandemic. Effective control of community transmission of the virus from its first appearance in January 2020 helped to contain the spread of the disease and saved lives. The successful management of the pandemic also paid economic dividends, reducing the need for social distancing and lockdowns. Viet Nam recorded a GDP growth rate of 2.9% in 2020, lower than expected in a normal year but among the highest in the world.

Economic growth is expected to rebound in 2021 as global trade recovers and restrictions on international travel ease. Viet Nam has set an ambitious target of achieving upper middle-income status by 2030 and high-income status by 2045. These are ambitious goals, but they are achievable if the economy succeeds in sustaining its current high growth trajectory. Viet Nam's prospects of realising the Sustainable Development Goals (SDGs) also hinge crucially on improved management of natural resources and accelerating the transition from fossil fuels to renewable energy.

This report takes a broad view of the economic recovery, exploring international and domestic factors that will affect its pace and duration. It focuses on five loci of transformation: economic structure and ownership, urbanization, technological change and digitization, social change and the transformation of economic institutions. The authors argue that greater coherence and consistency in economic policy in each of these areas is needed to sustain the recovery and ensure continued progress toward the country's economic objectives.

We offer this report as a contribution to the Government's efforts to build forward better in the immediate aftermath of the Covid-19 pandemic and to implement the ten-year Socio-Economic Development Strategy and five-year Socio-Economic Development Plan. We are confident that the foresight and resilience that the Government and people of Viet Nam have shown during the pandemic are decisive factors that will empower the country to achieve the SDGs and build a prosperous, equitable and sustainable economy for all.

Caitlin Wiesen

UNDP Resident Representative

EXECUTIVE SUMMARY

Viet Nam has achieved impressive rates of growth and steady improvements in human development for three decades. The economy has created millions of good, steady jobs, lifting millions out of poverty. The government's early and effective response to the coronavirus pandemic helped Viet Nam avoid a deep recession in 2020 despite disruption to manufacturing supply chains in the early part of the year and a more lasting impact on services. A robust recovery is predicted for 2021, supported by a rebound in global demand and, when it can be implemented safely, a relaxation of international travel restrictions.

Viet Nam has set a target of attaining high income status by the time of the nation's centennial in 2045. This is a challenging but obtainable goal. Several East Asian countries made the transition from low to high-income status in the second half of the last century, and Viet Nam is poised replicate this achievement in the first half of this century. Some of the lessons learned from this experience remain relevant today: the strategic role of manufactured exports in boosting productivity growth and incomes; early and sustained investment in health, education and training; public support for research and development; and stable food prices obtained through sustained productivity growth in agriculture. Viet Nam will confront new challenges, such as rising protectionist sentiment in the advanced countries and heightened risk of financial instability associated with sudden shifts in movements of capital into and out of developing countries. Opportunities include a new trade deal with Europe, closer regional integration, new industries like renewable energy and e-mobility and rapid technological change in agriculture and agro-processing.

This report considers some of the key strategic issues facing Viet Nam as the economy recovers from the Covid-19 recession and resumes its high growth trajectory. The main include:

- The role of growth of manufactured exports in sustaining productivity and income growth and the role of government in supporting the ability of national champion firms to compete in export markets;
- The high cost to the economy of fragmentation in the formulation and implementation of economic policy across sectors and between national and local institutions;
- Sustaining a high rate of public and private investment to drive productivity growth and develop infrastructure, including adaptation to climate change and investment in renewable energy;
- Improved coordination of public investment at the national and regional levels, reducing fragmentation and duplication and aligning public investment with economic strategy;
- Closing the gap between the supply of and demand for long term, VND-denominated finance for slow-gestating public and private sector projects;
- The role of the national innovation system in promoting the competitiveness of national firms, especially in export manufacturing.

One of the main conclusions of the report is that reform of economic institutions is needed to sustain the growth of manufactured exports, increase the supply of long-term, VND-denominated finance, improve coordination of

national and regional public investment, and accelerate the development of technological capacity in national enterprises. Creating a favourable environment for private investment is important but not sufficient to sustain rapid growth: the government will be called on to structure market incentives to lengthen time horizons of firms and households and to promote research, education, infrastructure and renewable energy and other investments necessary for a sustainable recovery and productivity growth over the long period.

The Global Context and Economic Recovery

Viet Nam's recovery prospects are good, but the country may encounter headwinds from the global economy. The Covid-19 pandemic will have long-term effects even if the rapid deployment of vaccines and therapeutics succeed in bringing it under control in the coming months. The strength of the global recovery is also complicated by imbalances carried over from the Global Financial Crisis (GFC) in 2008, some of which were magnified by the response to the Covid-19 pandemic hit. High levels of indebtedness, soaring asset prices and financial volatility were already weighing on international markets before the pandemic. One of the main lessons from the GFC is that monetary policy can stave off bankruptcies but is less effective when it comes to restarting growth. Continuation of the policies pursued in the advanced countries of monetary loosening combined with fiscal austerity could mean another decade of economic underperformance on a world scale.

Political challenges to the multilateral trading regime are another threat to growth. The expansion of world trade since the 1990s delivered substantial benefits to Asian

economies. Recently, trade policy has become more transactional, with the advanced countries seeking to use their leverage to extract concessions from trading partners. Protectionism in the form of tariffs and a retreat from multilateral agreements attracted broad political support in the United States and other countries, where voters blame trade liberalization for the loss of domestic manufacturing jobs. As support for multilateralism wanes, regional trading arrangements, especially in Asia, will take on greater importance.

Slowing productivity growth since the 1970s is a reminder that technological innovation does not automatically translate into higher rates of economic growth. The ICT revolution transformed the way we work and live, but the benefits of these technologies have been unequally shared. The Fourth Industrial Revolution will introduce new ways to produce and consume goods and services. However, the capacity of these technologies to drive growth will hinge crucially on sustaining high rates of demand and investment, which in turn requires a fairer distribution of the benefits of growth.

Three Pillars of Development: Growth, Equity and Sustainability

Viet Nam has been ranked among the world's top performing economies for the past three decades. Rapid growth has transformed the country from one of the poorest in the world to a dynamic, middle-income country. Viet Nam has participated fully in the globalization of manufacturing, creating millions of new jobs in garment, footwear, electronics, and other industries. Agriculture has also made a substantial contribution to exports, job creation and productivity growth, and has kept food prices stable despite the large-scale exodus

of labour from the rural sector. Growth in Viet Nam has reduced the incidence of poverty and increased the earnings of middle-income groups, resulting in a relatively stable distribution of income.

However, globalization also entails risks. Viet Nam has had first-hand experience of the costs of financial instability during the East Asian Financial Crisis and the GFC. Capital inflows contribute to financing development, but they also destabilize currency and credit markets, and can spark inflation and create asset bubbles. Viet Nam's partially closed capital account and nonconvertible currency will help the country navigate the difficult period after Covid-19, when excess liquidity in the advanced countries is likely to generate volatility in emerging markets. Additional controls on short-term capital inflows are warranted as are curbs on speculative behavior. There is an urgent need for counter-cyclical fiscal institutions to increase resilience in case of sudden shifts in capital flows.

Viet Nam faces numerous challenges over the coming decade. Closing the infrastructure gap will require higher levels of public investment, but government revenue has fallen as a share of GDP. New sources of long-term capital are needed to support the development of technological capacity of domestic firms. Small, undercapitalized commercial banks still represent a risk to financial stability, and many of these institutions still have too much exposure to speculative ventures and connected lending. The pandemic has added to the stock of non-performing loans in the banking system, a problem that will remain a burden on the banks until the reform of bankruptcy laws and regulations enables banks to foreclose on collateral and dispose of assets. All this needs to be achieved in the context of a global economy weighed down by the Covid-19 pandemic and the lingering effects of the GFC in 2008.

Although measured inequality in Viet Nam has held steady at moderate levels, disparities still exist between groups in society. Poverty is heavily concentrated among ethnic minorities and in remote rural areas. The rapid accumulation of wealth among a small number of ultra-high net worth individuals suggests that capital gains tax policies should be reviewed, and steps taken to discourage speculation in land and financial assets.

As a coastal country with two low-lying deltas, Viet Nam is vulnerable to sea level rise and an increase in the number and severity of typhoons due to climate change. The quality of the air and water has deteriorated because of overreliance on fossil fuels and poor enforcement of environmental laws and regulations. More investment in renewable energy and reforestation is needed if Viet Nam is to meet its Nationally Determined Contribution of reducing the emission intensity of GDP by 20% (compared to 2010 levels) and increasing forest cover by 45% by 2030.

Viet Nam in Multiple Transformations

Change is apparent in every aspect of economic, social, and political life in Viet Nam. This report focuses on five aspects or loci of transformation: structure and ownership, urbanization, technology, society, and economic institutions. The list is not exhaustive but is intended to spell out some of the key challenges that the country faces as it makes the transition from an agrarian to an industrial economy; from a rural to an urban society; from a lower middle-income to high income country; from an adopter to a creator of technological innovation; and from an economy dominated by small producers to more diverse industrial structure, including large, national (public and private) firms.

The transformations described in this report are

interrelated but not necessarily synchronous. Contradictions and tensions arise in the development process as some sectors advance while others lag, some initiatives succeed while others fail, and disparities open between sectors and regions. The unbalanced nature of growth is not necessarily a cause of concern, and can even be beneficial, as Albert Hirschman argued many years ago. Bottlenecks and gridlock have a way of focusing the minds of policymakers and shaking up the status quo. Viet Nam's recent history provides numerous examples of positive change emerging from periods of disequilibrium, when it became apparent that the assumptions underlying existing models and policies needed to be revisited.

Viet Nam's recovery and long-term economic prospects depend on the reform economic institutions. New sources of long-term financing are needed to invest in infrastructure and other slow-gestating projects. In other developing countries, national development banks have filled this gap, providing long-term loans or loan guarantees to public and private sector projects. Development of the regulatory and institutional infrastructure of the domestic corporate bond market is also needed. The social protection system is another potential source of long-term capital, especially in light of Viet Nam's relatively young demographic structure.

The development of public infrastructure is also constrained by poor regional and sectoral coordination. Decentralization of decision-making to the provincial level and separation of project selection from financing decisions has led to a proliferation of small projects, duplication and missed opportunities to realize economies of scale. Weak local government capacity has contributed to cost overruns and delays. The costs of fragmentation are recognized in the Law on Planning enacted in 2017, but there is little evidence of change thus

far. Public investment decisions should be more closely integrated into national and regional development plans and strategies, promoting industrial clustering wherever possible to enhance export competitiveness.

Viet Nam's national innovation system is underfunded and not sufficiently well-integrated with the nation's export and industrial strategies. The current mix of research institutes, universities, firms, and financial institutions lacks a clear sense of mission and coherence. The aim of creating a supportive ecosystem for innovation is worthwhile but falls far short of what is needed to build the technological capabilities of national firms. A stronger focus on export growth, particularly in manufacturing, and instruments to increase demand for, as well as supply of innovation are needed.

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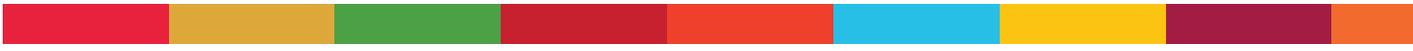
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SECTION 1: INTRODUCTION

Viet Nam ranks among the world's most successful middle-income economies, recording impressive rates of income and export growth and improvements to human development over a period of three decades. Rapid productivity growth and structural change have created good, steady jobs, lifting millions of people out of poverty. Owing to the government's early and effective response to the coronavirus pandemic, Viet Nam was one of the few middle-income countries to post a positive rate of growth in 2020 despite the devastating effects of the virus on transportation, tourism and other services and temporary disruption to manufacturing supply chains. A rebound in economic growth is predicted for 2021, supported by recovery of global demand and, eventually, a relaxation of international travel restrictions.

Viet Nam has set an ambitious target of reaching high income status by the nation's centennial in 2045. This is a challenging but obtainable goal. Other countries in the region made the transition from low to high-income status in the second half of the last century, and Viet Nam is poised replicate this accomplishment in the first half of this century. Some of the lessons learned from successful East Asian developing countries remain relevant: manufactured exports as a driver of productivity growth; a strong emphasis on health, education and training; generous public support for research and development; and maintaining stable domestic food prices obtained through sustained growth of agricultural productivity. Viet Nam will confront new challenges, such as rising protectionist sentiment in the advanced countries and the risk of financial instability associated with sudden shifts in global capital flows. But there are also new opportunities on the horizon: a new trade deal with Europe, closer regional integration, new industries like renewable energy and e-mobility and rapid technological change in agriculture and agro-processing.¹ Viet Nam has also learned key lessons from its own experience, not least of which is the importance of crisis and disaster preparation and the need to manage risks associated with price inflation and asset bubbles.

This report presents an analysis of the key economic issues facing Viet Nam as the country emerges from the Covid-19 pandemic and resumes its high growth trajectory. The report discusses multiple transformations that are unfolding concurrently in Viet Nam: i) transformation of economic structures and ownership; ii) spatial transformation; iii) technological and digital transformation; iv) social transformation; and, v) the transformation of economic institutions. These processes are interrelated and mutually reinforcing, but not necessarily synchronous: the experience of the successful East Asian countries has shown that when it comes to economic development all good things to do not always come together. As Albert

¹ *The European Union-Viet Nam Free Trade Agreement was signed on June 30, 2019 and ratified by the National Assembly on June 8, 2020. The Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) was agreed in 2018 by eleven countries including Viet Nam, Australia, Canada, Japan and Malaysia. The Regional Comprehensive Economic Partnership (RCEP), which also includes China, the Republic of Korea and all of the ASEAN countries, was signed on November 15, 2020.*

Hirschman pointed out in his prescient early writing on development strategy, the unbalanced nature of development actually creates opportunities for change, as progress in one domain or sector generates bottlenecks and tensions that generate demand for change in others (Hirschman, 1972). As observers of Viet Namese history can attest, development is neither linear nor tidy, and it is precisely periods of disequilibrium that have proven the most fertile for reform.

Notwithstanding the setback of the global pandemic, Viet Nam's performance in the past decade has brought the economy to the threshold of an historic breakthrough in productivity growth and living standards. With forward-looking policies and a supportive external environment, Viet Nam should emerge as the newest member of the G20 group of nations and the second largest economy in Southeast Asia within 25 years. Such a favorable outcome is not inevitable, and the country must manage significant risks. In addition to the threats posed by disasters and infectious diseases, the next decade will see mounting costs to agriculture and coastal communities from the effects of climate change; periodic episodes of financial instability and potentially large swings in commodity prices, including energy; and global risks relating to trade, geopolitical instability, terrorism and cybersecurity. No doubt the future will bring other surprises. Yet Viet Nam has demonstrated tremendous resilience during the Covid-19 pandemic, and this capacity to confront challenges head on will be called on in the coming years.

The focus of the present study is on policy areas critical to Viet Nam's economic recovery and long-term progress toward the goals of prosperity, equity and sustainability. These include:

- The close relationship between productivity growth and the rate of growth of manufactured exports, and the government's key role in supporting national champion firms in their efforts to compete in export markets;
- The high cost to the economy of policy fragmentation and the need to coordinate policy formulation and implementation across sectors and between national and local authorities;
- Building national and regional capacity to plan, implement and evaluate public investment projects to reduce fragmentation, tackle critical issues like climate change and disaster resilience, and support the development of domestic industries;
- Sustaining a high rate of domestic investment to drive productivity growth and competitiveness, and to adapt to and mitigate the effects climate change;
- Closing the gap between the supply of and demand for long term, VND-denominated financing of slow-gestating public and private sector projects;
- Reducing dependence on potentially destabilizing external capital flows; and
- Strengthening the national innovation system, including support for research and development, research-focused institutions of higher learning, and partnerships between government and the domestic private sector in emerging fields of technology.

Addressing these issues will require new state and non-state institutions, and improved coordination among institutions within and between the public

and private sectors. Institutional development and reform is never easy, and fragmentation—the proliferation of new institutions that compete rather than cooperate with each other for resources and influence—remains a serious problem in Viet Nam (Pincus, 2015). In our view, existing institutions are not up to the tasks of export promotion, the provision of long-term domestic finance, regional investment coordination and technological innovation. A central role for markets in addressing these issues does not imply that liberalization is sufficient: Viet Nam has consistently achieved faster growth than countries ranking much higher on various business environment surveys.² Government will be called on to structure market incentives to lengthen the time horizons of firms and households and to promote investment in research, education, infrastructure and renewable energy.

The rest of the paper is structured as follows. The next section reviews the global economic context and identifies several external challenges and opportunities. The impact of Covid-19 will be long-term, even if the development of vaccines and therapeutics succeed in bringing the pandemic under control this year. The section emphasizes four additional challenges: i) the impact of rising protectionism and weakening support for the multilateral trading system; ii) the global debt overhang resulting from excessive reliance on monetary stimulus in the wake of the Global Financial Crisis and the Covid-19 pandemic; iii) slow productivity growth and weak investment in the advanced countries; and iv) rising within-country inequality, especially in the advanced countries, which has important economic and political implications for emerging countries like Viet Nam.

Section 3 turns to the domestic context and is organized around the three pillars of development: growth, equity and sustainability. Viet Nam has been among the world's top performers for the past three decades, transforming the country from one of the poorest in the world to a dynamic, middle-income country. The benefits of growth have been widely shared, with most measures of economic inequality remaining stable over the past three decades. Yet challenges remain in all three dimensions of development. Episodes of financial instability have had a negative impact on growth and development, and the risk of future volatility is significant. Building managerial and technological capacity of domestic firms is essential to sustaining growth and job creation. While most regions and people have benefited from growth, pockets of poverty remain and require special attention. Addressing the impact of sea level rise and the increase in the number and severity of typhoons due to climate change will require large-scale public investment and policies to assist people and communities to find new jobs and, in some cases, to relocate.

Section 4 explores five perspectives on social and economic transformation: economic structure and ownership; spatial transformation and urbanization; technology and innovation; social change; and institutional development and reform. These loci of change are interrelated and can be mutually reinforcing. However, in middle-income countries institutional transformation has tended to lag other changes despite pressure from rising incomes, shifts in the composition of the labour force, urbanization and the development of new industries. The paper addresses opportunities for institutional reform in public finance, investment and the national innovation system. The final section concludes and identifies priorities for the coming decade.

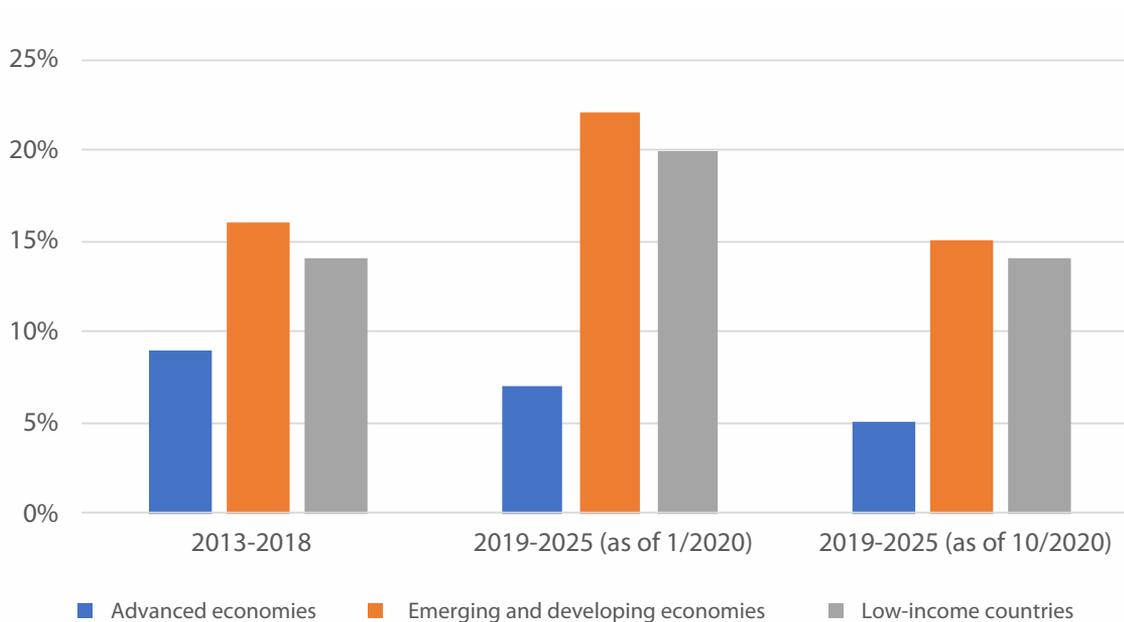
2 *No statistical relationship exists between rankings on the World Bank's Ease of Doing Business survey or the World Economic Forum's Competitiveness survey and the rate of economic growth for any period since the surveys were launched. For the period 2015 to 2019, none of the countries that ranked higher on the World Bank's Ease of Doing Business survey posted a higher growth rate than Viet Nam. In 2019, Viet Nam ranked 70th out of 190 countries in this survey.*



SECTION 2: GLOBAL CONTEXT AND ECONOMIC RECOVERY

The world economy is still reeling from the impact of the coronavirus pandemic. A global peak of more than 700,000 daily cases was recorded on January 12, 2021, after which the world slowly began to emerge from the third wave of infections. However, by the end of February progress had stalled again, with case numbers rising in Latin America, Eastern Europe and the Middle East. The development, production and distribution of new vaccines has raised hopes that the virus will be contained, but as of mid-March just four percent of the world's population had received at least one vaccine dose. Trade and investment will be affected through 2022, reducing economic activity below potential. The difference between the International Monetary Fund's pre- and post-Covid growth forecasts for emerging and developing economies predicts that the crisis will reduce growth per capita in these countries by one-third for the period 2019-2025 (Figure 1).

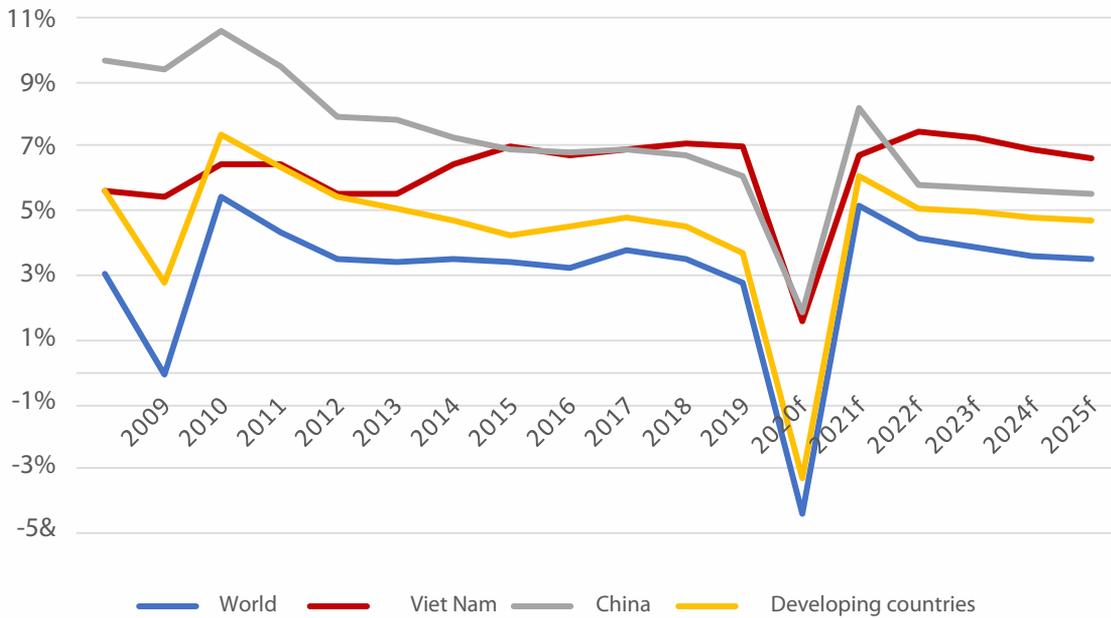
Figure 1. Cumulative GDP Growth per capita before and after Covid-19



Source: International Monetary Fund (IMF)

The economic impact of the Covid-19 pandemic was made worse by the uneven policy response to the Global Financial Crisis of 2008/9 (GFC) in the advanced countries. The world economy was already slowing before the pandemic, weighed down by low rates of investment, high levels of corporate and government debt, rising inequality, and challenges to the multilateral trading regime (Figure 2). The response to the GFC had relied too heavily on monetary policy while keeping a tight rein on government spending, in some cases pursuing an ill-advised fiscal austerity to balance public sector budgets in the middle of a deep recession. The results of this combination of massive injections of liquidity and weak demand were apparent to all by the end of the decade: soaring asset prices, slow productivity growth, declining trade volumes and rising indebtedness. The question now facing these countries—and the world—is whether the advanced countries have learned the appropriate lessons from this experience and will respond to the Covid crisis in a more forward-looking manner.

Figure 2. World economic growth 2008-2019 and forecast to 2025 (as of October 2020)



Source: International Monetary Fund

The global economy suffered an economic contraction of around 3.5% in 2020. The IMF predicts robust growth of 5.5% in 2021, but the magnitude of the recovery depends on our capacity to bring the pandemic under control and tackle problems carried over from the GFC. This section discusses four of these risks: i) challenges to the multilateral trading system; ii) the debt overhang from the GFC and Covid-19; iii) the long-term slowdown in productivity growth in the advanced countries; and, iv) rising within-country economic inequality. Viet Nam’s economic prospects during the next plan period will be shaped by these global factors and policy responses to them in the high-income countries.

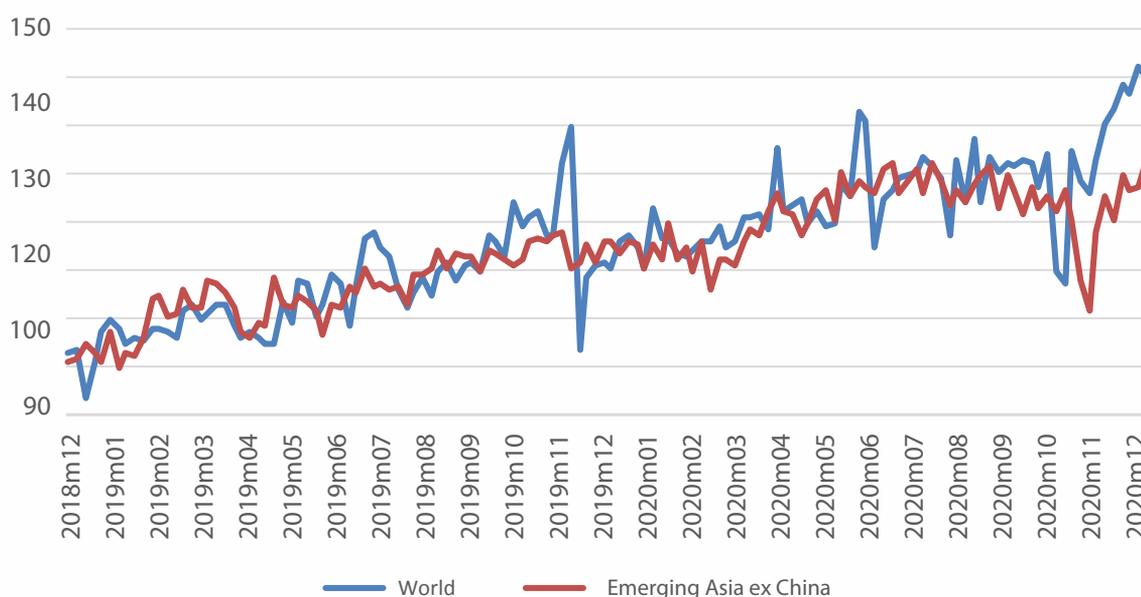


Challenges to multilateral trading arrangements

The trade dispute between the United States and China weighs heavily on the global economy. The US, which had acted as the guarantor of the multilateral trading system since World War II, is now its principal critic. The Trump administration worked behind the scenes to dismantle the dispute settlement capacity of the World Trade Organization (WTO), the main enforcement mechanism for multilateral trade agreements. While the defeat of the Republican party in the November polls signals at least a partial retreat from protectionism, the Trump tariffs and withdrawal from the Trans-Pacific Partnership Agreement (TPP) enjoyed broad political support in both parties. The longstanding bipartisan consensus favoring trade and investment liberalization in manufacturing and services (although not in agriculture) has collapsed, giving way to an escalation of anti-globalization rhetoric on both the right and left of the political spectrum. With the US taking a more instrumental approach to trade deals, other countries are seizing the opportunity to back away from their own WTO commitments.

The reemergence of trade barriers is an obstacle to export growth and the development of complex supply chains in industries like automobiles and electronics. Developing countries in Asia other than China saw export volumes fall in absolute terms in 2019, even before the Covid-19 pandemic (Figure 3). Global trade volumes grew by just 0.3% in 2019, the lowest level since the GFC. Hopes for a quick resolution faded as the issues under discussion widened from trade to security, and technology policy and currency alignment.

Figure 3. Export volumes, China and other Asian developing countries, 2010=100



Source: Netherlands Bureau for Economic Policy Analysis

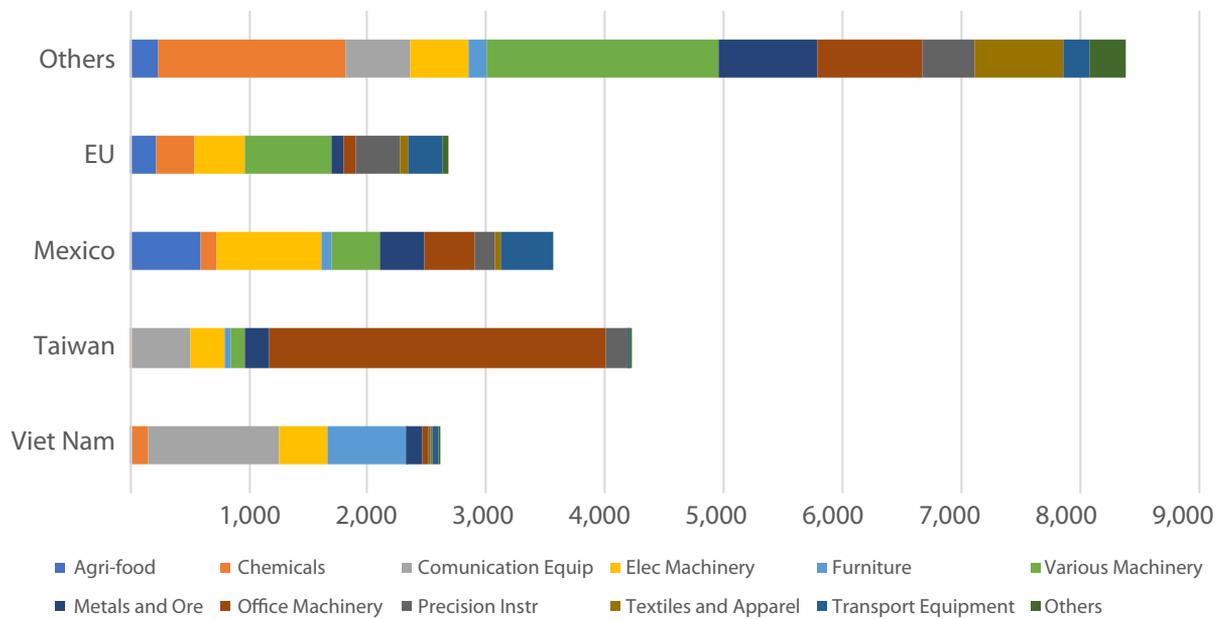
The multilateral trading system under the General Agreement on Tariffs and Trade (GATT) and the WTO created a legal and policy environment conducive to the exceptionally rapid development of manufacturing in Asia. As recently as 2000, the twelve largest East and Southeast Asian economies (other than Japan) accounted for just 12% of global manufacturing value added. By 2018 this figure had risen to 42%, a remarkable transformation in one generation.³ An open trading regime facilitated the growth of modular manufacturing, intra-firm trade and complex value chains in the region. Viet Nam is among the most internationally integrated, with nearly 60% of exports consisting of intra-company trade.⁴ Pessimists who claimed that the developing world was forever condemned to exporting natural resources and importing manufactured goods were proven wrong, as were WTO sceptics who warned China that acceding to the organization would hold back country's industrial development. Neither of these dire predictions came to pass, and the millions of steady jobs created by manufacturing firms have contributed to rapid growth of average incomes and poverty reduction in these countries. Whatever the shortcomings of the multilateral system, it provided a supportive regulatory framework for the growth of manufacturing enterprises in developing countries and some protection against *ad hoc* and unilateral trade barriers. The WTO dispute resolution process, although slow and cumbersome, demonstrated a capacity for impartiality with landmark rulings against US interests and in favor of developing countries in cases such as Brazil's 2003 complaint against US cotton subsidies.

New US trade barriers have prompted some manufacturers to relocate operations from China to other countries, including Viet Nam. Labour-intensive manufacturing had already been seeking new export platforms because of rising labour costs in China, but the intensity of the dispute from 2018 accelerated this process. Across a range of industries, supply chains have been reconfigured to relocate final assembly operations to countries posting smaller US trade surpluses or those that have bilateral agreements with the US. Viet Nam has thus far been one of the main beneficiaries of trade diversion from China, specifically in the mobile phone and furniture industries (Figure 4). Other beneficiaries include Taiwan, which has "reshored" computer component and assembly operations, Mexico and the European Union.

3 The countries are Bangladesh, China, India, Indonesia, Korea, Malaysia, Pakistan, Philippines, Singapore, Taiwan, Thailand and Viet Nam.

4 Participation in value chains is defined as the share of exports using intermediate imports and that are used by another country in the production of exports (UNDESA, 2020, p. 137).

Figure 4. Trade diversion resulting from US tariffs on China, US\$ millions



Source: (Nicita, 2019)

Trade diversion has delivered benefits to Viet Nam in the short term, but the long-term implications are less clear-cut. Viet Nam’s trade surplus with the United States was US\$55.8 billion in 2019, a 41% increase over the previous year. Viet Nam records the fifth largest surplus with the US (after China, Mexico, Japan and Germany). The risk is that rapidly growing surpluses will trigger retaliation in the form of tariffs on manufactured and agricultural exports. In October 2020, the US government announced that it had launched an investigation into alleged currency manipulation by Viet Nam, which could lead to the imposition of tariffs. A separate investigation into Viet Namese timber harvesting practices has also been initiated.⁵

Fading US support for multilateralism has focused attention on regional trading arrangements, especially in Asia. In the past, Asian countries worked to strengthen the region’s position as an export platform, reducing obstacles to the formation of complex value chains in manufacturing. New agreements build on these structures, but also capitalize on rising incomes and final demand within the region, especially Japan, China and the Republic of Korea. It is striking that as North America and Europe reconsider the benefits of regional economic integration, Asia is deepening ties through CPTPP and RCEP, among other initiatives.

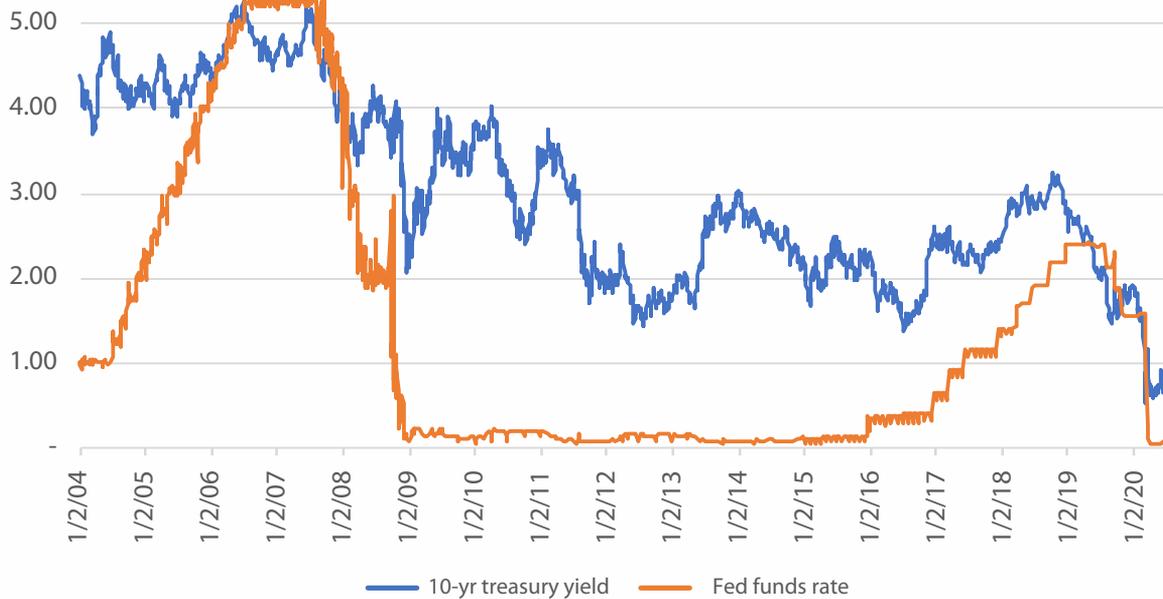
Over-reliance on monetary policy

High-income countries relied almost exclusively on monetary stimulus to stabilize financial markets and restart growth after the GFC. Quantitative easing injected trillions of dollars into global financial markets. In the US, the Fed Funds rate was held below one percent from the onset of the crisis until mid-2017, when early indications of price inflation and wage growth prompted a stepwise increase in

5 “US Launches Currency Manipulation Inquiry Against Viet Nam,” *Financial Times*, October 3, 2020.

interest rates. However, even a decade after the crisis, the recovery was still too fragile to withdraw the monetary stimulus (Figure 5). The inversion of the yield curve—long-term falling below short-term rates—sparked fears of recession and prompted central banks to reduce interest rates through the end of 2019. Rates were again slashed on March 16, 2020 as the economic impact of the Covid-19 pandemic became apparent.

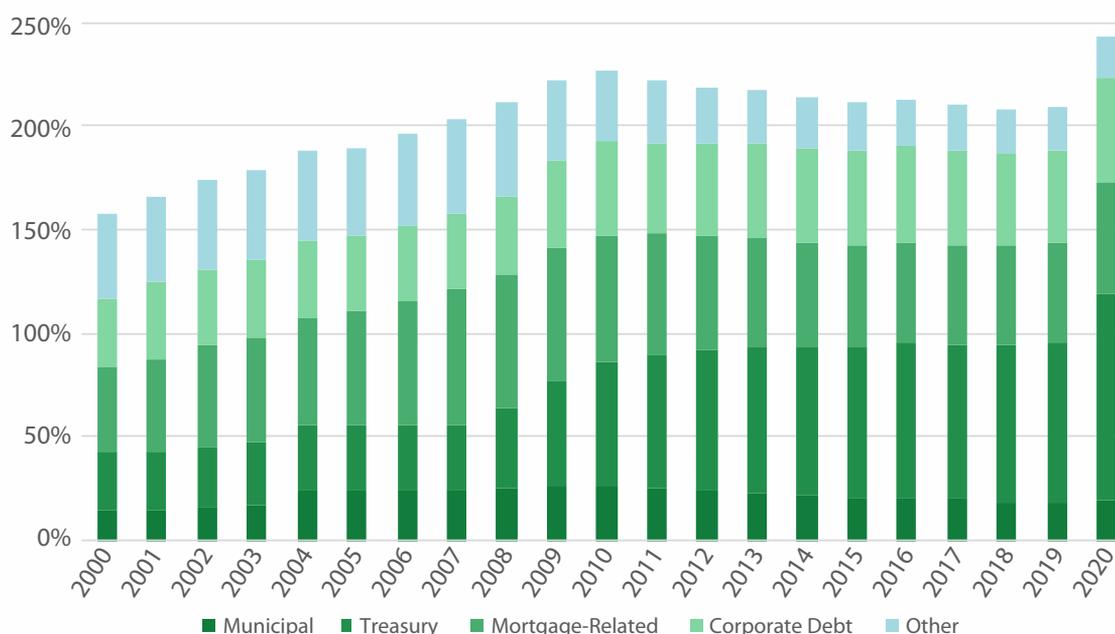
Figure 5. Federal funds rate and maturity on 10-year treasuries, 1990-2019



Source: US Federal Reserve

Aggressive monetary policy after the GFC helped prevent widespread bankruptcies but did not do enough to support the level of effective demand. According to the Institute of International Finance, the ratio of global debt to economic output reached a record high of 331% in the first quarter of 2020, with total debt of nearly US\$ 260 trillion (Figure 6). Low interest rates kept many companies on life support and drove investors into riskier assets in search of higher returns. Stock prices soared to historic levels, fueled by cheap credit and an absence of productive investment opportunities. Even the economic disruption of Covid-19 did nothing to dampen the enthusiasm of speculators: their response to a second quarter GDP contraction of 31% was to drive the up S&P 500 by 18%. While it took forty-two years for Apple to achieve a valuation of US\$1 trillion, the company added a second trillion in just 21 weeks from March to August 2020—during the deepest downturn since the Great Depression. Asset prices had lost touch with economic fundamentals.

Figure 6. Accumulated US bond market debt as % GDP, 1989-2019

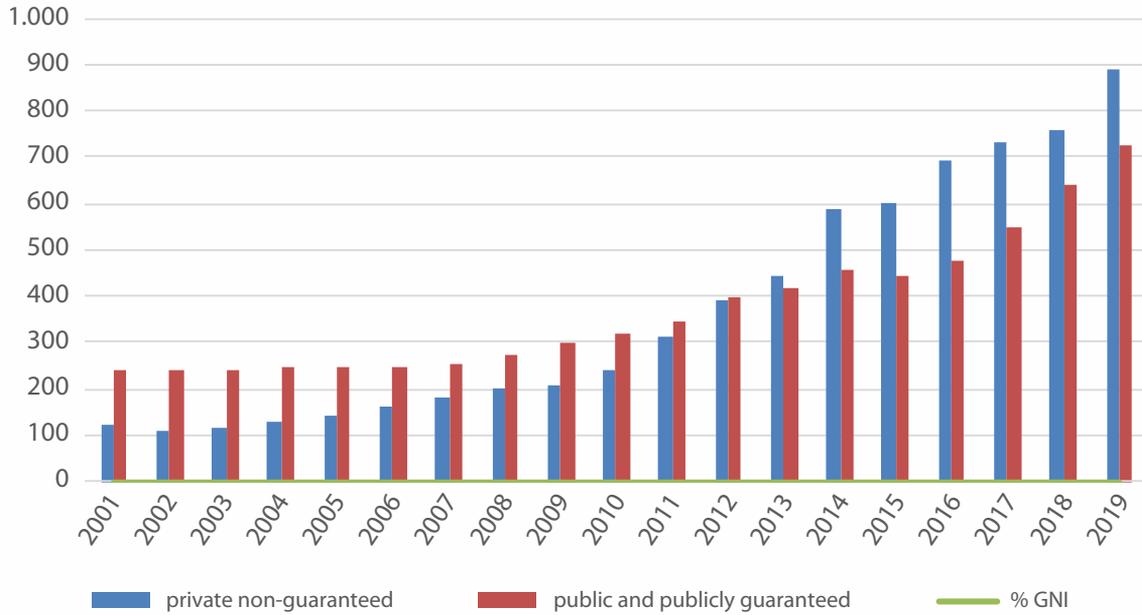


Source: Securities Industry and Financial Markets Association and the Federal Reserve Bank of St Louis

One of the worrying trends in the post-crisis period is the increase in leveraged corporate borrowing in the form of high-yielding, syndicated loans for heavily indebted companies. The value of this market was US\$ 1.3 trillion in early 2020, with about half of the total originating in the US (Plender, 2020). In September 2019, the US Federal Reserve was forced to inject \$140 billion of liquidity into the capital markets on fears that borrowers were unable to refinance their obligations. Corporate debt in the US rose from 35% of GDP before the crisis to 50% in 2020 (Figure 6). Corporations have also sought to maintain high share prices by borrowing cheaply on debt markets and buying back their own stock. This is a short-term fix that supports equity prices (and executives' bonuses) but channels capital away from productive investment. Cheap credit has also stimulated a wave of mergers and acquisitions in all major markets. Net capital investment remained below pre-crisis levels in 2019 in the US, UK, eurozone and Japan. Central banks are caught in a dilemma: while they acknowledge the build-up of risks associated with cheap credit, aggregate demand is still too weak to permit a return to conventional monetary policy, especially in the wake of the Covid-19 pandemic.

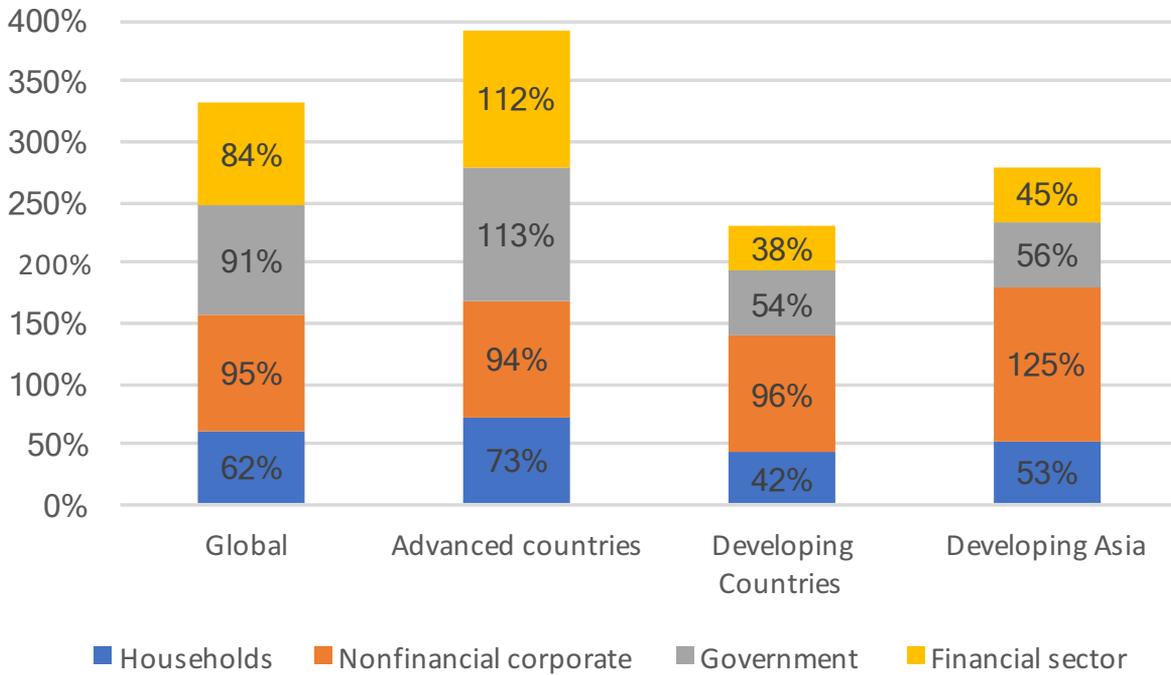
Excess liquidity in international markets has serious implications for financial stability in the developing world. Low interest rates in the advanced countries drive capital to emerging markets in search of higher yields. Brazilian President Dilma Rousseff memorably referred to the rush of capital into the developing economies after 2008 as a "monetary tsunami." Total indebtedness among low- and middle-income countries rose at an average rate of 9% per year from 2008 to 2018. The pace of borrowing was particularly rapid in East Asia, where public sector external debt rose by 8% and private debt by 15% per year (Figure 7). By the end of 2018, the region's total external debt stock was US\$2.8 trillion, about half of which was short term (maturities of one-year or less). Non-financial corporate debt was 125% of GDP at the end of the Q1 2020 (Figure 8). The rise of foreign currency-denominated, short-term corporate debt is a cause of concern because it coincides with a slowdown in global trade and economic growth, and fluctuations in foreign exchange markets.

Figure 7. Public and private external debt stocks, East Asia and Pacific developing countries, US\$ billions and % GDP



Source: World Development Indicators

Figure 8. Debt as a share of GDP, March 2020



Source: Institute of International Finance

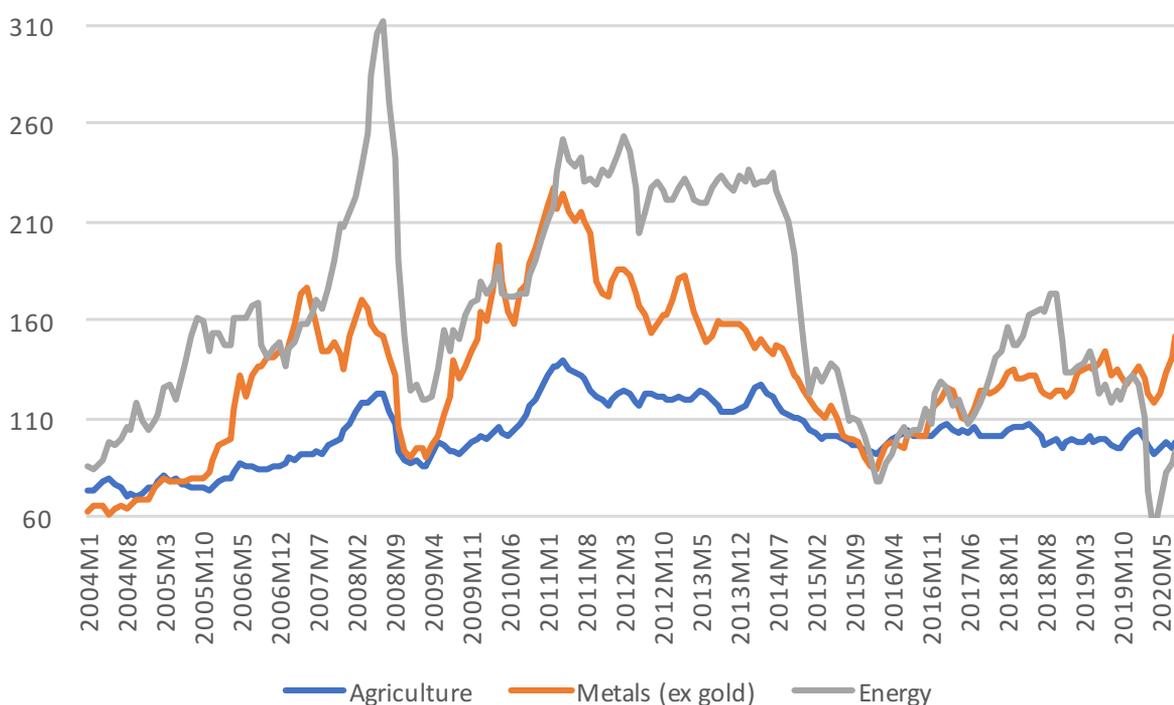


As Viet Nam experienced directly in 2007-2008, pro-cyclical capital inflows can fuel inflation and asset bubbles and stimulate domestic over-borrowing and speculation. Once dominated by public borrowing, capital inflows are now largely absorbed by the private sector in the form of bonds, bank loans and foreign direct investment. In a world of unregulated capital flows and excess international liquidity there are no “automatic stabilizers” to restore equilibrium in the wake of a sudden rush of foreign capital. There is rather an inbuilt tendency for foreign capital to “overshoot,” causing economies to overheat. Large inflows also lead to exchange rate appreciation, with negative effects on the balance of trade as exports become less competitive and imports cheaper. As discussed in the next section, Viet Nam has had recent experience of a rush of foreign capital generating domestic price inflation. Steps should be taken to avoid the recurrence of this problem, specifically limits on short-term, US-dollar denominated borrowing and inflows of portfolio capital into property markets and domestic financial instruments.

The “Taper Tantrum” of 2013 was an example of the destabilizing effects of a sudden exit of capital from developing countries as investors anticipated interest rate rises in the advanced countries. Signs of price inflation or overheating in the US in 2021 could spark a rerun of this phenomenon, weakening Asian currencies, driving up domestic interest rates and slowing economic growth.

The slowdown in growth after 2014 reduced demand for commodities and led to a fall in energy and metal prices (Figure 9). Prices enjoyed a modest recovery in 2017 and 2018, but lost momentum again in 2019. Energy prices collapsed during the Covid pandemic, but metals were supported in the second half of 2020 by the prospect of a surge in infrastructure investments. Agricultural commodities, including food, held constant during the pandemic.

Figure 9. Commodity price indices, 2016=100



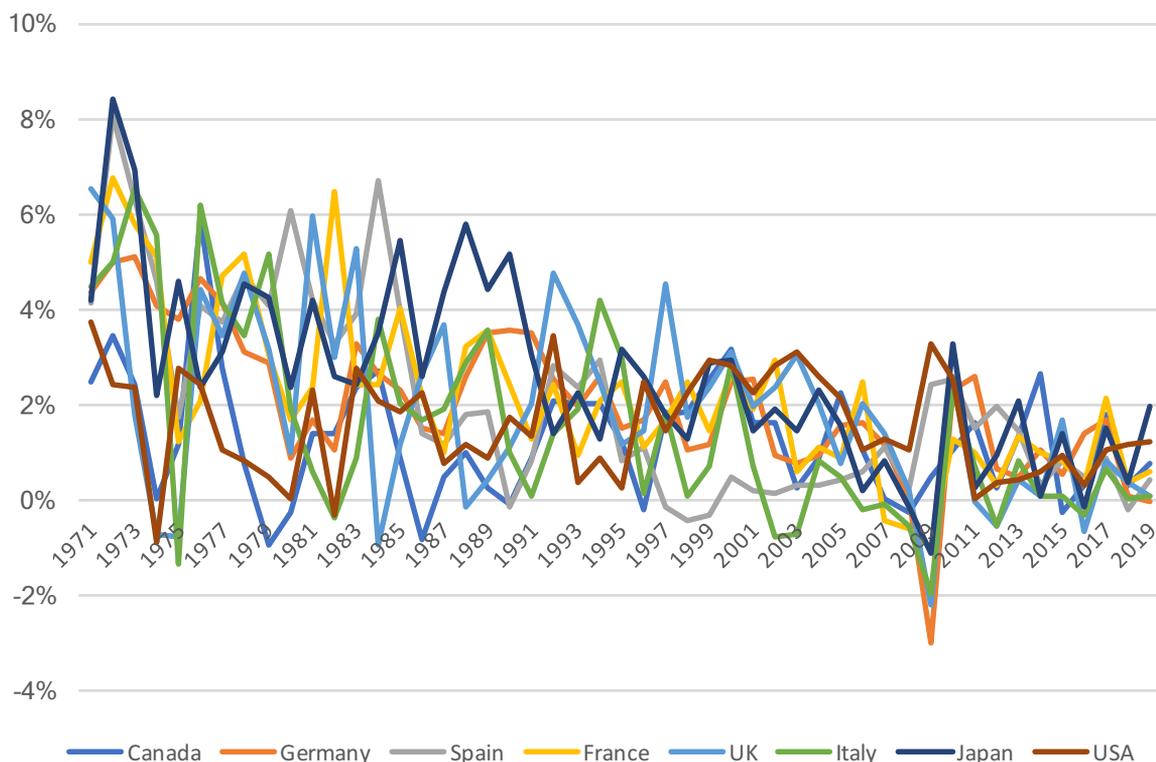
Source: International Monetary Fund

An important policy lesson from the years following the GFC is that monetary policy is an important tool to avert financial disaster, but it is ineffective when it comes to restarting economic growth. Massive injections of liquidity create financial vulnerabilities in the form of asset bubbles and highly leveraged firms and households. As discussed below, one of the defining characteristics of the post-GFC recovery was historically low rates of investment and slow productivity growth. The recent enactment of a large fiscal stimulus measure in the US is a sign that policymakers are wary of repeating the post-GFC experience. Yet elsewhere there is already talk of the need for tax rises and spending cuts to pare back fiscal deficits. It remains to be seen whether common sense will prevail or and governments will once again take pro-cyclical austerity measures before the economic recovery has had a change to gather pace.

Long-term slowdown in productivity growth

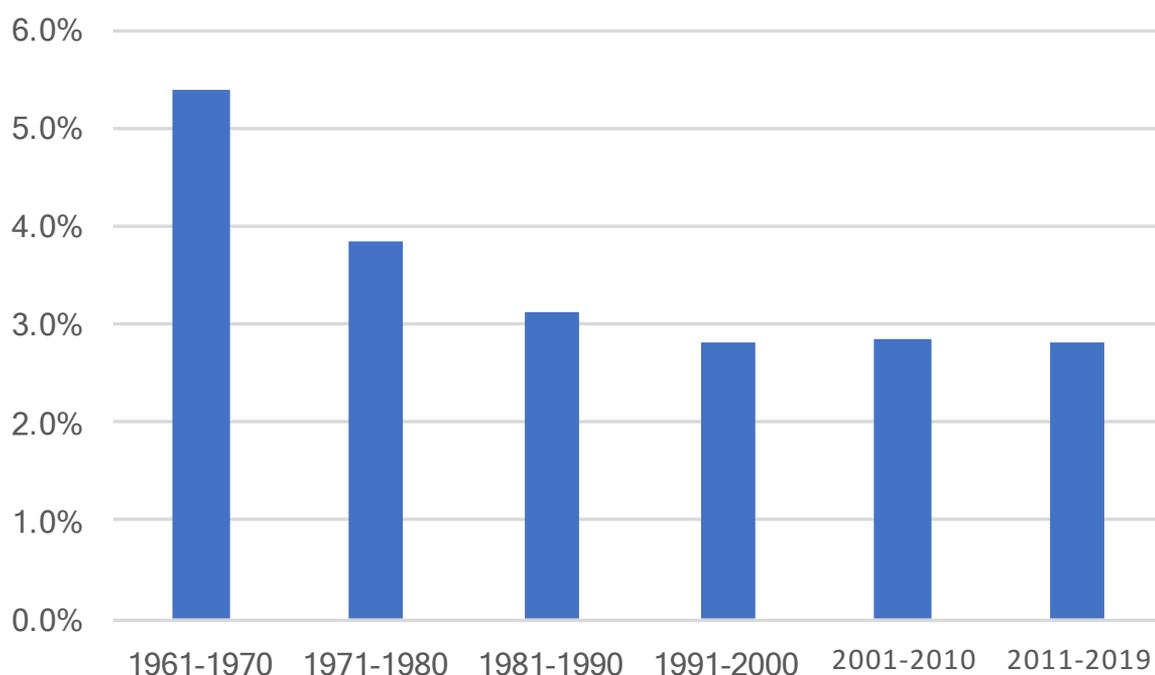
By definition, economic growth is a product of the growth of the labour force and growth of output per person. One of the most remarkable features of our era is the secular slowdown in labour productivity growth in the advanced economies since the 1970s, a period coinciding with globalization and the revolution in information and communications technologies (Figure 10). Trade liberalization, financial integration, digitization and containerized shipping transformed production systems, creating conditions conducive to specialization, the adoption of “just in time” production systems and increasing returns to scale. Despite these profound changes, productivity growth has decelerated, and with it the rate of economic growth (Figure 11).

Figure 10. Labour productivity growth in Canada, Germany, France, UK, Italy, Japan and USA, 1971-2018, 3-year moving average



Source: Organization for Economic Cooperation and Development (OECD)

Figure 11. World economic output growth, 1961-2019



Source: World Development Indicators

At the risk of oversimplification, two hypotheses have been put forward to explain the apparent anomaly of slower growth with the spread of efficiency-enhancing technologies and the globalization of production. The first hypothesis holds that periods of exceptionally rapid productivity growth are the exception, not the rule. From 1890 to 1970 the world experienced the Second Industrial Revolution, when electrical power and the internal combustion engine made possible extraordinary productivity gains. The information and communications advances associated with the Third Industrial Revolution—microcomputers, the internet and mobile phones—changed much about the way we live, but did not fundamentally transform production systems in ways equivalent to the Second Industrial Revolution (Gordon, 2012).

The alternative view is broadly Keynesian in that it attributes the slowdown in productivity growth to constraints on the growth of effective demand. In opposition to supply-side theories of productivity growth, this view focuses on the role of demand in stimulating investment in productivity-enhancing technologies. Various explanations have been proposed to explain the shortfall in demand, including labour's declining share of national income, rising inequality and concentration of economic power, excess savings in China and other Asian countries (including foreign exchange reserves accumulated to self-insure against currency crises), the spread of labour-displacing technologies and slowing population growth.⁶ Financial liberalization has also diverted capital into rentier finance, speculation and mergers and acquisitions.⁷ These activities generate high returns for owners of capital but do not contribute to final demand or technological progress.

6 For an example see Eggertsson and Mehotra 2014.

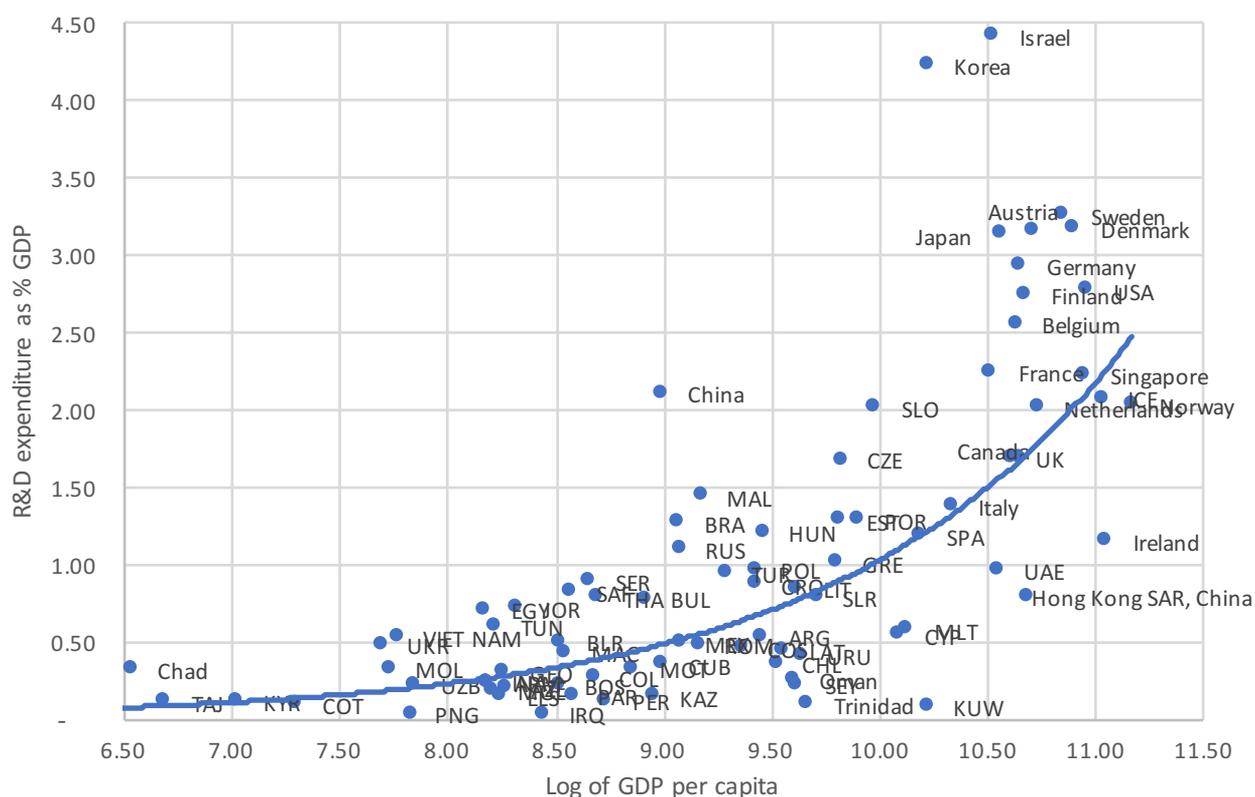
7 For a recent, in-depth discussion of the relationship between industrial concentration and slow productivity growth see Philippon 2019.

It is not necessary for present purposes to adjudicate between these competing explanations of lagging productivity growth. However, we should heed the lesson from recent history that technological change does not inevitably generate productivity growth (and hence economic growth). Production in the future may well be transformed by artificial intelligence, nanotechnology, 3D printing and the “internet of things,” but social, economic and political factors mediate between technological progress and its impact on productivity. If we have learned anything from the Third Industrial Revolution, it is that productivity growth depends on the rate of investment even within a context of rapid technological change. The policy implication for developing countries is that productive investment—meaning investment leading to the production of goods and services rather than speculation in land or financial assets—is the main driver of productivity growth.

Even within an overall pattern of slower growth, performance has varied markedly from country to country. As already noted, sustaining a high rate of investment while discouraging speculation in risky assets is closely associated with rapid growth. Successful countries have also invested early and heavily in research and development. As shown in Figure 12, there exists a close relationship between R&D spending and the level of development. In a handful of countries, R&D investment is exceptionally high relative to per capita income, and these countries—China, Israel, Korea, Japan and several northern European countries—have had more success than most in creating national champion firms. Israel and the Republic of Korea stand out for the level of R&D spending (absolutely and relative to GDP per capita) and growth of exports. These two countries together account for 17 of the Boston Consulting Group’s 100 Emerging Market Tech Challengers in 2020.⁸

8 See (Chan et al., 2020). *Israel has nine companies on the list, concentrated in software and cybersecurity/ payments systems. The eight Korean companies are drawn mostly from the e-commerce industry. There are forty Chinese companies on the list. By way of comparison, Latin America and the Caribbean are represented by just six companies, and there were only three from Africa. Although just a snapshot of innovation in the developing world, the report is revealing because of the close relationship between R&D effort and the emergence of national champion firms.*

Figure 12. R&D spending as % GDP and GDP per capita, 2016



Source: Authors' calculations from UNESCO and World Development Indicators

Viet Nam currently outperforms other countries at a similar level of development, but the absolute level of R&D investment is small. The challenge for the coming decade is to sharply increase spending on research, training and innovation in both the public and private sectors. This will mean more public support for universities and a willingness to focus resources on specialized institutions that can attract world-class scientists—including members of the Viet Nameese diaspora that would welcome the opportunity to return home to contribute to national development. Taiwan and China have had success recruiting diaspora scientists back to national education and research institutions by creating positions that provide them with facilities (laboratories, equipment and research funding) equivalent to those that they have access to in advanced country institutions. Partnerships between domestic and international institutions is also an important driver of research quality and ambition. We will revisit the issue of strengthening the national innovation system in Section 4.

Rising inequality

The two dominant trends in the global distribution of income and wealth are the narrowing gap *between* nations—driven primarily by the rise of East Asia—and rising inequality *within* nations. The *2019 Human Development Report* presents a careful analysis of the asymmetrical impact of technological change, climate change and political power imbalances on the living standards of disadvantaged populations and regions. Globally, while we have made some progress in reducing extreme deprivation, we have also failed to address the concentration of income, wealth and opportunity within the most well-off segments of society. “Time and again,” the report concludes, “the analysis shows that countries and people at the bottom are catching

up in basic capabilities while those at the top pull away in enhanced capabilities” (UNDP, 2019a, p. 24)“ISBN:”978-92-1-126439-5”“language:”English”“note:”OCLC: 1130905759”“publisher:”United Nations Development Program”“publisher-place:”New York”“source:”Open WorldCat”“title:”Human Development Report: Beyond income, beyond averages, beyond today: Inequalities in human development in the 21st century”“author:”{”family:”UNDP””given:””}”“issued:”{”date-parts:”[[”2019”]]}”“locator:”24”}”“schema:”https://github.com/citation-style-language/schema/raw/master/csl-citation.json”}.

While many factors have contributed to this pattern, globalization has proved to be a powerful force for both poverty alleviation and the concentration of income and wealth at the top of the pyramid. The relocation of manufacturing from Europe and North America to Asia created millions of formal sector jobs in East and Southeast Asia for people previously dependent on agriculture and other low-productivity occupations. Although in absolute terms, the incomes of the Asian middle classes are lower than their counterparts in the advanced countries, they are higher than alternative income earning opportunities at home and thus represent a significant improvement in well-being (Milanović, 2016, p. 11)Branko Milanovic presents a bold new account of the dynamics that drive inequality on a global scale. Drawing on vast data sets and cutting-edge research, he explains the benign and malign forces that make inequality rise and fall within and among nations. He also reveals who has been helped the most by globalization, who has been held back, and what policies might tilt the balance toward economic justice. Global Inequality takes us back hundreds of years, and as far around the world as data allow, to show that inequality moves in cycles, fueled by war and disease, technological disruption, access to education, and redistribution. The recent surge of inequality in the West has been driven by the revolution in technology, just as the Industrial Revolution drove inequality 150 years ago. But even as inequality has soared within nations, it has fallen dramatically among nations, as middle-class incomes in China and India have drawn closer to the stagnating incomes of the middle classes in the developed world. A more open migration policy would reduce global inequality even further. Both American and Chinese inequality seem well entrenched and self-reproducing, though it is difficult to predict if current trends will be derailed by emerging plutocracy, populism, or war. For those who want to understand how we got where we are, where we may be heading, and what policies might help reverse that course, Milanovic’s compelling explanation is the ideal place to start.”--Provided by publisher”“call-number:”HM821 .M555 2016”“event-place:”Cambridge, Massachusetts”“ISBN:”978-0-674-73713-6”“number-of-pages:”299”“publisher:”The Belknap Press of Harvard University Press”“publisher-place:”Cambridge, Massachusetts”“source:”Library of Congress ISBN”“title:”Global inequality: a new approach for the age of globalization”“title-short:”Global inequality”“author:”{”family:”Milanović””given:”Branko”}”“issued:”{”date-parts:”[[”2016”]]}”“locator:”11”}”“schema:”https://github.com/citation-style-language/schema/raw/master/csl-citation.json”}.

At the same time, globalization and technological change have favored people with advanced skills and educational qualifications and owners of capital. Trade and financial liberalization have reduced costs and increased returns on assets for investors and enabled companies and individuals to shelter income from tax. Policies in the industrialized countries—for example, tax cuts, financial liberalization and labour deregulation—have also favored the rich since the 1980s (Milanović, 2016, p. 54)Branko Milanovic presents a bold new account of the dynamics that drive inequality on a global scale. Drawing on vast data sets

and cutting-edge research, he explains the benign and malign forces that make inequality rise and fall within and among nations. He also reveals who has been helped the most by globalization, who has been held back, and what policies might tilt the balance toward economic justice. *Global Inequality* takes us back hundreds of years, and as far around the world as data allow, to show that inequality moves in cycles, fueled by war and disease, technological disruption, access to education, and redistribution. The recent surge of inequality in the West has been driven by the revolution in technology, just as the Industrial Revolution drove inequality 150 years ago. But even as inequality has soared within nations, it has fallen dramatically among nations, as middle-class incomes in China and India have drawn closer to the stagnating incomes of the middle classes in the developed world. A more open migration policy would reduce global inequality even further. Both American and Chinese inequality seem well entrenched and self-reproducing, though it is difficult to predict if current trends will be derailed by emerging plutocracy, populism, or war. For those who want to understand how we got where we are, where we may be heading, and what policies might help reverse that course, Milanovic's compelling explanation is the ideal place to start.

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The big losers from globalization are the middle classes in the advanced countries, who have suffered a series of setbacks since the 1980s that reversed decades of economic gains and closed off traditional avenues of social mobility. In addition to the loss of manufacturing employment, automation eliminated entire classifications of administrative jobs and deskilled others. In the United States, labour unions were weakened by anti-union legislation and the cost of education and health care rose significantly as a share of disposable income. The attempt by Americans in these income groups to sustain consumption levels by borrowing (mortgages, credit cards and student loans) was one of the main causes of the GFC in 2008.

These shifts in the global distribution of income have contributed to the rise of populist nationalism in the Western world. The resurgence of protectionist and anti-immigration sentiment is a cause for concern for successful exporting countries like Viet Nam that record large trade surpluses with the United States and other importing countries. These countries can expect that every aspect of their trade relationships will come under scrutiny, from health and safety standards to labour conditions, environmental regulations and exchange rate issues. Governments in exporting countries can minimize the impact of these disputes by supporting the efforts of domestic companies to achieve international technical, health and environmental standards. Regional trade agreements like the eleven country Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) and the larger Regional Comprehensive Economic Partnership (RCEP) have taken on greater importance as challenges to the multilateral trade system have mounted. The acceptance of common rules among Asian exporting countries will strengthen the region's bargaining power and promote the development of regional value chains. As incomes rise in Asia, intra-regional trade is also likely to make up a larger share of final demand.

Rising in-country inequality also weighs on global economic growth. Higher inequality is associated with both slower growth and shorter duration of growth spells (Ostry et al., 2014). There are two main channels through which this occurs. First, inequality is a drag on aggregate demand because wealthier households save a larger share of their income. Slow growth of consumption discourages investment in new plant and equipment, and job creation (Carvalho & Rezai, 2016). Second, inequality generates financial instability as households attempt to sustain living standards through borrowing, amplifying credit cycles and increasing the frequency and depth of financial crises.

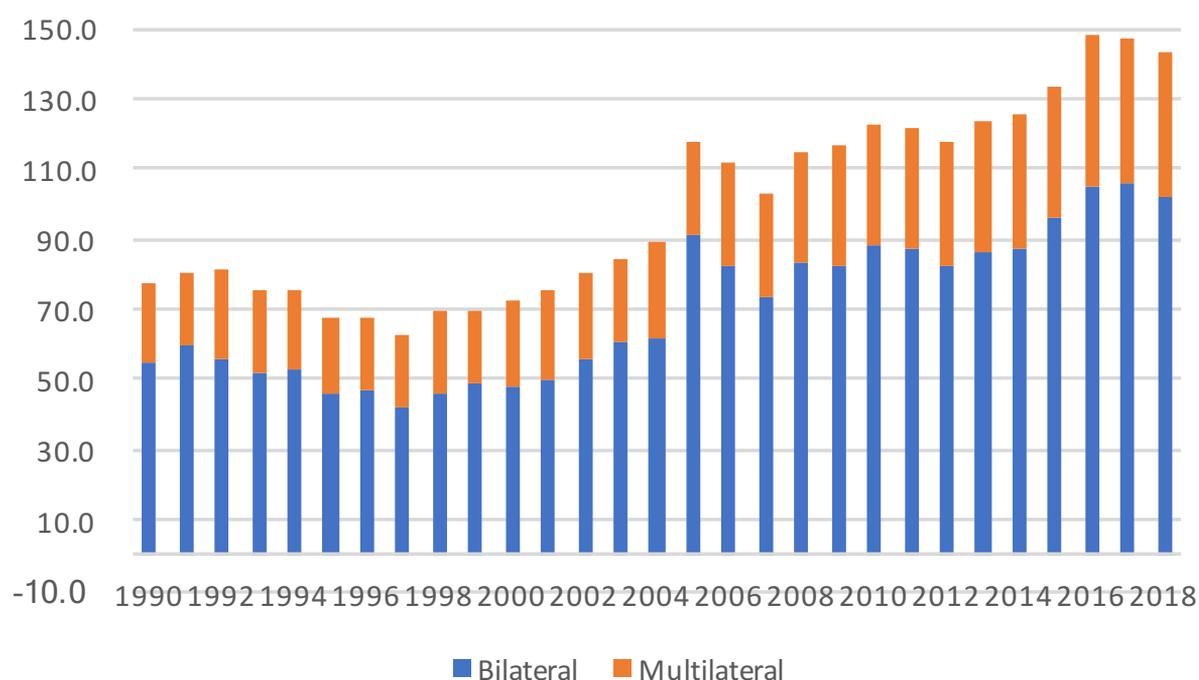
Inequality and the trend toward the concentration of wealth and income will influence global growth prospects over the coming decade. The Covid-19 pandemic has widened disparities in the advanced countries in the short term as low-income households were more likely to lose their jobs or suffer loss of income. The negative impact on small businesses will affect the distribution of income for years to come. Children in poorer households were also more likely to experience interruption to their education, with potentially significant long-run consequences for lifetime earnings. As mentioned above, governments in the advanced countries must learn the lessons of the GFC and not rely exclusively on monetary policy to counter the economic effects of Covid-19.

Shifting patterns of Official development Assistance

The Millennium Development Goals (MDGs) injected new momentum and brought greater focus to the delivery and use of development assistance (Figure 13). From a period of stasis in the 1980s and 1990s, aid flows increased substantially in the new millennium. Net bilateral and multilateral disbursements rose by seven and three percent per annum, respectively from 2001 until the onset of the GFC. The MDGs and related initiatives galvanized support for the fight against global poverty and reestablished the role of overseas aid in these efforts.

The momentum of the early years of the decade was lost with the arrival of the GFC. Net disbursements continued to rise, but at a slower rate. Major bilateral donors like the US and Japan reduced allocations, although some countries (the EU, Germany and the UK) continued to increase spending. Multilateral disbursements fell in real terms after 2016.

Figure 13. Net ODA disbursements in constant 2017 US\$, billions



Source: OECD

ODA has reached a post-MDG plateau below the levels needed to achieve the Sustainable Development Goals (SDGs). In 2019, only five of the thirty members of OECD’s Development Assistance Committee (DAC) met the ODA target of 0.7% of GDP. Several governments have abandoned the 0.7% target, while reclassifying economic and trade-related spending as aid. On a more positive note, the statistics reported in Figure 14 do not include official development assistance from China. China is expected to invest US\$ 1.3 trillion in its Belt and Road Initiative in more than sixty countries, some of which is offered at concessional rates. Nor do the figures include transfers originating from private foundations and charities, which are increasing steadily but from a low base.

The composition of aid flows has also changed in recent years. An increasing share of commitments is directed to humanitarian relief operations in war-torn countries and within-country allocations to settle refugees. Disbursements to middle income countries have declined as donors focus attention on low-income countries. The tendency to conflate poor countries with poor people is problematic because most of the world’s poor now live in the middle-income countries like India, Brazil and Indonesia. The concessionality of ODA has also declined as bilateral donors have shifted from grants to loans while reducing allocations to social sectors in favor of infrastructure (United Nations & Department of Economic and Social Affairs, 2019, p. 81).

The Covid-19 pandemic has reversed progress toward the SDGs in many developing countries, especially in low-income countries lacking resources to provide adequate health care and protection to vulnerable populations. Loss of jobs and income could

add as many as 150 million people to the ranks of those living in extreme poverty.⁹ New ODA resources will be needed to support the hardest-hit countries, for example those dependent on remittances, international tourism and commodity exports. The IMF has provided over US\$100 billion in assistance and debt relief to 81 countries and the World Bank launched the Debt Service Suspension Initiative to allow 76 low-income countries to suspend principal and interest payments in 2020. These programs, while welcome, are small relative to the \$2.2 trillion in the external debt stock of low- and middle-income countries in 2020. While donors have promised additional resources, it is difficult to know the extent to which these pledges represent new resources or reprogramming of existing commitments.

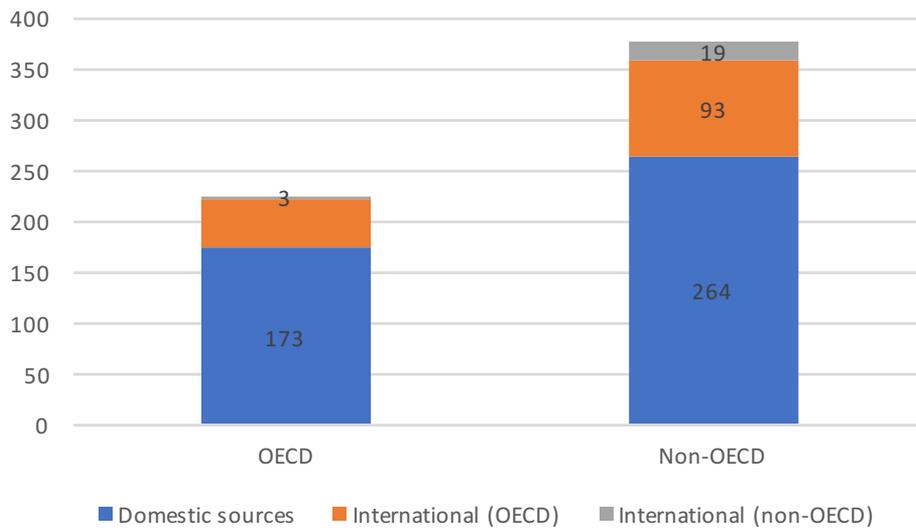
Before the pandemic, UNCTAD had estimated that achieving the SDGs in the developing world would cost between \$3.3 to \$4.5 trillion per year, much of which is needed for basic infrastructure. This implies an investment gap of \$2.5 trillion per year in SDG-related sectors (UNCTAD, 2014). The response of the international community to this massive shortfall was the 2015 Addis Ababa Action Agenda, which calls on governments to align public, private and ODA sources to finance achievement of the SDGs. Given fiscal constraints in developing countries and the plateau in ODA, the Action Agenda relies heavily on private finance, including “blended finance” that uses public resources to reduce the risks associated with large-scale private infrastructure investments. However, the \$10 to \$20 billion in transactions achieved per year between 2014 and 2018 suggests that it would be fanciful to rely too heavily on public-private partnerships to close the financing gap (Convergence, 2019).

Climate finance increased significantly in the years following the Paris Accords, reaching an average of \$579 billion per year on average in 2017/18, about one-third of which was directed to projects in East Asia and the Pacific (ex-Japan). However, 70% of funding for climate-related projects in non-OECD countries was derived from domestic sources, and 60% financed by market-rate loans (Figure 14). Moreover, these figures fall far short of the \$1.6 to \$3.8 trillion required each year to 2050 to prevent temperatures rising by more than 1.5 degrees centigrade, let alone the additional adaptation costs of US\$180 billion per year from 2020 to 2030 (Buchner et al., 2019, p. 3). Multilateral climate funds such as the Green Climate Fund and Green Environment Facility have increased financing but the amounts available are still insignificant relative to domestic sources.

ODA allocations tend to be procyclical as donor countries reduce commitments during recessions to redirect funds to domestic purposes. Severe fiscal pressure on donor countries during the pandemic makes it unlikely that we will see a surge in ODA in response to Covid-19. Developing countries, especially middle-income countries, will have to rely on domestic sources to finance SDG and climate-related investments for the foreseeable future.

9 “Covid to Add as Many as 150 million Extreme Poor,” <https://www.worldbank.org/en/news/press-release/2020/10/07/covid-19-to-add-as-many-as-150-million-extreme-poor-by-2021>.

Figure 14. Climate finance sources and destinations 2017/18, US\$ billions



Source: Climate Policy Initiative

Section summary

This section has reviewed risks facing the global economy and their implications for developing countries like Viet Nam. Global growth was slowing even before the Covid-19 pandemic because of over-reliance of the advanced countries on monetary policy after the Global Financial Crisis of 2008. The build-up of debt increased the risk of financial instability by driving up asset prices and increasing corporate and household leverage. Developing country governments and corporations also borrowed more. The main lesson from the GFC for the post-Covid period is that flooding markets with liquidity can resuscitate financial institutions and stave off mass bankruptcies but cannot restore the economy to its potential rate of growth. Investment responds to aggregate demand (or perceptions of future trends in aggregate demand), but not to access to credit or interest rates. Fiscal policy will need to play a larger role in the recovery from the pandemic, including public investment and strengthening social protection systems.

Political challenges to the multilateral trading regime are another threat to growth. The expansion of world trade since the 1990s delivered substantial benefits to Asian countries that capitalized on their comparative advantage in low-cost labour to boost investment, employment and exports. The ability of these countries to move up the value chain and compete with the leading economies has shifted the economic balance of power from West to East, upsetting the consensus in favor of an open trading regime. Trade policy has become increasingly transactional, favoring bilateral approaches in which large countries can use their leverage to extract concessions from trading partners. Voters in these countries blame trade liberalization for the loss of manufacturing jobs, and pressure politicians to erect trade barriers to protect local jobs. Given that these jobs are unlikely to return, we can expect challenges to multilateralism to continue. Regional trading arrangements in Asia are likely to play a larger role in the coming decade.

Slowing productivity growth since the 1970s is a reminder that technological innovation does not automatically translate into higher rates of economic growth. The ICT revolution has transformed the way we work and live, but the benefits of these technologies have been unequally distributed. The so-called Fourth Industrial Revolution will introduce more changes, but the relationship between technological change and growth will hinge crucially on sustaining a high rate of investment and taking steps to achieve a fairer distribution of the benefits of growth.



SECTION 3. KEY PILLARS OF VIET NAM'S DEVELOPMENT AND ECONOMIC RECOVERY

This section reviews three pillars of Viet Nam's development: prosperity, equity and sustainability. As one of the world's top growth performers over the past three decades, Viet Nam has transformed itself from a war-scarred, Least Developed Country into a thriving, emerging economy that has nearly eliminated extreme poverty and has achieved a high level of Human Development. The Viet Nameese economy is among the most globally integrated in the world, with exports of manufactures and agricultural products growing at double-digit rates. Despite rapid economic transformation, income distribution indicators are stable, avoiding the extremes that have plagued other fast-growing countries in the region.

Maintaining the pace of progress in the coming decade will not be easy. The Covid-19 pandemic has brought about the deepest contraction in global output for more than seventy years. While Viet Nam's early and effective response to the virus reduced its domestic impact, trade, tourism and investment have been affected and the negative impact is expected to last for several years. As discussed in the previous section, the global economic recovery faces considerable risks. Climate change is the greatest long-term challenge facing Viet Nam, and adaptation and mitigation will require large-scale mobilization of capital for infrastructure and for the development of sustainable energy systems.

Realizing the Government's vision of a prosperous, equitable and sustainable economy will above all mean maintaining a high rate of *productive* investment. By productive investment we mean investments that increase output in agriculture, industry or services or that provides the infrastructure, knowledge and skills that companies and individuals need to build capacity. Productive investment *specifically excludes* speculation in assets like land and financial instruments, which can be made less attractive through tax policy and regulation. Government must act to increase the supply of long-term domestic finance, which may be underprovided by the banking system, and which will constitute an significant bottleneck over the medium to long term.

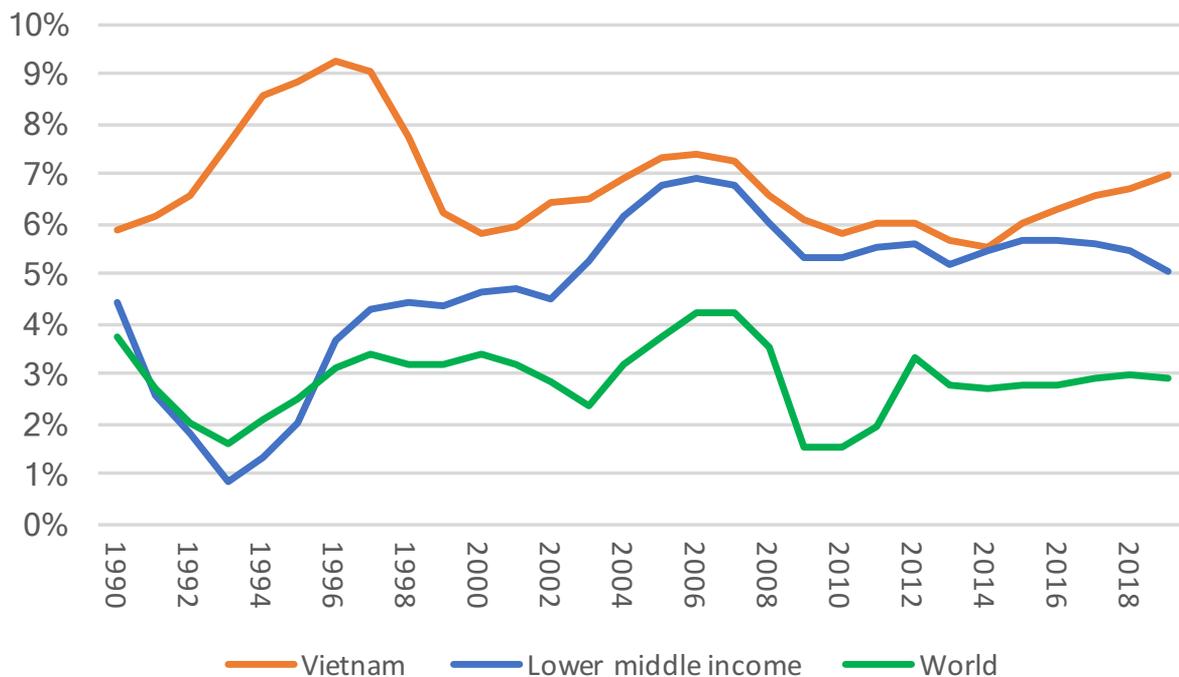
The government must take steps to ensure that public and private investment increase the country's resilience to the effects of climate change, including rising sea levels and the expected increase in adverse weather events like cyclones (Arndt et al., 2015). Development of infrastructure in places at less risk to climate change will reduce future losses, but must also be paired with investment in sustainable and affordable housing and transportation to reduce the negative impact on the poor (Bangalore et al., 2019). Sustainable investment will reduce the rate of environmental degradation including deforestation, air and water pollution, and exploitation of non-renewable resources.

The First Pillar: Economic prosperity

Growth

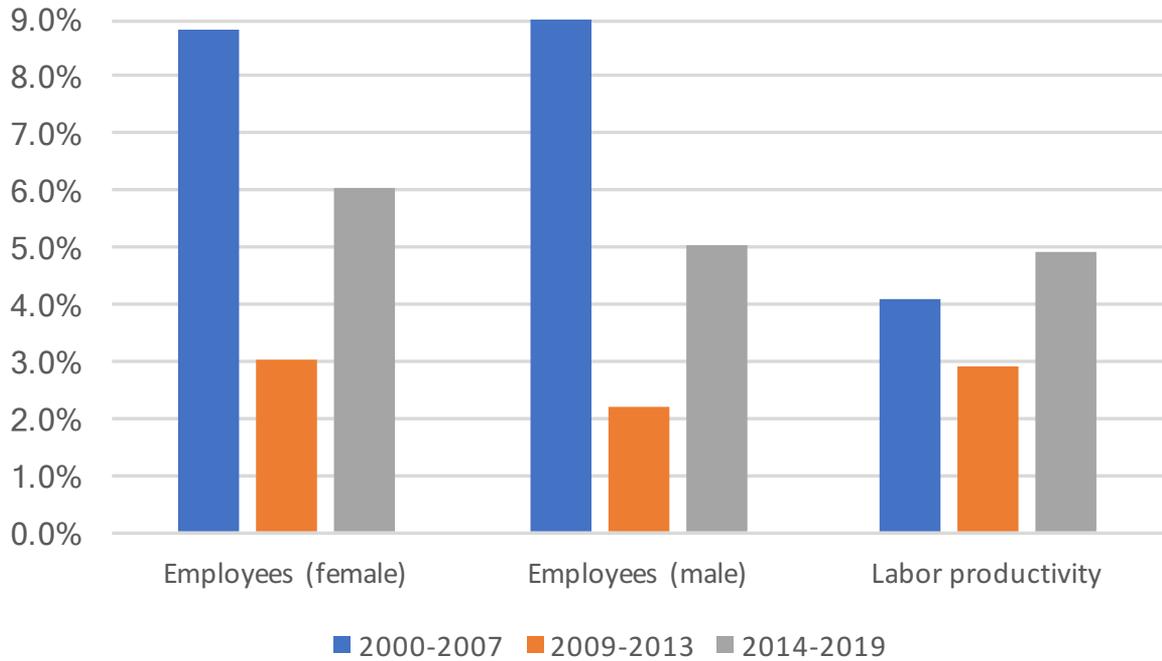
Viet Nam has outperformed other lower-middle income countries in two periods: 1990 to 2003, and 2014 to the present (Figure 15). In the first, barriers to Viet Nam's reintegration into the global economy were removed, along with internal obstacles to trade and investment. Growth slowed in the aftermath of the GFC but picked up again after 2014 as manufactured exports expanded and diversified and agricultural exports penetrated markets for higher value-added products. The rate of labour productivity growth in the recent period was among the highest in the world, easily exceeding the levels recorded in the 1990s (Figure 16)

Figure 15. Economic growth in Viet Nam, the World and Lower-Middle Income Countries, three-year moving average, 1990-2019



Source: World Development Indicators

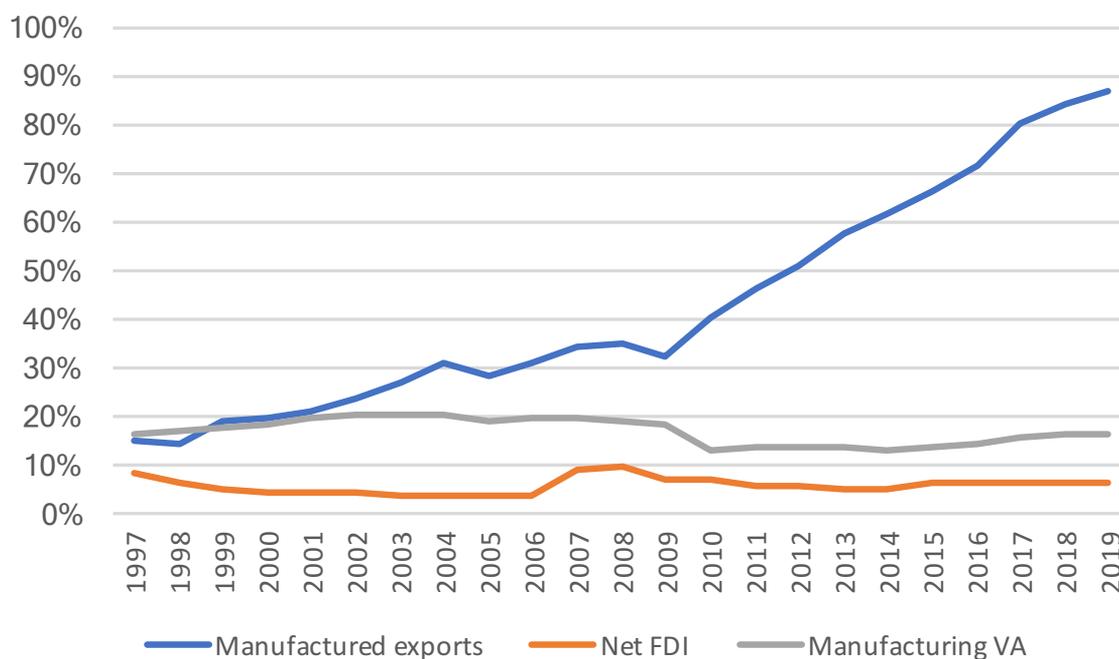
Figure 16. Labour force and labour productivity growth



Source: International Labour Organization (NB: no data available for 2008)

The Viet Nameese economy changed in fundamental ways after the GFC. The value of manufactured exports rose from 32% of GDP in 2009 to 87% in 2019 (Figure 17). However, manufacturing value added as a share of GDP had still not recovered 2009 levels. Although manufacturing output was growing fast, domestic value added was not keeping pace because of the import-intensiveness of manufactured exports. Viet Nam was increasingly integrated into global value chains, but largely in the labour-intensive, low-value segments of these industries. Meanwhile, traditional industries oriented to the domestic market were contracting. Foreign direct investment remained stable at high levels, typically between seven and eight percent of GDP.

Figure 17. Manufactured exports, Net FDI and manufacturing value added as percent of GDP, 1997-2019



Source: World Development Indicators

Table 1. Leading manufactured exports, 2010-2019

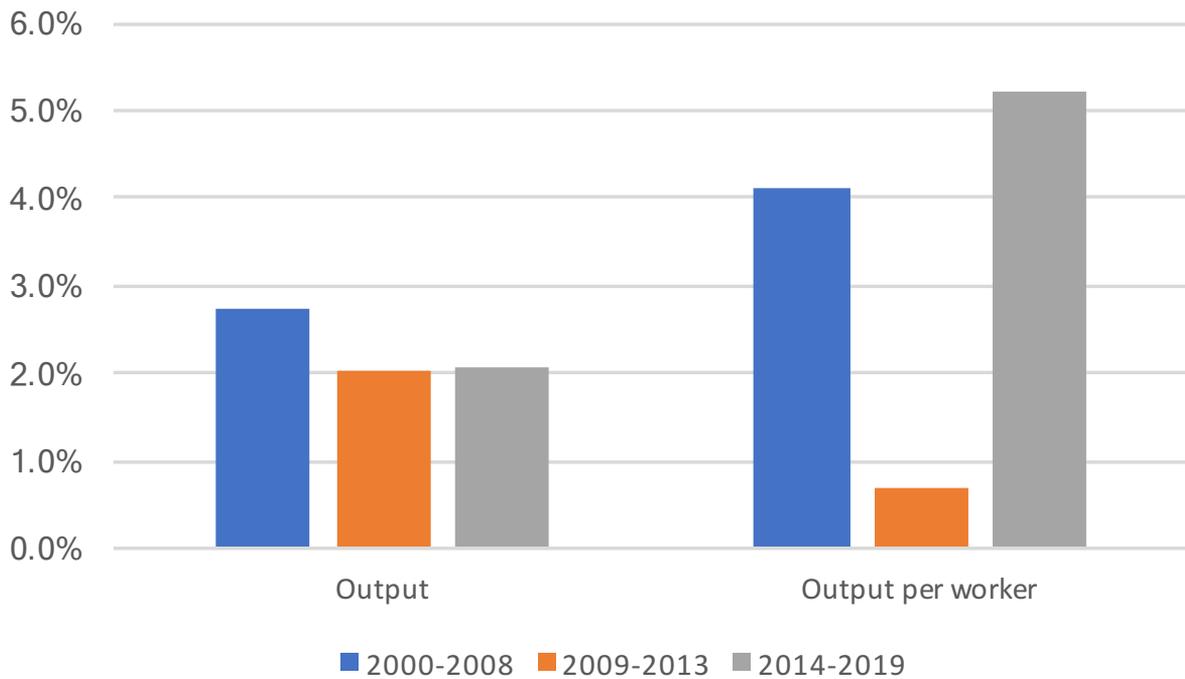
Commodity	Value US\$ 2019 (billions)	Average annual growth 2010-2019	share of goods exports 2019
Telephone sets	56.4	39%	21%
Garments	31.8	11%	12%
Transistors and integrated circuits	20.1	27%	8%
Footwear	18.2	14%	7%
Furniture	9.5	12%	4%
Fish and crustaceans	8.4	5%	3%
Broadcast equipment	8.4	32%	3%
Electrical machinery	5.5	14%	2%
Computers	5.1	29%	2%
Printers	3.6	7%	1%
Leather goods	3.5	15%	1%
Cashew	3.1	10%	1%
Cotton yarn and cloth	3.0	16%	1%
Rice	2.4	-3%	1%

Source: UN Comtrade

The real rate of growth of manufactured exports was phenomenal. Cellular telephones, transistors and integrated circuits, computers, broadcast equipment and electrical machinery were the standout performers over the decade (Table 1). These categories accounted for 37% of merchandise exports in 2019. Traditional manufactured exports like garments, cotton yarn and cloth, footwear and furniture are still important and have also grown rapidly.

Viet Nam is a major agricultural exporter, and both exports and output have continued to expand. Productivity growth in agriculture is important not only as a source of jobs and exports, but also because of the fundamental importance of producing sufficient supplies of essential goods for the growing labour force outside of agriculture. Many developing countries have experienced rising food prices as labour leaves the farm and enters factories and modern services. During this period of rapid change, Viet Nameese agriculture has begun to modernize at historically rapid rates. Labour productivity growth in agriculture has exceeded five percent per year since 2014, a rate that the sector must sustain if the growth of industry and services is not to result in rising food prices and additional pressure for higher money wages (Figure 18). As domestic rice demand has increased, exports have declined, although exports of fish and other commodities like cashew nuts have continued to grow rapidly.

Figure 18. Growth of output and labour productivity in agriculture, 2000-2019

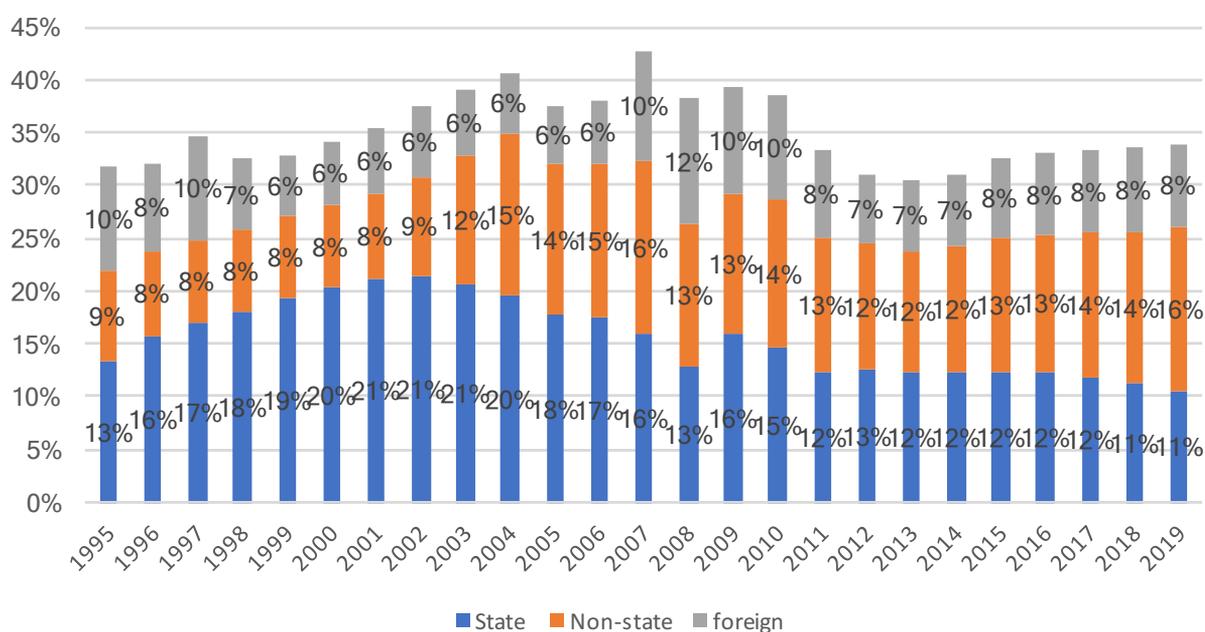


Source: World Development Indicators

Economic growth has become less dependent on natural resources. Mining accounted for seven percent of GDP in 2017 and the export value of crude oil in 2018 was just over US\$ 2 billion, which represents less than one percent of export revenues.¹⁰ Pressure on forests from agriculture and the furniture industry has increased, with the country losing 10% of its remaining forest cover in the period after 2002.

Another significant trend is the decline of public investment relative to non-state investment. Public investment fell from 21% of GDP in 2001 to 11% in 2019, while non-state investment rose during the same period from 8% to 16% (Figure 19). Total investment recovered slowly after the GFC from a low of 30% of GDP in 2013 to 34% in 2019. A challenge for the post-Covid period will be to raise the level of public investment in a sustainable manner that avoids large fiscal deficits, especially during periods of rapid economic growth.

Figure 19. Public, non-state and foreign investment as % GDP, 1995-2019



Source: General Statistics Office

The sources of growth in the next period will build on the post-GFC success in expanding manufactured exports, continuing the process of relocating labour from agriculture and traditional services to formal sector employment and sustaining productivity growth in agriculture and fisheries. With more than one-third of the labour force still in agriculture, this process still has a long way to run. Export-led growth has created millions of steady jobs and generated billions of dollars in revenues. Maintaining competitiveness in manufacturing will require sustained investment in infrastructure and education and training, and policies to support innovation and the development of domestic firms' technological and managerial capabilities.

10 Data from Ministry of Planning and Investment. See also <http://vneconomy.vn/xuat-khau-dau-tho-cua-viet-nam-mang-ve-2-ty-usd-20181214152546673.htm>.

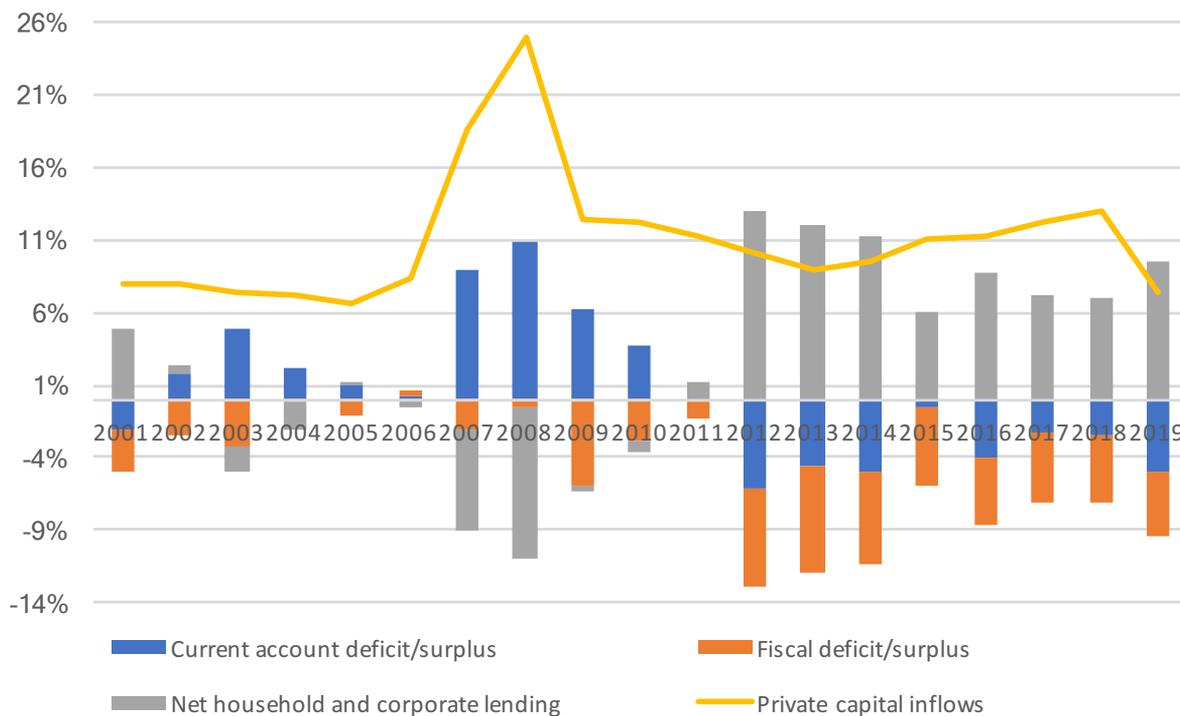
Macroeconomic stability

Viet Nam is no stranger to financial crisis. In recent years, the country experienced the Asian Financial Crisis of 1997-1998, overheating of the domestic economy caused by massive capital inflows 2006-2008, and the Global Financial Crisis of 2008-2009. As in other countries, the effects of financial crises extend for several years after the event and result in a significant loss of potential output. Viet Nam did not fully recover from the GFC until 2013, a full five years after the onset of the crisis. Avoiding crisis is therefore essential to sustaining a high rate of economic growth over the medium to long term.

External capital flows are often a source of macroeconomic instability in developing countries. A sudden surge in capital inflows, if not properly managed, can ignite price inflation and currency appreciation, making exports less competitive. Capital inflows may also bid up domestic asset prices, prompting investors to redirect capital from productive investments to speculation in land and financial assets. Conversely, large and sudden capital outflows (as in the case of the East Asia financial crisis) can lead to a sudden depreciation of the domestic currency, a rise in government budget deficits, slumping asset prices, corporate bankruptcies and bank failure.

During periods of rapid growth, public and private sector entities acquire foreign-exchange denominated liabilities, creating balance sheet mismatches to the extent that revenues are in local currency. An appreciating exchange rate encourages yet more borrowing and more imports; and rising asset prices stimulate more foreign and domestic borrowing. When capital flows abruptly reverse direction, for example during the Taper Tantrum of 2013, balance sheet effects are deflationary. Government and private actors cannot meet their foreign currency obligations and are forced to liquidate assets, driving down prices and increasing leverage. If the reversal is large enough as in the case of the East Asian financial crisis, domestic currency depreciation causes distress among holders of foreign liabilities. Government revenue falls just as the public sector is called on to support demand and bail out troubled public and private institutions.

Figure 20. Net lending by sector as % GDP, Viet Nam



Source: International Monetary Fund

The effect of capital flows on the domestic economy is illustrated in the flow of funds accounts. Figure 20 presents net lending by government, households and businesses and the rest of the world (current account balance) for the years 2001 to 2019. Viet Nam does not yet publish separate data for households and businesses, so these sectors are combined in the presentation. Capital flooded into Viet Nam around the time of Viet Nam's WTO accession, rising to 19% of GDP in 2007 and a breathtaking 26% in 2008. Inflows financed an increase in imports, much of which consisted of capital goods and intermediates. Domestic corporate and household borrowing accelerated rapidly, including speculation in land and financial assets. The government's stance was pro-cyclical in 2007, adding to the inflationary pressure.

The response of the State Bank of Viet Nam (SBV) was to impose credit restrictions to bring inflation under control and take the froth off asset market prices. Ultimately, the arrival of the GFC brought the episode to a close, as exports collapsed, and aggregate demand drained from the economy. Asset prices fell and banks were suddenly faced with a surge in non-performing loans as the value of collateral and earnings plunged. The government supported domestic demand with subsidized lending and easing of banking rules, policies that helped cushion the blow of the crisis but encouraged even more borrowing by state and private companies and continued speculation in risky assets.

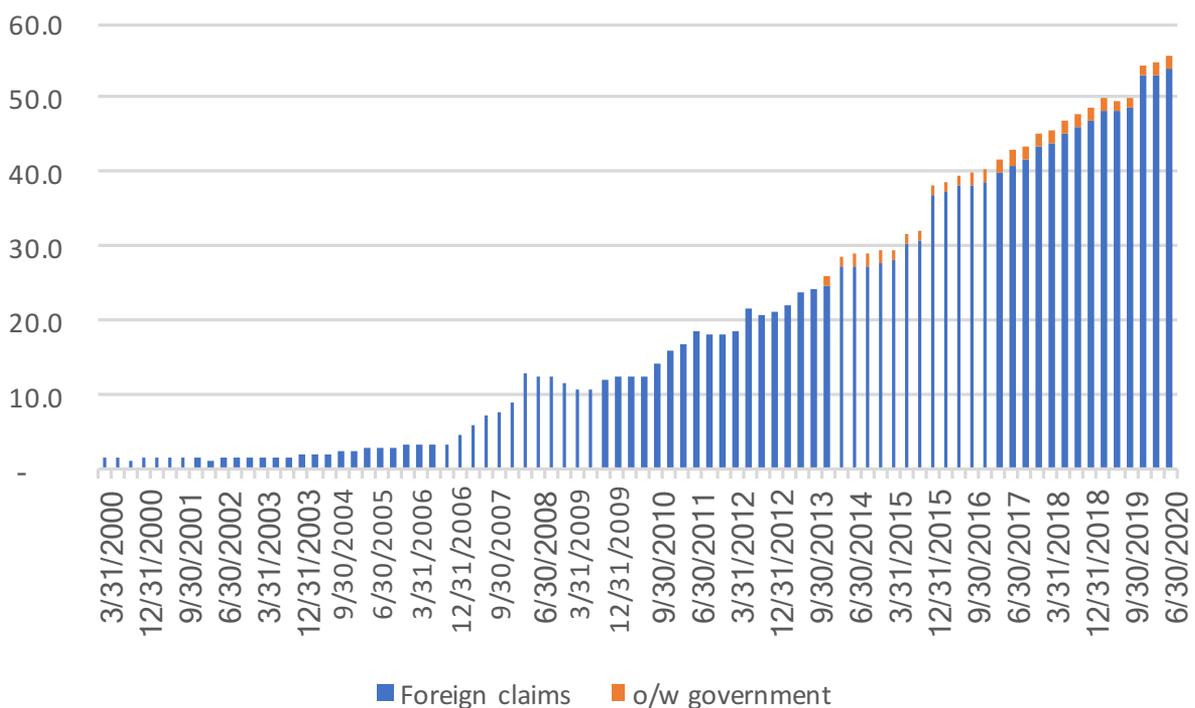
As the government withdrew the stimulus in 2011, households and businesses began the long process of deleveraging. Net lending by households and businesses (negative net borrowing) peaked in 2012 at 12% of GDP. Economic growth slowed as consumption and investment were squeezed to pay down liabilities. Lower commodity prices, a reduction in corporate income tax and falling trade taxes

reduced government revenue, resulting in fiscal deficits through 2016.

The main lesson from this experience was the high price in terms of growth forgone of financial crises. Looking ahead, the risk of a renewed bout of financial instability resulting from a surge in capital inflows or a sudden reversal of flows—should interest rates go up in the advanced countries—cannot be ruled out. The world is awash in liquidity following the GFC and during the Covid-19 pandemic, and in Viet Nam domestic balance sheets already contain large stocks of foreign liabilities. According to BIS, the period after the GFC has seen a 400% increase in foreign borrowing, and this is most likely an underestimate because the figures are based on reports from international banks and exclude borrowing from other sources (Figure 21). Non-state entities, including banks and non-financial corporations, account for nearly all this borrowing. Less than US\$ 200 million was directed to households and individuals. We also do not know the proportion of this borrowing that is tied to imports of capital equipment and intermediate goods by foreign-invested and domestic enterprises.

The country's partially closed capital account and nonconvertible currency afford some policy space to control inflows, but additional limits on the ability of domestic corporations and banks to acquire dollar denominated debt may be necessary. Close monitoring of the build-up of US\$ denominated debt from all sources is needed to avoid a situation in which a sudden halt of lending or fall in exports leaves Viet Nameese companies unable to meet their overseas obligations.

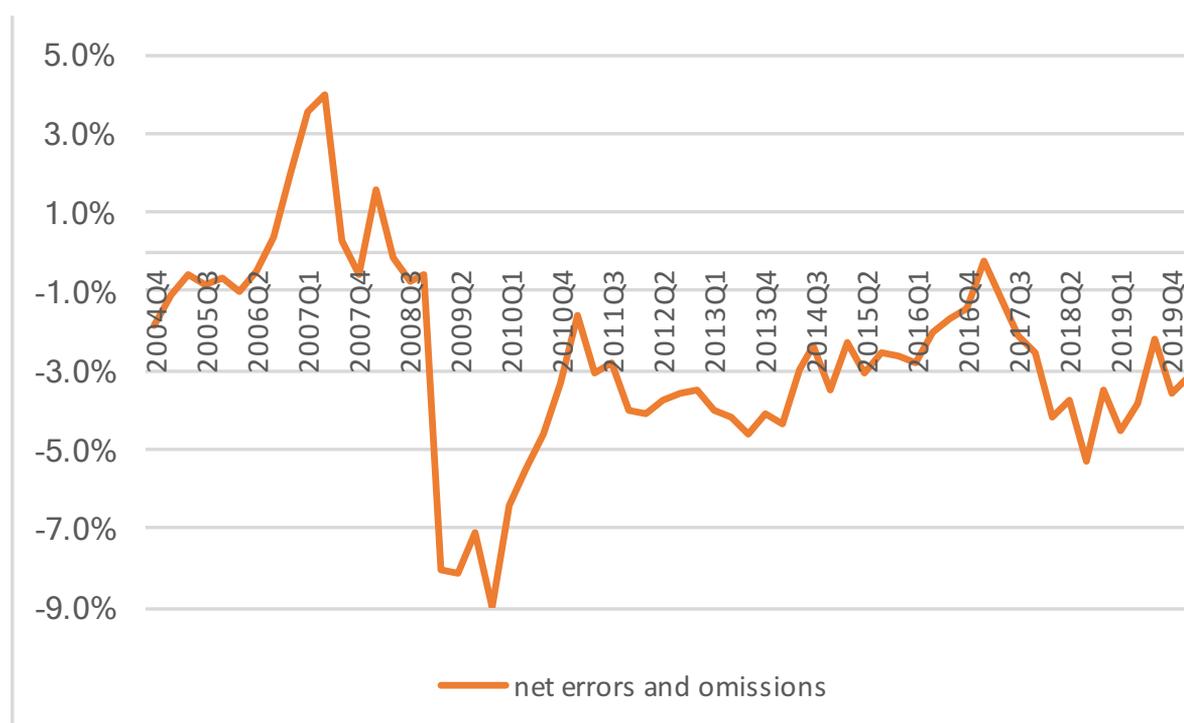
Figure 21. Foreign banks claims on Viet Nameese entities



Source: Bank for International Settlements

Viet Nam has pursued an “easy in, hard out” policy that imposes relatively light restrictions on capital inflows but limits outflows to profit remittances, liquidation of direct investments and few other categories. However, the policy is partially undermined by transfer pricing and other mechanisms that enable foreign and domestic parties to make international payments despite the restrictions. These unregulated transfers turn up as errors and omissions in the balance of payments, which soared to 9% of GDP at the height of the GFC and have averaged about 4% of GDP since then (Figure 22). Additional restrictions on short term capital inflows—for example unremunerated reserve requirements that have been used successfully in Latin America and Thailand—could reduce the risk of overheating without restricting access to long-term finance.

Figure 22. Quarterly net errors and omissions as % GDP, one year moving average



Source: International Monetary Fund

The banking sector emerged from the GFC weakened by non-performing loans. Some small banks were technically insolvent, but legal procedures under existing regulations complicated efforts to take over or close banks. The Government established the Viet Nam Asset Management Company to acquire and liquidate non-performing loans, but the process has taken many years owing to conflict over the control of and legal title to collateral assets. The slow pace of the workout held back the recovery, as cash-strapped banks could not lend and trillions of VND were tied up in fixed and financial assets that could not be sold and repurposed.

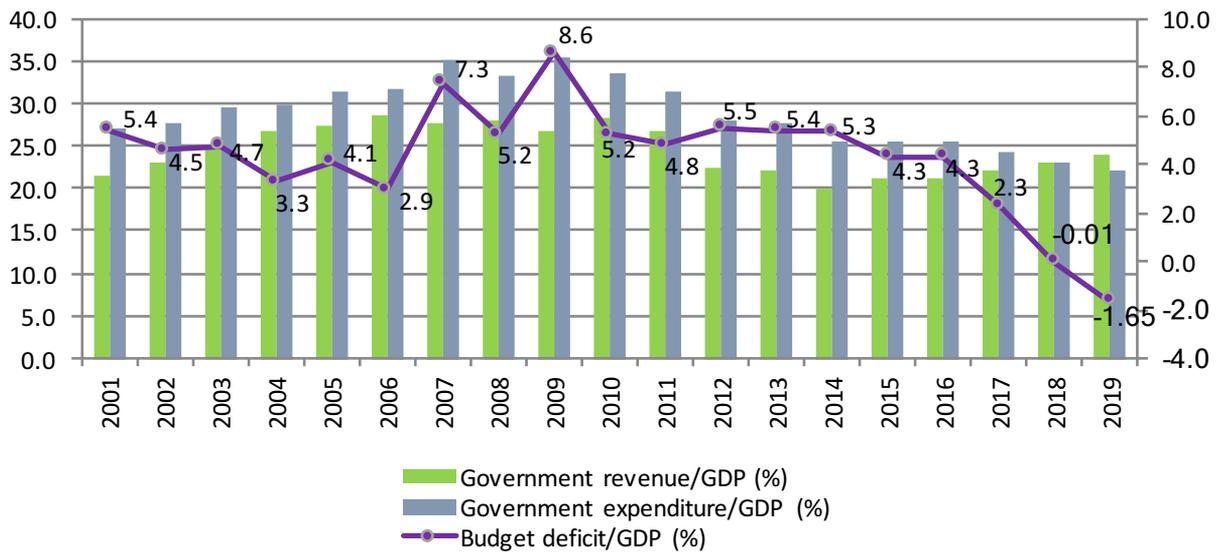
Recently, there has been progress meeting Basel II capital adequacy standards. In 2018, commercial banks accelerated the process of increasing equity and by the end of 2019 eighteen banks had met Basel II standards ahead of plan.¹¹ Meeting capital

11 Source: <https://bizlive.vn/tai-chinh/10-diem-noi-bat-trong-hoat-dong-ngan-hang-viet-nam-nam-2019-3531326.html>

adequacy requirements also has a downside. Major domestic commercial banks in which the state owns a major share (Vietcombank, Vietinbank, BIDV) are facing an “impossible trinity”: (i) expanding credit to firms to support economic growth; (ii) meeting stringent requirements of Basel II; (iii) and raising equity capital from retained earnings at the expense of dividends to the government budget or mobilizing additional capital from non-state investors which would reduce the government’s share of revenues.

Pro-cyclical fiscal policy is another potential source of macroeconomic instability. In general, the government should borrow to invest in infrastructure and other durable assets but should not borrow for consumption. The main exception to this “golden rule” is during periods of recession, when government should increase spending, including social assistance and protection, to support aggregate demand and return the economy to its potential growth path. Problems arise when the government borrows for consumption during periods of rapid growth. This practice is destabilizing for two reasons: i) it can cause inflation, currency instability and current account deficits; ii) it can lead to a build-up of public sector debt, which impairs the government’s ability to borrow during recessions.

Figure 23. Government revenue, expenditure and fiscal deficit, 2001-2019



Source: General Statistics Office

The Government of Viet Nam ran large fiscal deficits after the GFC to support aggregate demand, protect jobs and prevent mass insolvencies in the corporate and banking sectors. The deficit reached 8.6% of GDP in 2009 and remained elevated through 2016 (Figure 23). By 2018, the government budget was in balance, resulting in a decline in public debt from 63.7% of GDP in 2016 to 58.4% in 2018, below the National Assembly's mandated ceiling of 65%. This was achieved through a combination of budget cuts and increases in revenue despite lower oil prices. Debt servicing was still 18% of government expenditure in 2018. Additional spending and tax relief introduced during the Covid-19 pandemic increased the fiscal deficit to four percent of GDP in 2020.

The years ahead will not be free from economic and financial instability. The global recovery from the Covid-19 pandemic will be uneven, which will weigh on trade and tourism. Heavy reliance on monetary policy in the advanced countries will fuel asset price inflation and stimulate lending to the developing world. Foreign lenders will compete to offer loans to Viet Nameese companies and the public sector as a country with sound economic fundamentals that managed the Covid-19 pandemic well. Limits on foreign borrowing should be maintained and closely monitored to avoid the accumulation of currency and credit mismatches on public and corporate balance sheets. Restrictions on short-term borrowing would reduce the risk of instability without restricting access to long-term finance.

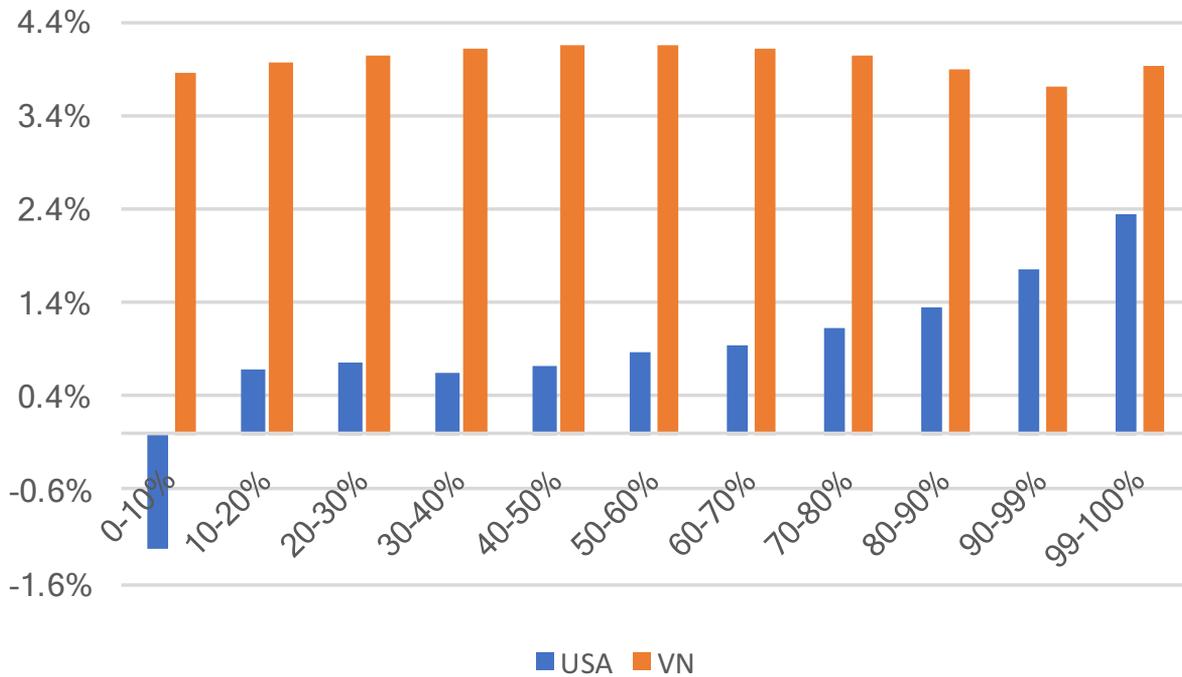
The Second Pillar: Equity

Inequality indicators in Viet Nam are moderate and stable. Economic growth has lifted more than 30 million people out of poverty over the past three decades and has raised incomes in the middle of the distribution more rapidly than the extremes. Inequality as reported in Gini or Theil indices has remained at levels lower than other countries in the region. Human Development Indicators show significant improvements in access to secondary education, mean years of schooling and life expectancy.

Based on official data, Viet Nam's growth has been equalizing. The highest rates of income growth in real terms were recorded by the middle groups of the population, between the 40th and 70th percentiles ranked by per capita income.¹² Incomes rose quickly even in the bottom decile of the population (3.8% percent per annum over a thirty-year period). By way of contrast, growth in the United States widened the income gap between the rich (the top decile or the top one percent) and everyone else. Americans in the poorest decile lost ground in real terms over this period, and income growth for the bottom half of the population was negligible. Some of the same factors shape patterns of income distribution in Viet Nam and the rest of the world, including the relocation of manufacturing employment from the advanced countries to developing Asia. Other factors were also in play in the US, for example time limits and other restrictions on social assistance payments introduced in the 1990s, rising education and health care costs and the decline of trade union membership. The net effect of these changes was declining social mobility in the US and the rise of the middle classes in Viet Nam.

¹² In 2019 constant local currency, purchasing power parity terms.

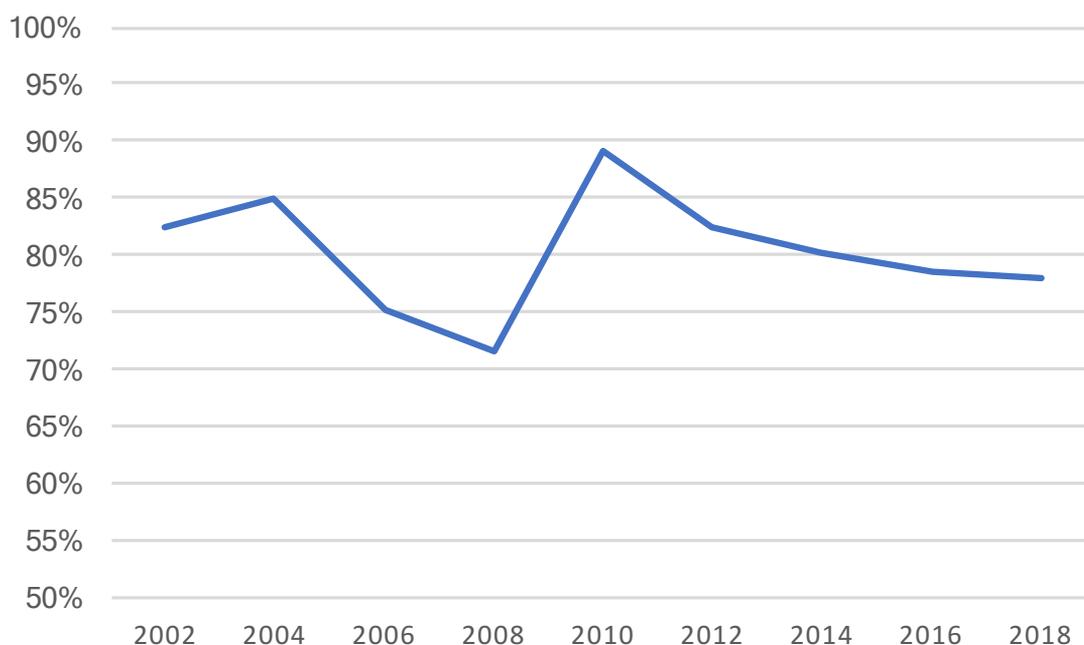
Figure 24. Growth incidence curves, USA and Viet Nam 1990-2019 (average annual growth in adult per capita income for each income group over the period)



Source: Authors' calculations from World Inequality Database

The Viet Nam Household Living Standards Survey detects relatively slow income growth among the highest earners, but this result should be treated with some caution. Underreporting and under-sampling of wealthier households is common in consumption surveys like VHLSS. Measurement of the incomes of better off households may be getting less accurate over time. The disparity between total consumption as reported in the national accounts and that reported by the Viet Nam Household Living Standards survey has increased since 2010 (Figure 25). The discrepancy between these two figures has many potential causes, but one of the most common is under sampling of the rich and under-reporting of consumption when they are surveyed. Categories that are routinely under-reported are educational expenses (especially for children overseas), travel and purchases of durable goods like automobiles.

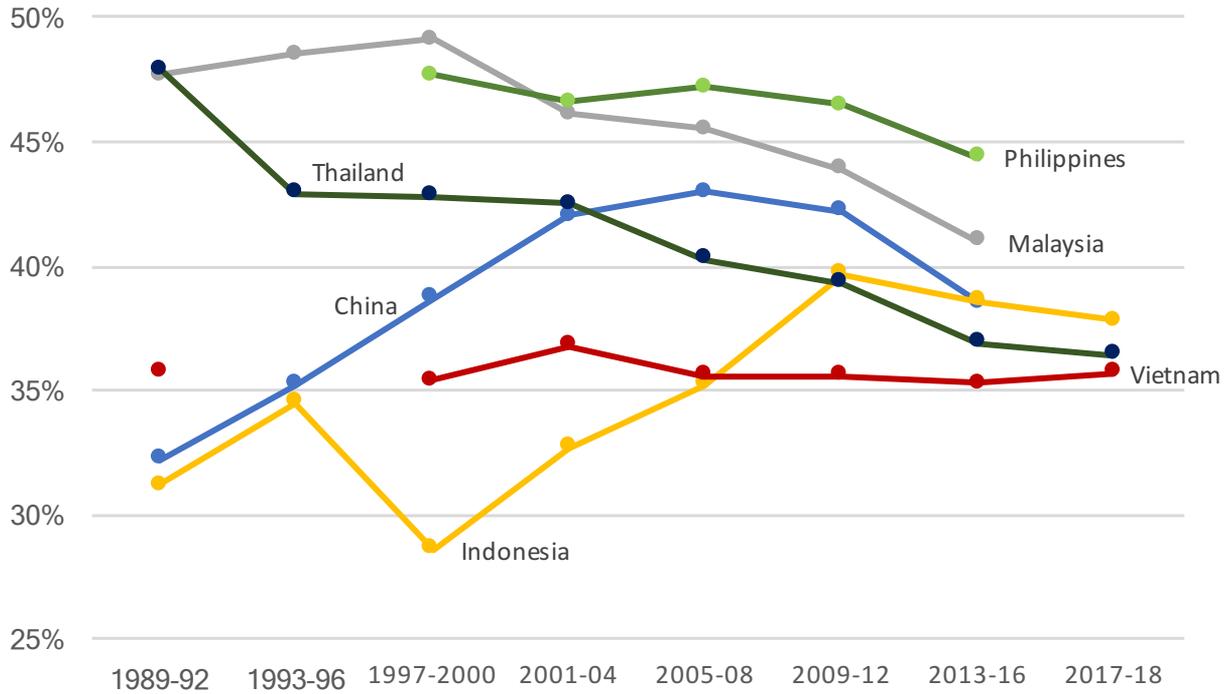
Figure 25. Consumption in VHLSS and national accounts, 2002-2018



Source: General Statistics Office

Compared to other countries in the region, Viet Nam's Gini coefficient—a measure of inequality that ranges from 0 (perfect equality) to 1 (perfect inequality)—is moderate and stable (Figure 26). Care is needed when comparing inequality indicators between countries, however, because sample sizes, sampling methods and coverage differ markedly from place to place. Nevertheless, the figures suggest that income inequality has declined in the region from its peak in the 1990s and early 2000s. The reasons for the drop in measured inequality differ among countries, but two factors stand out: first, the growth of manufacturing employment, which has created stable jobs and income-earning opportunities for low and semi-skill workers; and increased spending on health, education and social assistance in most countries, notably Malaysia and Thailand. In Indonesia, inequality rose during the commodity boom when the pace of job creation slowed but has since leveled off as manufacturing and tourism have recovered. Inequality will increase across the region in 2020 because of the negative impact of the Covid-19 pandemic on employment, small businesses, migrants and remittances.

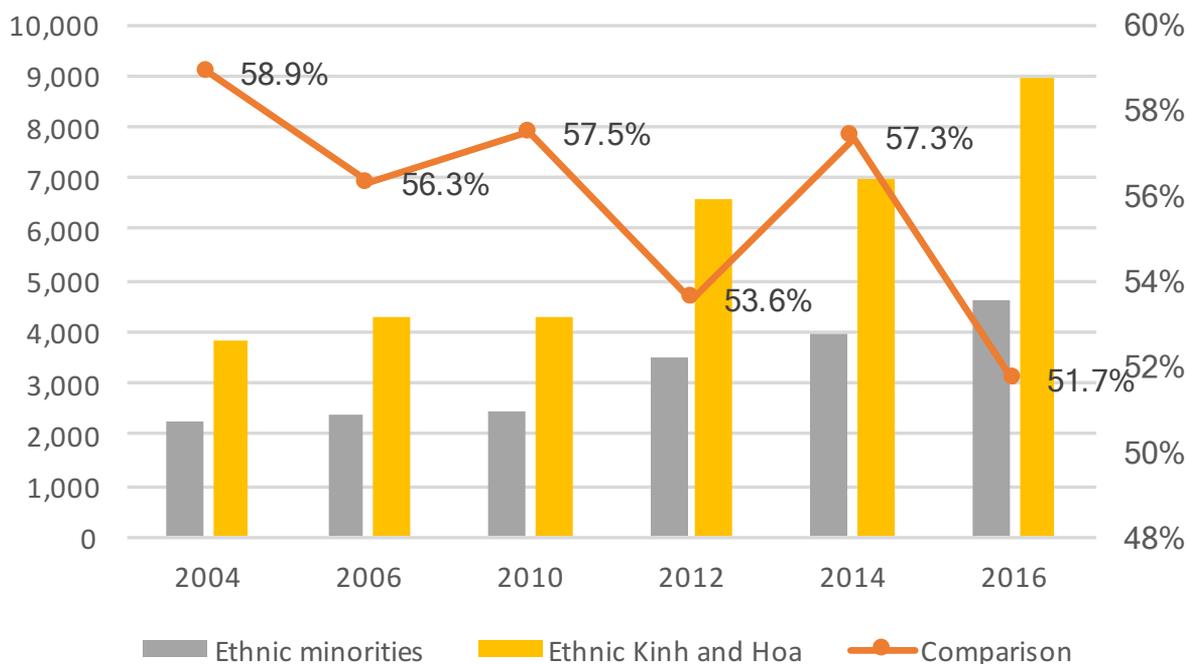
Figure 26. Gini ratios in Southeast Asia and China, 1989-2018



Source: World Development Indicators

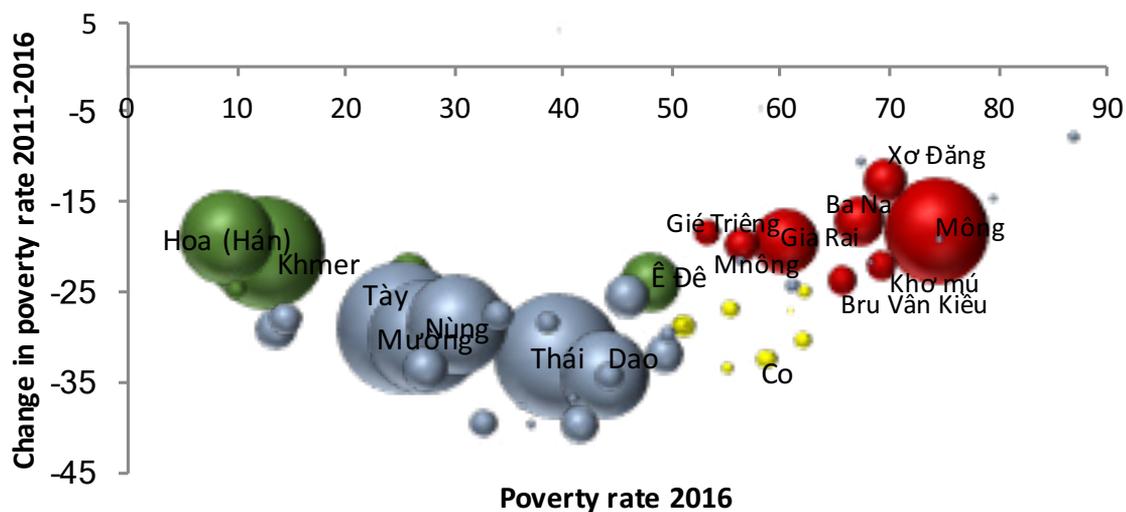
The disparity in incomes between ethnic minorities and the Kinh majority remains an important source of inequality in Viet Nam. The expenditure gap in absolute terms between these groups increased from 2004 to 2016, and in relative terms ethnic minority expenditure fell from 59% to 52% of the average level of ethnic Kinh and Hoa (Figure 27). Among ethnic minorities, the high poverty rates associated with slow income growth among H'Mong, Xo Dang and Gia Rai groups show that these relatively large ethnic groups have not fully benefited from Viet Nam's fast-growing economy (Figure 28).

Figure 27. Income disparities between the Kinh majority and ethnic minorities



Source: (UNDP, 2018c)

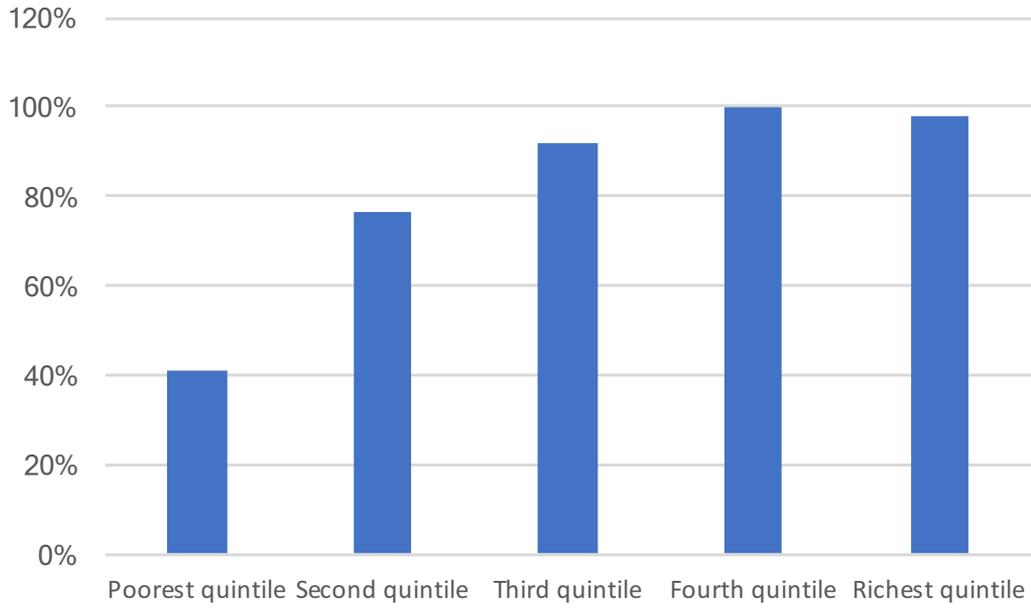
Figure 28. Poverty Reduction Among Ethnic Groups



Source: (UNDP, 2018c)

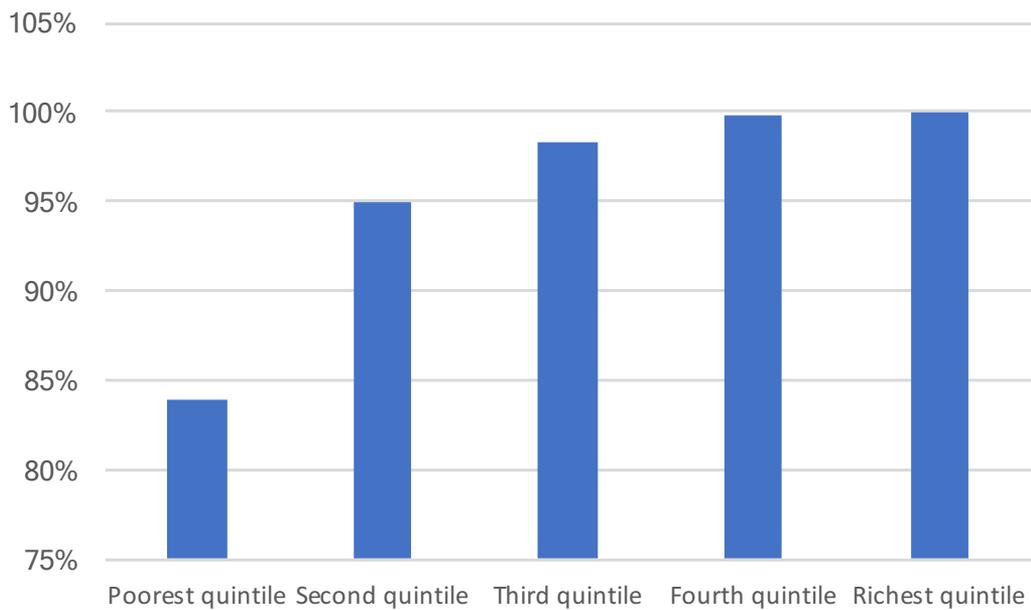
The widening gap between the poor and better-off households also applies to access to basic infrastructure. People falling within the poorest quintile by expenditure are less likely to benefit from basic sanitation and water facilities than richer groups (Figures 29 and 30). The problem is acute in regions populated by ethnic minorities, and leads to higher rates of diarrhea, pneumonia and parasitic infections.

Figure 29. Access to basic sanitation facilities by income quintile, 2017



Source: World Development Indicators

Figure 30. Access to basic drinking water facilities by income quintile, 2017



Source: World Development Indicators

Statistics on the distribution of wealth as opposed to income are limited by the absence of reliable information on asset ownership. The estimates that do exist suggest that wealth in Viet Nam is highly concentrated and may be becoming more so. According to Credit Suisse, ninety individuals controlled more US\$100 million in assets in 2019, including eleven who controlled more than \$500 million. Credit Suisse estimates the Gini coefficient for wealth at 74%, a figure indicating that the richest 10% of the population control 70% of the nation's wealth (Credit Suisse, 2019). Knight Frank estimates the growth rate of ultra-high net worth individuals (those controlling more than \$30 million) at 223% for the period 2014-2019, and predicts that the rate for 2019-2024 will be 64% (Knight Frank, 2020). The pace of accumulation at the top of the pyramid raises the issue of the taxation of capital gains, including profits from speculation in property and financial assets. Taxing windfall gains from speculation would reduce the attractiveness of property and financial assets relative to productive investments that create value and jobs.

The Third Pillar: Sustainability

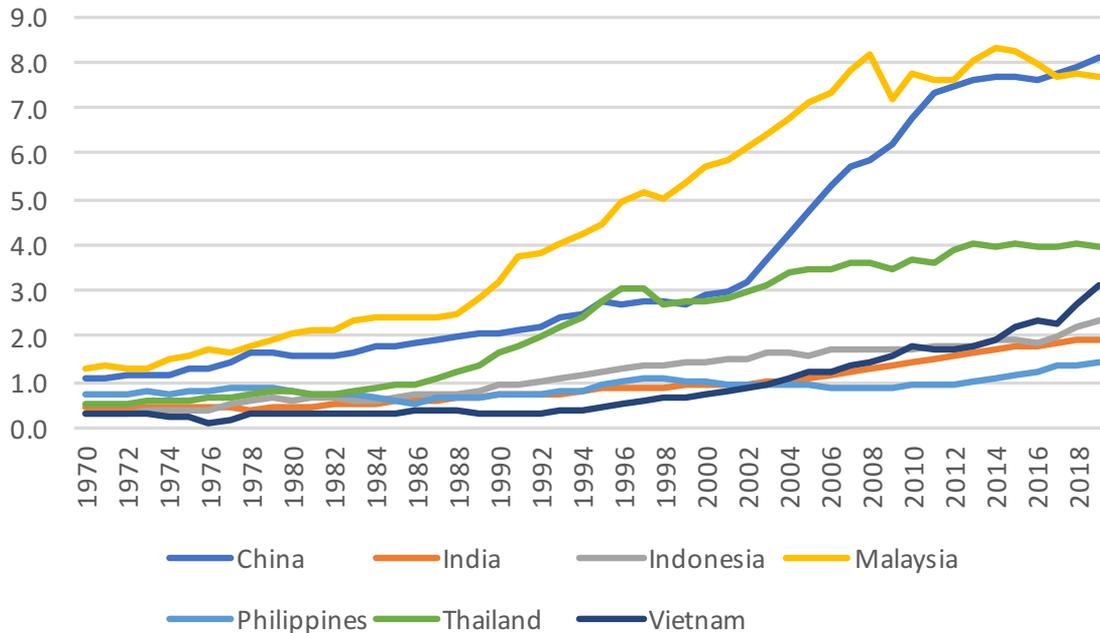
With its long coastline and low-lying delta regions, Viet Nam ranks among the top five countries most heavily affected by climate change and natural disasters. The Government has responded with the National Climate Change Strategy in 2011 and the National Green Growth Strategy in 2012. The Law on the Environment, passed by the National Assembly in 2014, includes a chapter on climate change that codifies the actions set out in various policies and strategies. Revisions to the Law on the Environment were submitted to the National Assembly in November 2020.

Viet Nam's greenhouse emissions have risen from 2014 with additions to power generation capacity but are still low relative to regional peers (Figure 31). The Human Development Report 2020 classifies Viet Nam in the bottom half of countries in terms of carbon emission per capita (UNDP, 2020). Viet Nam submitted its first NDC in 2015, and the commitment was updated in November 2020 reducing greenhouse gas emissions by nine percent by 2030 compared to the business-as-usual scenario. Reducing dependence on fossil fuels for power generation and transportation, and conservation initiatives in industry and by households, are key to attaining these new targets.

The recent surge in solar power generation has contributed to Viet Nam's efforts to reduce emissions. Viet Nam currently operates 82 solar power projects with a total capacity of 4,460 MW connected to the national grid, Solar power accounts for about 10% of electricity production. Viet Nam has emerged as one of the most popular destinations for solar power investment in the Asia-Pacific region.¹³

13 Source: <https://baodautu.vn/viet-nam-la-diem-dau-tu-nang-luong-mat-troi-nong-nhat-khu-vuc-chau-a---thai-binh-duong-d108006.html>

Figure 31. Climate change: CO₂ emissions (metric tons per capita) in Southeast Asia, 1970-2019



Source: Emissions Database for Global Atmospheric Research (<https://edgar.jrc.ec.europa.eu>)

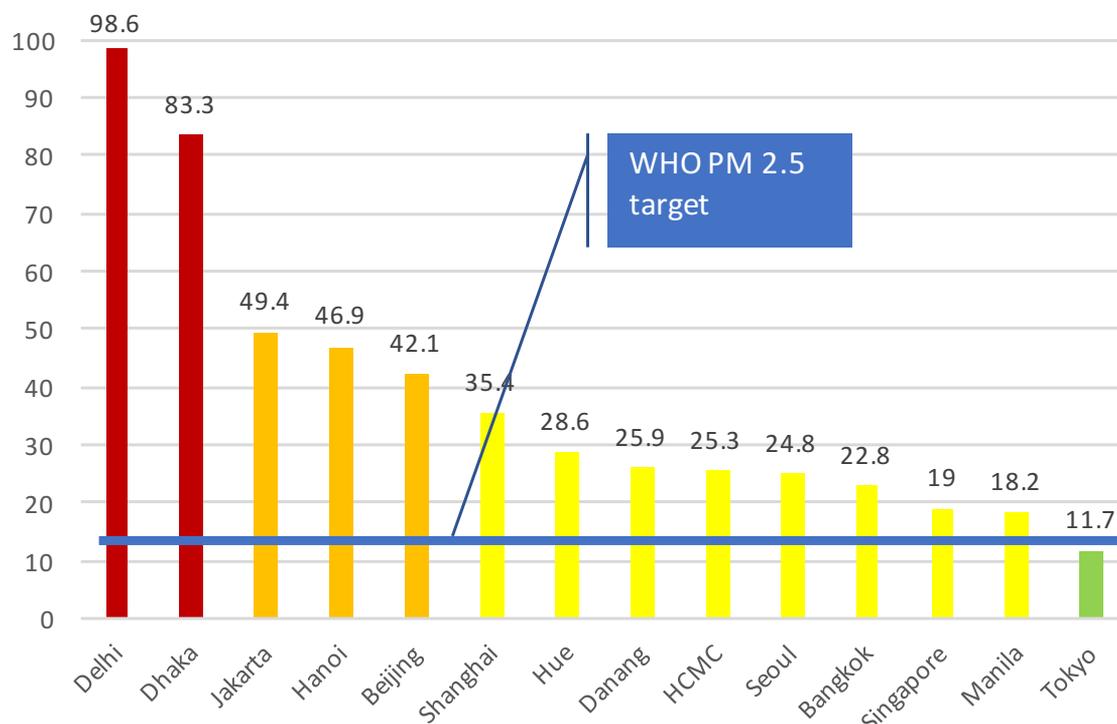
Adaptation efforts undertaken by the Government include building forecasting capacity, early warning and monitoring systems for extreme weather events and sea level rise, restoring forest and mangrove cover, designing technical standards for climate-proof infrastructure, and developing integrated farming systems that are resilient to flooding and drought.

Deforestation has accelerated over the past decade with the growth of upland agriculture and the furniture industry. Since 2001, Viet Nam has lost about one-fourth of its tree cover or 2.5 million hectares of forest. Forest loss and degradation are most intensive in higher elevation locations in the North Central, Northeast and Central Highlands regions. The highest rates were recorded in Binh Phuoc, Quang Tri, and Lao Cai provinces. Deforestation on this scale causes irreparable loss of Viet Nam's rich biodiversity and economic costs resulting from flooding and soil erosion. Expanding forest restoration programs and enforcement of regulations preventing encroachment on the forest by provincial government would stabilize forested area, safeguard protected forests and improve forest governance (Khuc et al., 2018).

Viet Nam's major cities are suffering from mounting environmental problems mainly due to delays in the development of mass transit systems. Air quality is poor in Hanoi, Ho Chi Minh City, Danang and Hue, according to the World Health Organization (Figure 32). The problem is most severe in Hanoi, where the concentration of particulate matter is five times the WHO standard of 10 µg/m³. Transportation is the main cause of poor air quality, and the development of mass transit systems and the transition to electric vehicles powered by renewable energy sources will improve the situation in the long term. However, immediate intervention is needed to reduce the impact of pollution on human health,

including strict monitoring of emissions standards, building out infrastructure for electric vehicles and additional taxes on internal combustion engines to accelerate the transition to e-mobility.

Figure 32. Average annual PM2.5 concentration ($\mu\text{g}/\text{m}^3$) in 2019



Source: World Health Organization

Key performance indicators (KPI) at the national and local levels are biased toward the achievement of economic milestones. Local authorities are also incentivized to increase local revenues. Balanced scorecards, with more weight given to environmental indicators, would support corresponding changes in urban planning and management, including adjusting transport development plans, increasing parking fees and raising the bar on the issuance of permits for high rise buildings. Budget allocations and promotions should pay more attention to sustainability indicators. Improving transparency and responsiveness to public feedback focuses the minds of policy makers on quality of life issues including health and the environment. In short, incentive structures need to be changed to encourage a healthy race to the top.

Section summary

Viet Nam has ranked among the world's top performing economies for the past three decades. Rapid growth has transformed the country from one of the poorest in the world to a dynamic, middle-income country. Viet Nam has participated fully in the globalization of manufacturing, creating millions of new jobs in the garment, electronics and other industries. Agriculture has also made a substantial contribution to exports, job creation and productivity growth, and has kept food prices stable despite the large-scale exodus of labour from the sector. Growth in Viet Nam has

reduced poverty and expanded middle-income groups, stabilizing the distribution of income.

However, globalization also entails risks. Capital inflows contribute to development financing, but can also destabilize currency and credit markets and drive up asset prices. Viet Nam's partially closed capital account and nonconvertible currency will help the country navigate the difficult period after Covid-19, when excess liquidity in the advanced countries will generate volatility in emerging markets. Additional controls on short-term capital inflows are warranted as are curbs on speculative behavior. There is an urgent need for counter-cyclical fiscal institutions to increase resilience in case of sudden shifts in capital flows and trade volumes.

Viet Nam faces numerous challenges over the coming decade. Public investment needs to increase to close the infrastructure gap despite a decline in government revenue as a share of GDP. New sources of long-term capital are needed to support the development of technological capacity of domestic firms. Small, undercapitalized commercial banks still represent a risk to financial stability, as many of these institutions have too much exposure to speculative ventures and connected lending. The pandemic has added to the stock of non-performing loans in the banking system, a problem that will remain a challenge until reform of bankruptcy laws and regulations enables banks to foreclose on collateral and dispose of assets. All this needs to be achieved in the context of a global economy weighed down by the Covid-19 pandemic and the lingering effects of the GFC in 2008.

Although measured inequality is stable at moderate levels, substantial disparities still exist between social groups. Poverty is heavily concentrated among ethnic minority groups and in remote rural areas. The rapid accumulation of wealth among a small number of ultra-high net worth individuals suggests that capital gains tax policies should be reviewed, and steps taken to discourage speculation in land and financial assets.

As a coastal country with two low-lying deltas, Viet Nam is vulnerable to sea level rise and an increase in the number and severity of typhoons due to climate change. The quality of the air and water has already deteriorated during the period of rapid growth. Investment in renewable energy and reforestation are needed to enable the country to meet its Intended Nationally Determined Contribution of reducing the emission intensity of GDP by 20% (compared to 2010 levels) and increasing forest cover by 45% by 2030.



SECTION 4. VIET NAM IN MULTIPLE TRANSFORMATIONS

Social and economic change in Viet Nam is taking place at a breathtaking pace. This section considers five categories of change that will have a profound impact on the three pillars of development discussed in the previous section: i) transformation of economic structure and ownership; ii) spatial transformation; iii) technological change; iv) social change; and v) the transformation of economic institutions. These changes can be mutually reinforcing: for example, economic structure is a key driver of economic geography and social change; and technological change is both a cause and effect of economic transformation. However, change does not necessarily occur synchronously, with tensions and contradictions arising as a matter of course. An awkward but established fact of development is that all good things do not always, or automatically, come together. Development outcomes hinge on the government's capacity to formulate and implement Intelligent, forward-looking policies that maximize the positive effects of change for growth, equity and sustainability while minimizing negative social and economic consequences.

Managing economic change is never easy. There is no shortage of examples of countries that have seen growth stall or even reverse after a promising start. Viet Nam needs to navigate this sensitive period in the country's development at a time of exceptional global uncertainty. As climate change and its effects accelerate, Viet Nam will need to increase investment in adaptation and mitigation measures and fast-track the transition from fossil fuels to renewable energy. The rise in protectionist sentiment and long-term slowdown in productivity growth in the advanced countries are troubling developments for outward-oriented economies like Viet Nam. Financial turbulence is an ever-present threat in a world of volatile capital flows, unprecedented levels of debt and flexible exchange rates.

In this context, government policy must lead rather than react to change. Business as usual, or even improving the business environment, will not be enough to ensure favorable outcomes. The main message is that the government will need to be more proactive, and that the capacity of the government to formulate and implement policy in a more *coherent* and *coordinated* fashion will be of the utmost importance. Issues addressed in the section include the planning system and public investment, education and skills, research and innovation, financial system development and social protection. Others of equal importance, such as energy and environmental regulation, have not been taken up here as they have been examined in depth elsewhere.¹⁴ However, the same lessons apply in each of these spheres: the capacity of government to formulate and implement forward-looking policies that anticipate threats and vulnerabilities, and to strengthen communication, collaboration and synchronization between sectors and levels of

¹⁴ See, among others, (Neeffjes & Dang Thi Thu Hoai, 2017; Ortmann, 2017; Phuong et al., 2018; UNDP, 2018b; United Nations, 2019).

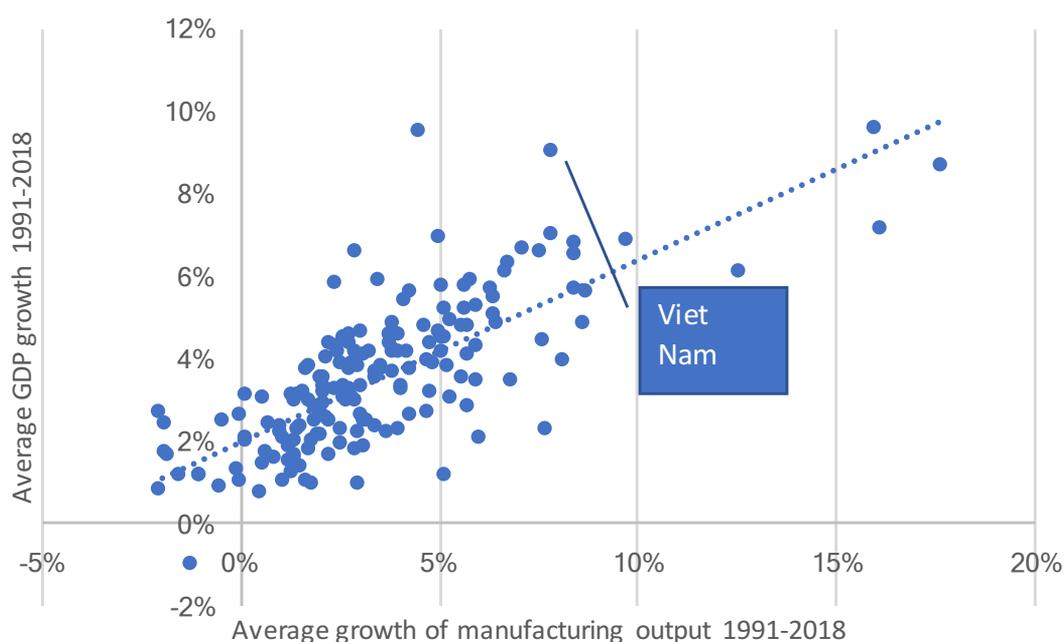
government, and between government and the private sector, will be decisive as the country strives to manage these multiple and profound transformations.

Transformation of economic structure and ownership

By definition, the rate of economic growth is the product of additions to the labour force and the growth of output per person per day. It follows that creating productive jobs for people who were either out of work or working in very low productivity jobs is an important driver of growth, especially in developing economies where a large share of the labour force works in agriculture and traditional services.¹⁵ Manufacturing is the sector that is most capable of generating good, stable jobs in sufficient numbers. The successful economies of East Asia achieved rapid growth in productivity and incomes through the growth of manufactured exports, a strategy that Viet Nam has also pursued to great effect. It is therefore not surprising that GDP growth is closely associated with the growth rate of manufacturing among middle- and low-income countries (Figure 33).

The share of employment in industry rose after 2014 as the growth of manufactured exports accelerated (Figure 34). Modern services also expanded rapidly. The decline in the share of the workforce in agriculture despite the continued growth of agricultural output signals that the labour productivity gap between agricultural and industry has begun to narrow: fewer workers in agriculture are needed to produce larger volumes of higher value-added agricultural commodities.

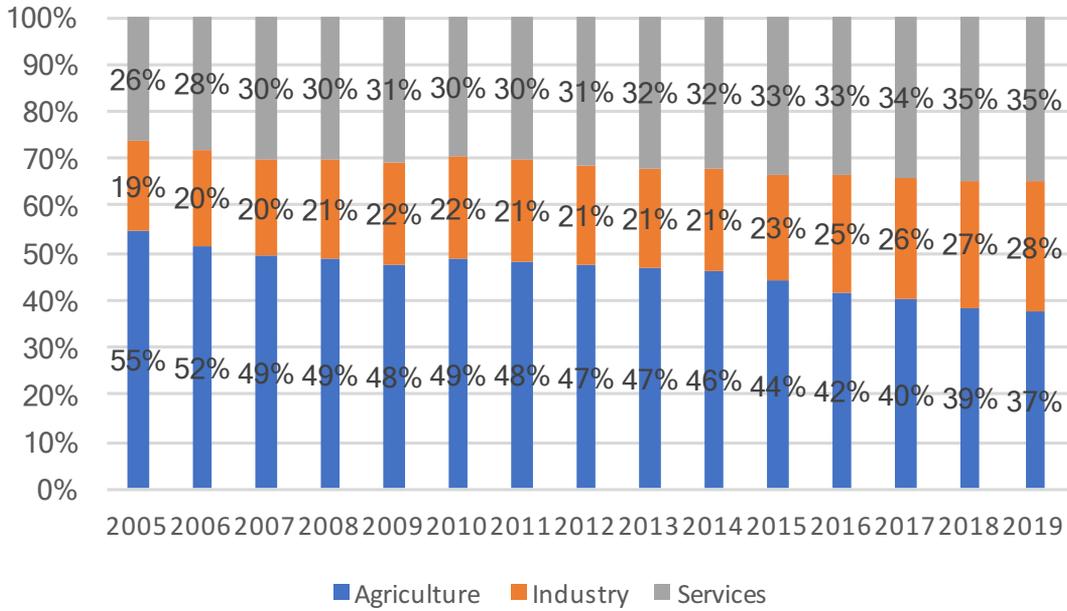
Figure 33. Average GDP growth and growth of manufactured output, 1991-2018



Source: World Development Indicators

¹⁵ Traditional services like domestic service and petty trade typically make up a large share of the employment, especially among women, in the early stages of development. In 1870, 52% of employed women in the United States were domestic servants. The corresponding figure for England and Wales reported in the 1911 census was 28%, or 1.35 million women.

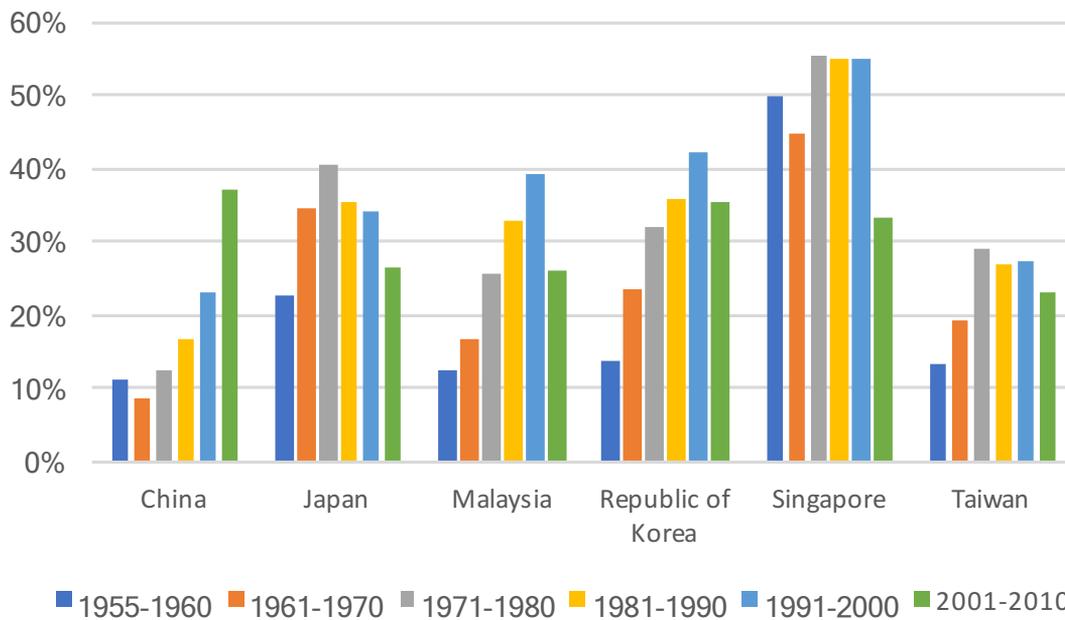
Figure 34. Sectoral composition of the labour force



Source: International Labour Organization

A high rate of domestic investment sustained over a long period of time is a necessary condition of industrial transformation (Figure 35). Although foreign direct investment plays a supporting role, the experience of successful Asian developing countries shows that most investment will come from domestic sources. Retained profits are the principal source of investment capital, supported by bank credit. Equity markets were of minor importance in East Asia, as elsewhere. Public investment in infrastructure, education, healthcare, and research plays a vital role in structural transformation, promoting productivity growth, trade and job creation.

Figure 35. Investment as a share of GDP, 1955-2010

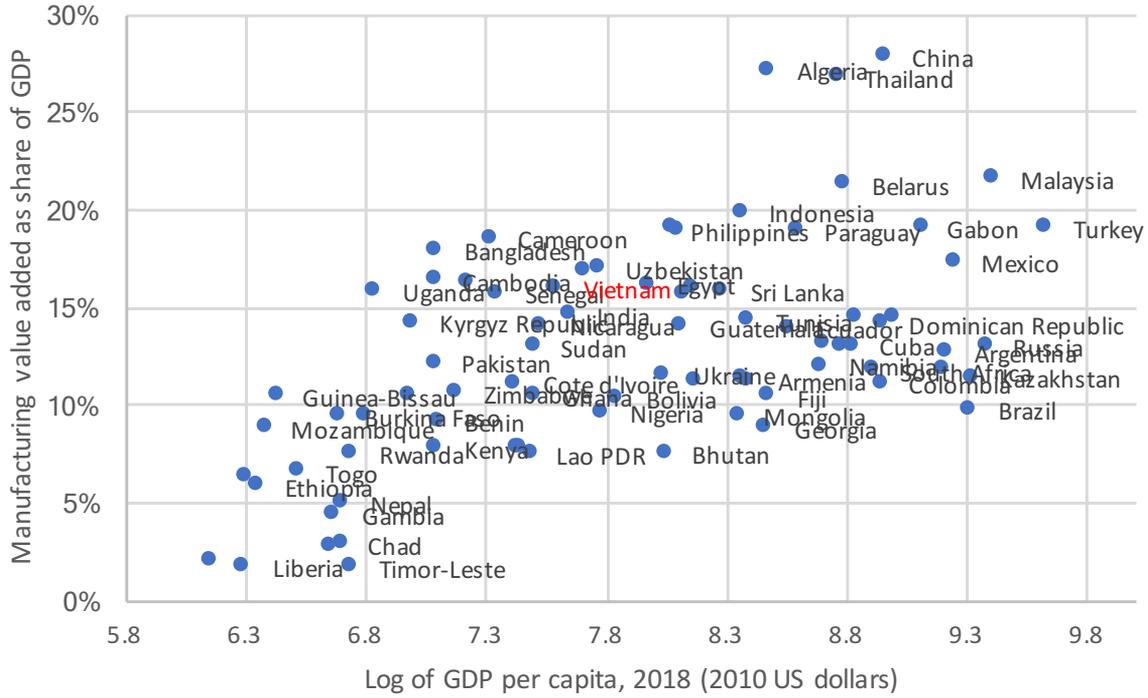


Source: Penn World Tables

Rapid growth of exports also drives structural change. Developing countries are typically foreign exchange constrained, in the sense that the capacity to import is a limiting factor in the growth of domestic demand. Trade policy can reduce the import-intensiveness of growth (for example, tariffs and taxes on imports, especially luxury and other non-essential goods) but the growth of exports is decisive. Failure to expand exports at the required pace will ultimately force the government to take steps to restrain domestic demand and can also cause exchange rate instability and price inflation.

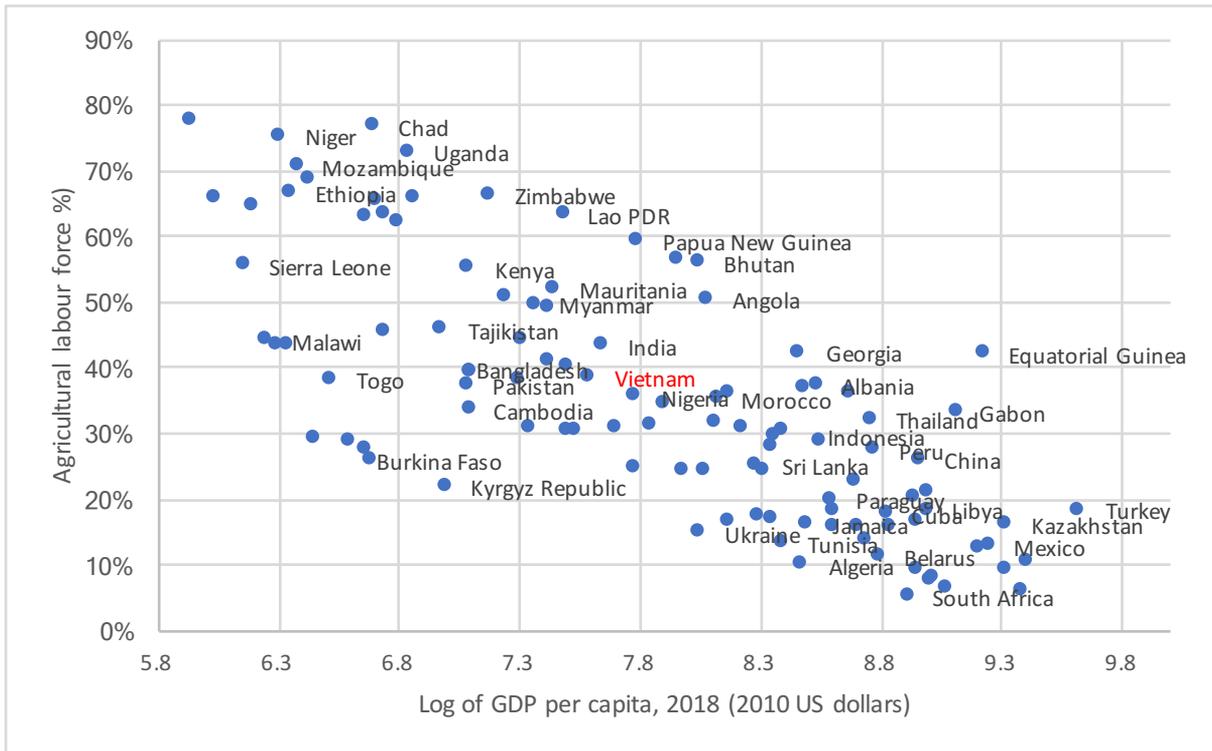
As Adam Smith noted two centuries ago, expanding exports is important because access to larger markets promotes specialization, technical change and increasing returns to scale. The nature of these transformations is apparent in Figures 36 and 37, which map manufacturing value added as a share of GDP and agriculture as a share of the labour force for low- and middle-income countries in 2018. The figures reveal a consistent positive relationship between income per person and the share of manufacturing in economic output, and a negative relationship between income per person and agriculture's share of the labour market.

Figure 36. Manufacturing value added as a share of GDP and the log of income per capita, 2018 (constant 2010 US dollars)



Source: World Development Indicators

Figure 37. Share of agriculture in total labour force and log of income per capita, 2018

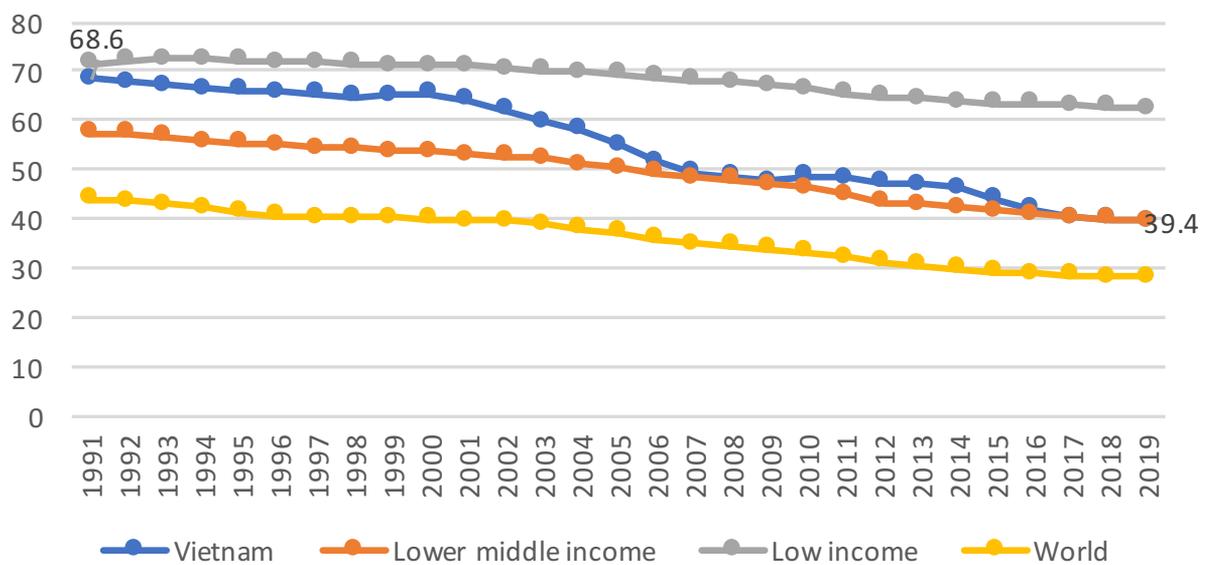


Source: World Development Indicators



Viet Nam's transformation from a primarily agrarian to an industrial economy began around the turn of the new millennium with the country's entry into trade agreements that opened foreign markets to agricultural and manufactured exports. Labour moved from agriculture to manufacturing at an accelerated pace, a process that paused during the GFC but picked up again after 2014 (Figure 38). Since average productivity is higher in manufacturing than in agriculture, the movement of labour between sectors is a significant source of economic growth. In 2018, UNDP estimated that the structural change effect accounted for 28% of productivity growth from 2007 to 2016 (UNDP, 2018d).

Figure 38. Share of agriculture in total employment, 1991-2019



Source: World Development Indicators

Transformation has also occurred within sectors, from small to large-scale, from traditional to modern production methods, and from simple to complex products and services. In agriculture, export values of traditional crops like rice and coffee have continued to increase, while new commodities like cashew and fruit have gained in importance (Table 2). Thanks to quality improvements and the ability to meet sanitary and other standards imposed by importing countries, Viet Nam has increased exports of high value-added commodities like fresh and frozen fish and shrimp. The shift from bulk commodities to fisheries, livestock and plantation crops has increased average farm sizes and raised labour productivity.

The development of new industries is even more apparent in manufacturing. Manufactured exports grew at an average annual rate of 17% in real terms from 2000 to 2019, with non-traditional exports growing at exceptionally high rates (Table 3). Exports of some communications and computing equipment have more than doubled every year. Traditional manufactured exports like garments, footwear and furniture have also increased at rates exceeding ten percent per annum.

Table 2. Top 20 agricultural exports 2019, constant 2010 US dollars (millions)

Commodity	2000	2019	AAGR
Fish, fresh and frozen	241.8	3,638.2	15%
Crustaceans and mollusks	1,534.4	3,537.6	4%
Cashew	213.8	2,628.8	13%
Rice	890.1	2,538.5	5%
Fruit	108.5	1,957.5	16%
Coffee	617.3	1,898.6	6%
Cassava	59.3	984.2	15%
Pepper	179.7	584.1	6%
Tea	85.7	197.4	4%
Vegetables	12.7	175.6	14%
Bananas	1.3	150.5	27%
Cinnamon	6.9	147.6	17%
Other nuts	53.0	140.4	5%
Sugar	5.2	80.8	15%
Milk	97.6	64.6	-2%
Milled flour	0.6	62.7	27%
Pork meat	24.0	52.8	4%
Maize	2.5	46.6	16%
Honey	4.1	45.3	13%
Cut flowers	0.7	42.8	23%

(Source: UN Comtrade)

Services are also modernizing at an impressive rate. Tourism has boomed in recent years, with growth of international tourist arrivals accelerating after the GFC. From 2015 to 2019, arrivals increased at an annual rate of 18%, more than doubling from 7.9 to 18 million arrivals within five years. Earnings rose during the same period from US\$7.4 to 11.8 billion. However, the average expenditure per tourist fell from \$930 to \$660 per arrival, which suggests that more work needs to be done to attract tourists in the luxury segment. About 2.7 million people worked in tourism or related industries in Viet Nam before the Covid-19 pandemic (Tung, 2020). Improving the experience of high-end tourists will increase the number of repeat visitors and accelerate the recovery of the industry from the pandemic.

Viet Nam's economic transformation is propelled by the country's integration into global value chains (GVC) and participation in regional production networks. FDI has played a pivotal role, especially in manufacturing. Although the rate of growth of FDI has slowed, Viet Nam has remained a favored destination (Figure 39). FDI delivers important benefits including access to GVCs, the creation of stable, formal sector jobs, forward and backward linkages to domestic industries, and demonstration effects for domestic firms. But FDI also entails costs (Table 4). Exports produced by FDI firms are import-intensive. The imported value added in exports is higher in Viet Nam than in Thailand and Malaysia in both manufacturing and agriculture (Table 5). As a source of investment capital, FDI is expensive, with remitted profits generating higher rates of return for investors than interest rates on bank loans. Profit remittances are a liability equivalent to foreign debt which need to be financed like any other financial obligation. Transfer pricing is a problem in Viet Nam as shown by the massive errors and omissions on the balance of payments. Foreign investors demand tax holidays, which if granted reduce the positive impact of inward investment on government revenue. FDI is pro-cyclical and can generate asset bubbles especially if directed to fixed or financial assets (Table 4).

Table 3. Top 20 manufactured exports 2019, constant 2010 US dollars (millions)

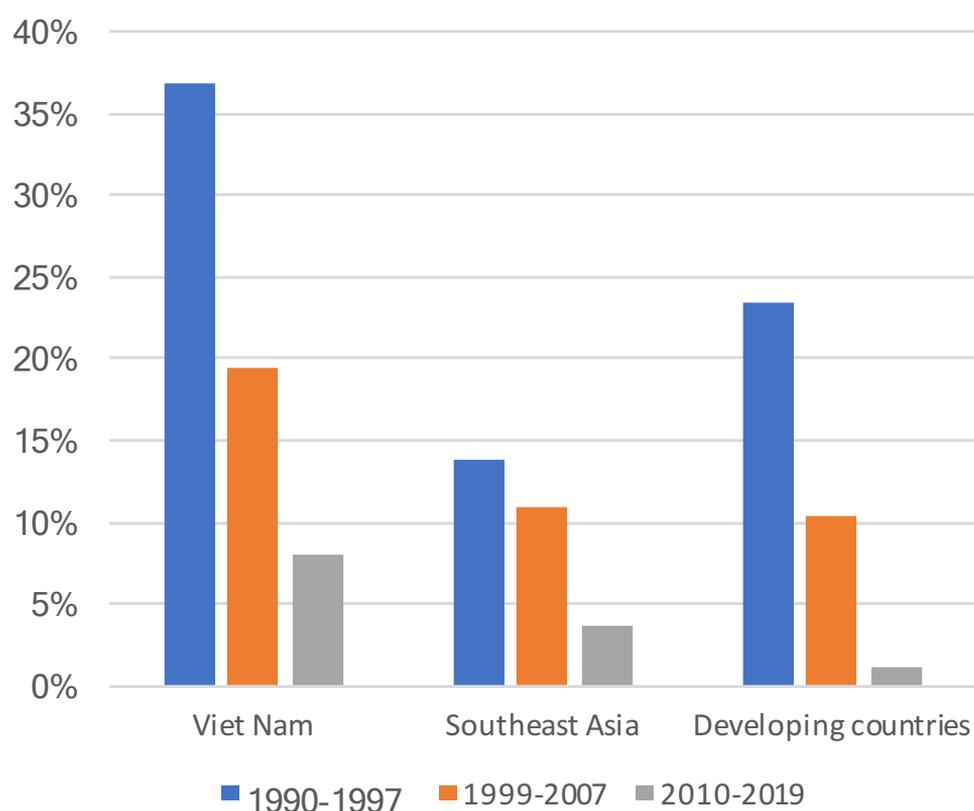
Commodity	2000	2019	
Transmission equipment	5.8	37,402.5	55%
Garments	2,198.1	25,703.1	13%
Footwear	1,811.7	16,249.2	12%
Telephones	20.3	15,165.8	39%
Integrated circuits	4.7	13,002.6	49%
Furniture	285.5	7,688.1	18%
Computers	598.5	6,964.3	13%
Iron and steel	75.3	5,894.4	24%
Televisions	39.6	5,279.6	28%
Electrical machinery	124.8	4,601.2	20%
Fabric	84.2	4,514.5	22%
Optical cable	159.3	4,029.0	18%
Audio equipment	23.2	2,716.2	27%
Auto and motorcycle parts	12.8	1,693.3	28%
Photographic equipment	22.1	1,652.8	24%
Yarn	138.8	1,556.7	13%
Liquid crystal displays	0	1,241.2	
Jewelry	0.8	1,215.9	44%
Aluminum	10.9	1,087.4	26%
Copper	4.2	1,040.7	32%

Source: UN Comtrade

Table 4. Benefits and costs of FDI

Benefits of FDI	Costs of FDI
Creates steady, formal sector jobs for un/underemployed workers	FDI is an expensive source of finance in the long run (profit remittances)
Generates tax revenue	If FDI investors demand tax holidays, revenue effect may be small
Generates exports, access to foreign exchange	Import intensive, may not improve balance of payments
Creates demand for domestically produced inputs and inputs for downstream industries	If FDI specializes in labour-intensive segments, linkages may be small (e.g., Mexico automobile industry)
Demonstration effects for domestic companies and skills development in labour force	Limited empirical evidence of horizontal technology spillover effects from FDI to local firms
FDI increases domestic investment rate (unlike portfolio flows, which do not)	FDI is pro-cyclical and can cause asset bubbles if invested in property and financial assets

Figure 39. Average annual growth of net FDI flows



Source: UNCTAD

Table 5. Import intensity of exports, Viet Nam, China, Thailand and Malaysia, 2017

	Viet Nam	China	Thailand	Malaysia
Manufacturing	52%	17%	41%	42%
Services	24%	8%	12%	28%
Agriculture and aquaculture	31%	5%	9%	19%
Energy and mining	11%	10%	11%	17%
Processed food	36%	8%	17%	42%
Construction and construction materials	44%	12%	29%	48%

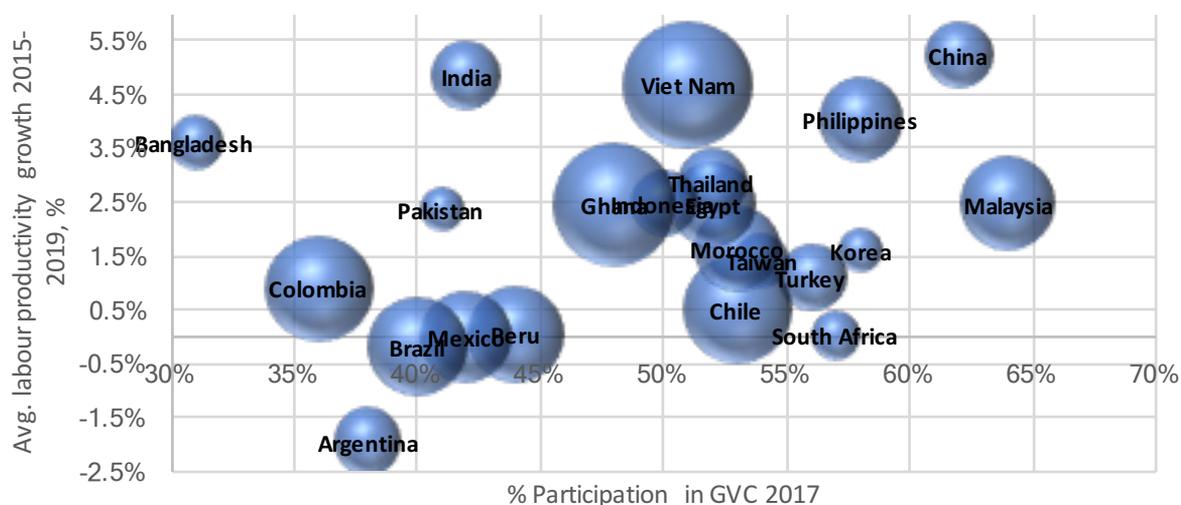
(Source: UNCTAD-Eora Global Value Chain Database)

Participation in global value chains is closely associated with labour productivity growth in middle income countries (Figure 40).¹⁶ Countries that are active in global production networks like China, Philippines and Viet Nam record higher rates of productivity growth than countries that do not. However, no relationship exists between the share of FDI in national income and productivity growth. Some countries that rely heavily on FDI have seen almost no productivity growth in recent years. There is a regional dimension to these relationships: China and Southeast Asia record both active GVC participation and high rates of productivity growth; South Asia achieves productivity growth at lower levels of GVC participation; and Latin America records low rates of productivity growth regardless of the level of GVC participation. Participation in GVCs is particularly important for labour surplus countries with a comparative advantage in abundant labour. This explains the differential impact between China and Southeast Asia on one hand and Latin America on the other. While intersectoral reallocation of labour also occurs in Latin America, prevailing wages in these countries are still much higher than in Southeast Asia.¹⁷ FDI channeled into fixed assets or activities oriented to the domestic market have tended to generate less labour productivity growth than export oriented FDI.

¹⁶ GVC participation is measured as an index of foreign value added in exports and domestic value added embodied in the exports of its trading partners. See (De Backer & Miroudot, 2013) for the derivation of the index. All the countries included in the figure have a total population of at least ten million.

¹⁷ Hourly compensation costs in Mexico were nearly twice as high as the Philippines in 2016 according to the Conference Board (see <https://conference-board.org/ilcprogram/>).

Figure 40. Participation in global value chains (share of foreign inputs and national exports and share of national inputs in other countries' exports), labour productivity growth and foreign direct investment



Source: Authors' calculations from UNDP, ILO and UNCTAD. The size of the bubbles represents FDI as a share of GDP

In addition to sectoral transformation, Viet Nam is also experiencing a transformation of ownership. The establishment of the Commission for the Management of State Capital at Enterprises (CMSC) was intended to separate ministries from SOE management.¹⁸ One of the mandates of CMSC is to promote equitization based on the principles of transparency and accountability, including listing on the stock exchange; paying special attention to preventing corruption and dealing with interest groups in all activities and stages of equitization. It is still too early to gauge the impact of CMSC on the performance of the SOE sector. Following the examples of Singapore and Norway, professionalization of the body, including incentives and key performance indicators (KPI), are needed to focus its activities and protect it from political influence. Other recent milestones include state divestment from Sabeco and other large SOEs.

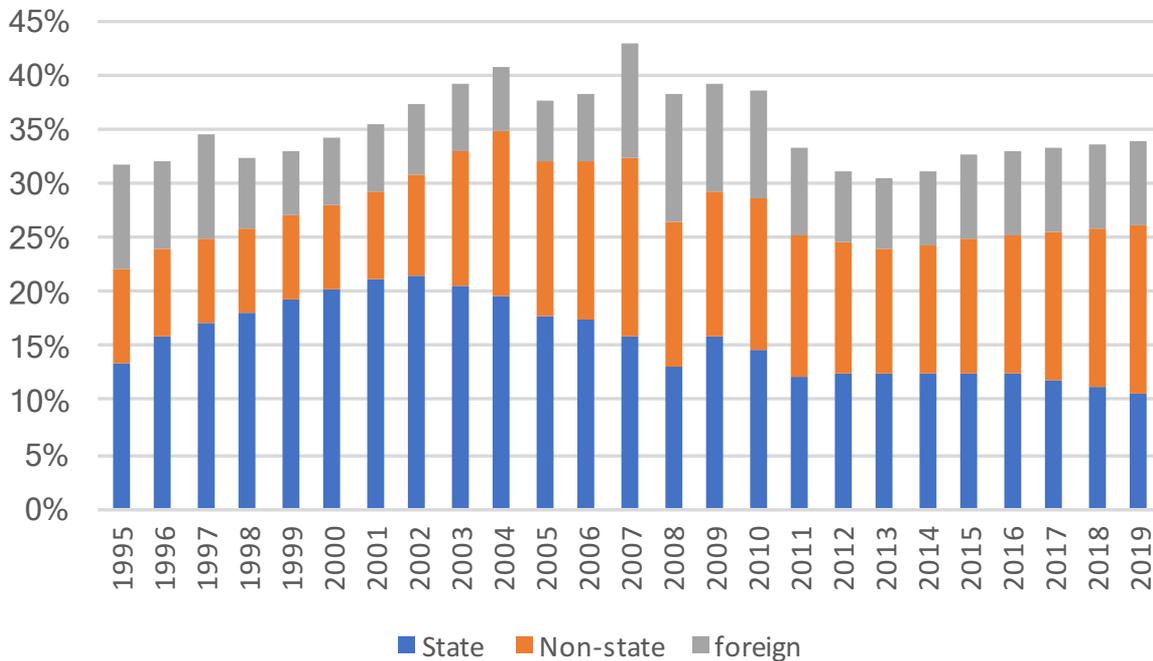
The private sector has posted impressive rates of growth since the GFC. Domestic non-state investment has doubled as a share of GDP since 2000, while public investment has nearly halved, from 20 to 11% (Figure 41). Although linkages between FDI and private domestic firms are still weak, signs of improvement have emerged. The number of first-tier vendors serving Samsung has tripled over the last five years, from 14 in 2014 to 42 in 2019. The number of second and third tier suppliers increased to 172 and 465, respectively. Another positive development is Samsung's decision to source molds and equipment locally in addition to parts and components.¹⁹ The case of Samsung shows that the rapid growth of production in Viet Nam and commitment of MNCs presents opportunities for domestic firms to accumulate experience and build up capabilities to meet the stringent requirements of FDI enterprises. However, as discussed in Section 4.5, a national innovation system, anchored by government and involving the private sector, is needed to develop domestic technological

18 Decree 09/NQ-CP dated February 3, 2018.

19 Source: <http://tapchicongthuong.vn/bai-viet/tin-anh-hoi-nghi-trien-khai-chuong-trinh-ho-tro-tu-van-cho-doanh-nghiep-tren-dia-ban-tinh-hai-duong-trong-linh-vuc-cong-nghiep-ho-tro-68485.htm>

capacity and prepare local companies to build stronger linkages with FDI firms.²⁰

Figure 41. Investment as a share of GDP, 1995-2019



Source: General Statistics Office

The emergence of national champion manufacturing firms in the private sector is an important development. The concentration of large domestic firms in real estate, retail, transportation and tourism contributes to growth and job creation. But these industries are focused on the domestic market and have limited backward and forward linkages. The entry of non-state domestic firms into food processing, vehicle assembly and electronics is encouraging, and could mark a shift in the direction of domestic private investment. These developments are closely linked to a shift in the mindset of Viet Nam's leadership, as manifested in Central Committee resolutions on SOE reforms (NQ 10) and private sector development (NQ 12) (signed 3 June 2017) and Politburo Resolution 50 on FDI (signed on 20 August 2019). These resolutions have paved the way for the legislative and executive branches of the government to institutionalize better treatment of the domestic private sector.

Viet Nam's economic transformation has unfolded at a breakneck pace, so it would not be surprising if it were to slow down, especially in the wake of the Covid-19 pandemic. Section 2 described the headwinds facing the global economy and the decentralized model of global manufacturing that has emerged in the 1990s. In the short term, tensions between the US and China will increase Viet Nam's attractiveness as an export platform, but even this success carries risks, as an

²⁰ The three parties – Samsung, domestic firms and central and local governments have worked closely with one another through a long-term cooperation program. The three parties recently organized a big event in Hai Duong province with the participation of a leader of government, MOIT minister and the provincial Party chief, and numerous Viet Namese firms (Source: <http://tapchicongthuong.vn/bai-viet/bo-cong-thuong-samsung-hai-duong-noi-dai-canh-tay-phat-trien-cong-nghiep-ho-tro-68455.htm>)

expanding trade surplus with the US could trigger reprisals.²¹ The long term is less certain. Unlike Japan, Korea and Taiwan, China has moved out of lower value added manufacturing slowly even as it has moved up the value chain (Hallward-Driemeier & Nayyar, 2018). As automation of manufacturing processes gathers pace, labour surplus economies could lose their comparative advantage in assembly and other labour-intensive activities. The “servicification” of manufacturing make it more difficult for firms in developing countries to move up the value chain, while placing a premium on the productivity of services embodied and embedded in manufacturing (Cruz & Nayyar, 2017). Higher value-added services are still in their infancy in Viet Nam, and if tourism is excluded Viet Nam’s trade deficit in services is substantial.²²

Spatial transformation

Viet Nam’s rapid economic transformation and international integration has had a significant impact on the country’s demography and economic geography. New trade theories and international experience emphasize the role of cities in realizing economies of scale in infrastructure and services. However, the relationship between economic density and efficiency is not linear, but instead follows an inverted U-shaped curve, rising to an optimal point and then declining when the benefits of agglomeration are outweighed by the costs of congestion and pollution. Investment in connectivity and policies to promote dispersion of investment (soft connectivity) such as universal coverage of social services, labour mobility, and enhanced regional planning can help reduce congestion and spread the benefits of development more widely.

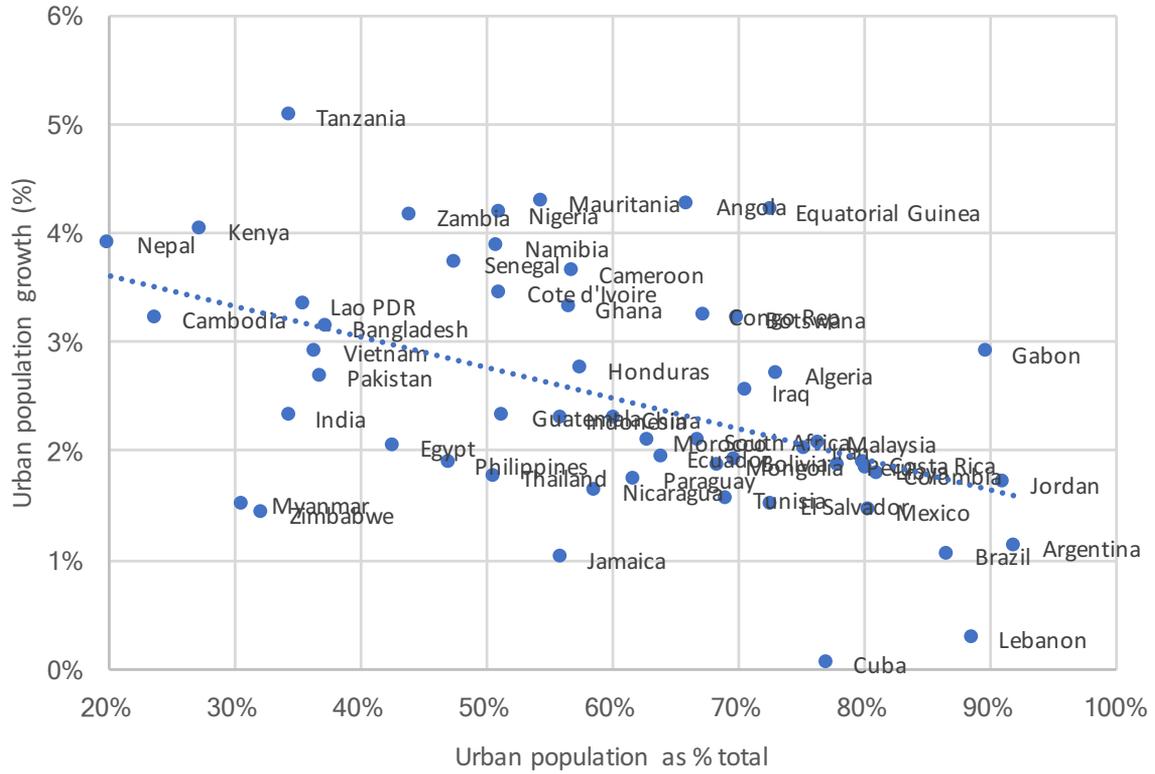
Compared to other middle-income countries, the level of urbanization in Viet Nam is moderate at less than 40% of total population, but the urban population is growing quickly, at a rate of three percent per annum (Figure 42). However, these figures underestimate the level of urbanization because they are based on administrative boundaries that do not change quickly enough to keep up with the pace of agglomeration. Many people live in areas still officially classified as suburban or even rural, but which have already been physically incorporated into cities or grown into cities in their own right. This also may result in underestimation of the growth rate of cities because people who move into areas still classified as suburban (but which in fact are urban) will not be captured in the data.

Figure 43 suggests that as the level of urbanization rises, the rate of growth of cities declines. This is to be expected, as once the urbanization level surpasses 50% there are fewer people to move from rural to urban areas. Thus, Viet Nam’s urbanization rate will moderate over the next decade, although the pace at which it does so will depend on the rate and pattern of economic growth.

21 In October 2020 the US launched an inquiry into Viet Nam’s exchange rate policy. If Viet Nam is deemed to have manipulated its currency, tariffs could be imposed on exports to the US.

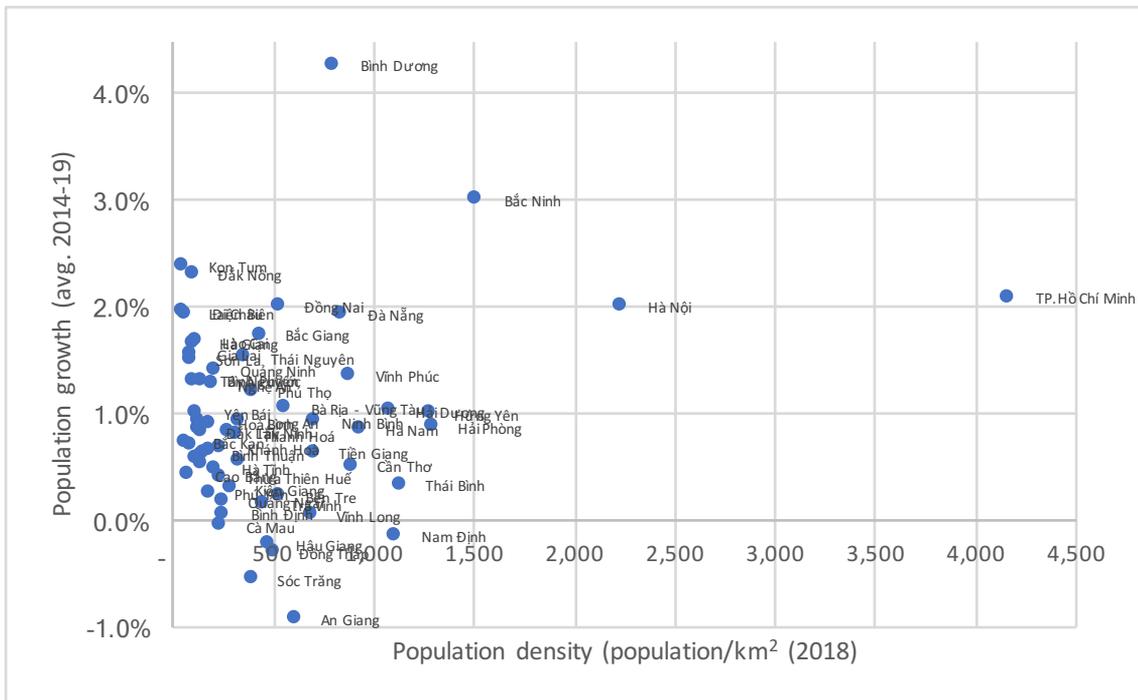
22 In 2019, deficit in trade in services was US\$ 2.5 billion, but if tourism, which run a surplus of US\$ 5.6 billion, is exclude, this deficit more than tripled, reaching US\$ 8.1 billion, which almost offset the surplus in trade in goods (Source: <http://www.gso.gov.vn/Default.aspx?tabid=621&idmid=&ItemID=19454>)

Figure 42. Urban population as percent of total and urban population growth, 2019



Source: World Development Indicators

Figure 43. Average population growth 2014-2018 and population density 2018 by province



Source: General Statistics Office

Viet Nam has one densely populated city, Ho Chi Minh City (HCMC), which is still growing at about two percent per annum (Figure 43). However, Viet Nam's pattern of urbanization is multipolar, with several industrializing regions growing as quickly or more quickly than HCMC. Binh Duong is still the fastest growing province by population, followed by Bac Ninh and then several urbanizing regions including Hanoi, Danang and HCMC. This multipolar pattern is an advantage in that it reduces pressure on the largest city and delivers benefits in the form of infrastructure, investment and employment to other regions.

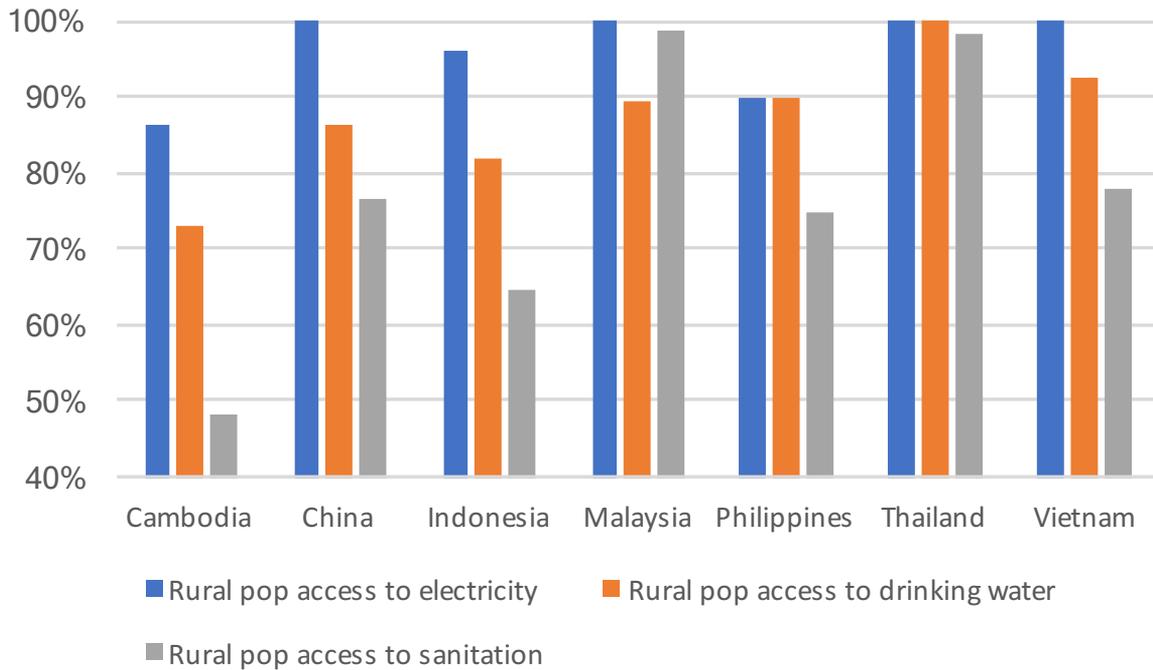
Urbanization has contributed to poverty reduction in Viet Nam through income diversification and migration (Aroui et al., 2017). Given the pace of economic transformation, it is not surprising that population mobility is exceptionally high. According to the National Internal Migration Survey, migrants make up 14% of the total population and 20% of urban residents. Relaxation of the provisions of the household registration system has reduced obstacles to accessing basic services, but migrants still report that they must pay more for education and utilities and cannot participate in poverty reduction programs (UNESCAP, 2017b).

Migration from the Mekong Delta region has accelerated over the past decade, partly in response to demand for unskilled labour in manufacturing, but also due to subsidence, salination, drought and flooding caused by climate change, the construction of dams on the Mekong River and the extraction of ground water. Migration will increase as drought and flooding become more common. Given that many of the causes of drought and floods are beyond Viet Nam's control, Government action is needed to ensure that emigration is orderly and does not lead to an increase in the incidence and depth of poverty (Berlemann & Tran, 2020).

As discussed in the previous section, rapid urbanization has entailed environmental costs, the most pressing of which are air quality, access to clean drinking water and solid waste management. Infrastructure is part of the response, but the active participation of residents is also important. For example, transitioning to more sustainable transport systems requires investment in mass transit, but also restructuring incentives to reduce the use of cars and motorcycles. Sustainable waste management means investment in technology to recycle waste and convert it into usable energy, but also changes in behavior (for example, separating household waste). Urban residents will need to learn to use energy and clean water more efficiently.

Viet Nam has also made good progress in reducing infrastructure gaps between rural and urban areas. Electrification and improved drinking water services are nearly universal, outperforming richer countries like Indonesia, the Philippines and China. Access to improved sanitation facilities has improved, but 20% of the rural population still does not have access to basic sanitation facilities, which should be a priority for the next plan period (Figure 44).

Figure 44. Rural population access to basic services (%)



Source: World Development Indicators

The connectivity situation is mixed, with Viet Nam excelling in some areas—such as cellular telephone subscriptions—but lagging in others (Table 6). Road, rail and air connectivity still have some way to go to achieve the standards set by the top performers in the region. Constraints on transport infrastructure are an obstacle to investment in regions outside of the main urban areas. Because Viet Nameese provinces are relatively small, both in terms of population and geographic area, planning must be carried out on a sectoral and regional basis. This was recognized in the Planning Law, which was enacted in 2017 and came into force in 2018. The enactment of the law is an opportunity to reduce fragmentation and achieve economies of scale in infrastructure development. Fragmentation increases the cost of public goods while reducing efficiency: for example, the construction of hundreds of small ports—and more local ports still in development—slows down the movement of goods and increases costs to business and consumers. A national system consisting of two or three deep water ports, linked together by integrated road and rail systems, would facilitate the transition to containerized shipping and complete the cold chain from farms to cities and ports. A national system of hub airports linked by rail and highways would be more cost effective than the construction of small, underutilized airports in every province.

The new planning system must improve coordination among ministries and sectors. For example, the Ministry of Transport (MOT), which is responsible for developing connective infrastructure, does not work sufficiently closely with the Ministry of Industry and Trade to properly integrate current and future trade flows into MOT's strategies and action plans.²³ As a consequence, infrastructure development is not properly aligned with Viet Nam's participation in global value chains.

²³ This can in part be explained by fact that Viet Nam still approaches spatial development planning predominantly from the supply side, not considering developments in global and domestic demand.

Table 6. Connectivity Indicators, 2019 (World Economic Forum)

	(A)	(B)	(C)	(D)	(E)	(F)	(G)
Viet Nam	63.3	7.6	364,184	68.8	99%	147.2	13.6
Bangladesh	57.5	21.8	48,504	12.1	80%	97.3	6.3
China	95.7	7.2	4,925,931	187.8	100%	115.0	28.5
India	75.8	22.7	1,224,526	59.9	88%	86.9	1.3
Indonesia	59.8	2.6	972,337	47.8	95%	119.8	3.3
Malaysia	40.0	6.8	420,240	109.9	98%	134.5	8.6
Philippines	51.6	1.7	306,153	29.0	88%	110.1	3.2
Thailand	80.0	8.7	670,387	48.0	100%	180.2	13.2

(A) WEF road connectivity scale (0-100) based on road connectivity between 10 largest cities

(B) Rail density (km/thousand km)

(C) International Air Transport Association (IATA) airport connectivity measure

(D) WEF liner shipping connectivity measure based on number of ships, capacity and services

(E) Percentage of population with access to electricity

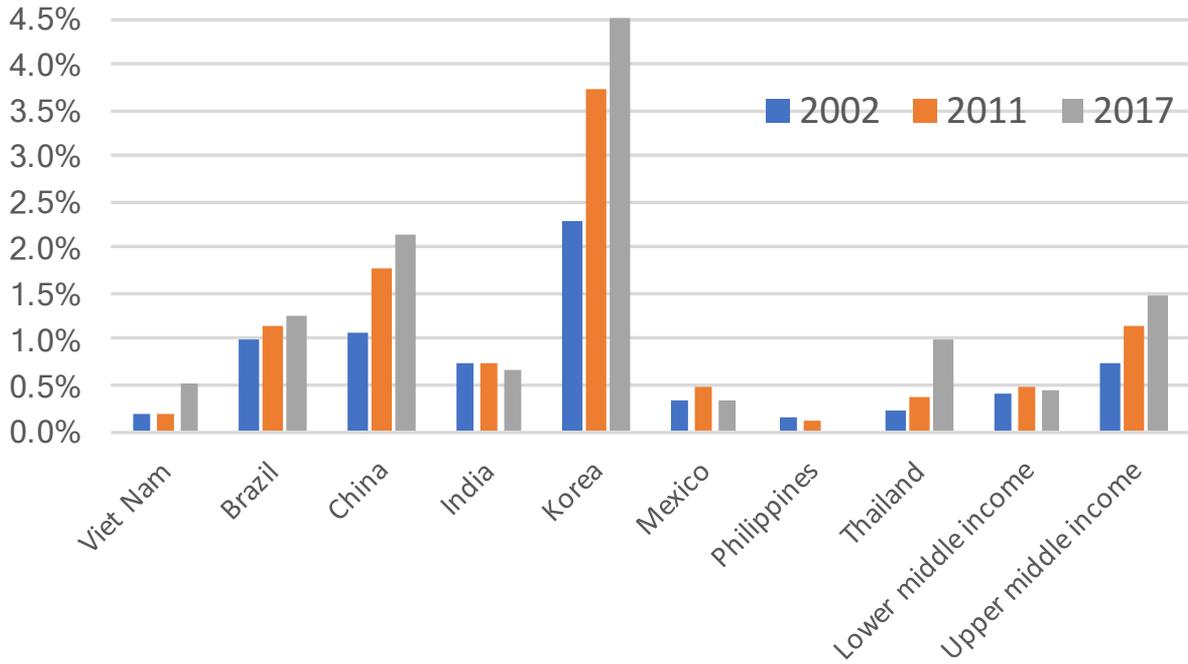
(F) Cellular telephone subscriptions per 1000 population

(G) Fixed broadband subscriptions per 1000 population

Technological and digital transformation

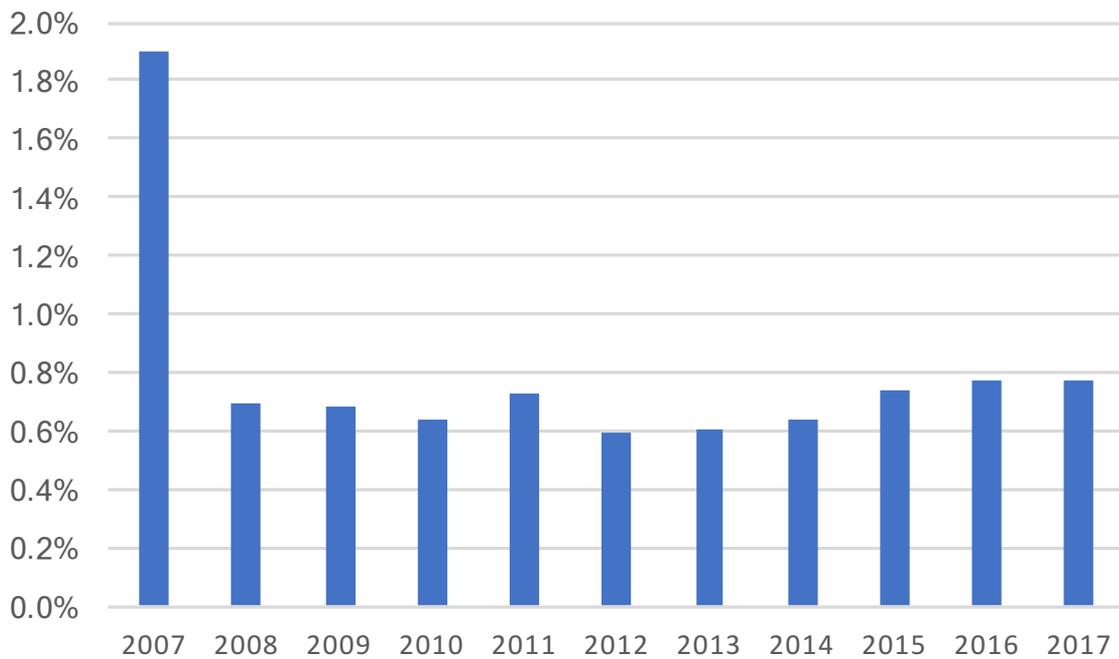
Viet Nam is experiencing a transition from the factor-driven development to growth that relies more on productivity and innovation. However, R&D spending remains low compared to other countries in the region, and about half of the average for middle income countries as a share of GDP (Figure 45). Moreover, there has been no improvement since the GFC in 2008 (Figure 46). Viet Nam's ranking is 76 out of 140 countries in innovation capacity in WEF's 2019 Global Competitiveness Report, including a rank of 91 in patent applications per capita (World Economic Forum, 2019).

Figure 45. Gross expenditure on research and development as % GDP



Source: UNESCO

Figure 46. Government spending on science and technology, 2007-2017



Source: Klingler-Vidra and Wade 2020

Thanks to the spread of high-speed internet, computing power and smaller sensors, the digital revolution is accelerating and converging toward integrated cyber-physical-biological systems. To improve the country's position in global competitiveness rankings, policy makers must properly integrate the development of disruptive technologies into national strategies and action plans. This process, termed by numerous commentators as the Fourth Industrial Revolution (Industry 4.0) has radically changed the way people live and do business. The new economy, or internet-based economy, has emerged as the driving force of growth. Digital platforms help cut down transaction costs, increasing efficiency, inclusiveness and innovation.

Viet Nam performs well in terms of providing firms and people with access to the Internet, which now covers 70% of the population, as compared to 35% for lower middle-income countries. Coverage of 4G technology infrastructure is 147 subscribers per 100 people, which compares favorably to other countries in the region and middle-income countries. The fiber optic network covers the whole country and the market for broadband cable has grown steadily in recent years. Viet Nam also ranks among the top five fastest growing information technology countries in the world. The first 5G video call was made in January 2020 on Viettel infrastructure "Make in Viet Nam." This giant telecom corporation is aiming to commercialize 5G Microcell across the network. Viettel will build civil and military products on a 5G technology ecosystem developed and manufactured in Viet Nam.²⁴

In future, Viet Nam should be prepared to seize the opportunities and rise to the challenges of the digital age. On a positive note, Viet Nam is among the few countries that explicitly embraces the concept of Industry 4.0, as manifested in the resolution of the Politburo on the Fourth Industrial Revolution issued on 27 September 2019.²⁵ The next step is for the Government of Viet Nam to elaborate the broad directions given in this resolution for inclusion in national strategies and action plans. Such a process should identify major opportunities and challenges associated with technological and digital transformation in the context of Industry 4.0 acceleration.

First, it is crucial to strike a balance between keeping the traditional economy moving forward while facilitating the emergence of the new economy. This problem in Viet Nam is not as acute as in developed countries because most workers have low incomes and therefore are not yet susceptible to automation and other labour-saving technologies. Nevertheless, the conflict between traditional and app-using workers and disputes between traditional and internet-based companies indicates that road maps supported by complementary policies and measures are needed to smooth the transition. Furthermore, anti-trust law needs to consider firms with market power, including those that do not have a presence in Viet Nam, but supply services across the border. Capabilities to tax these firms properly also need to be developed.

Second, balance is also needed between the competing priorities of strengthening cybersecurity and protecting privacy. Both are crucial to accelerate the digital transformation but dealing with trade-offs is challenging both technically and politically. Public investment in cybersecurity can give an edge to domestic firms

24 Source: <https://congnghe.tuoiitre.vn/thuc-hien-cuoc-goi-5g-dau-tien-tren-thiet-bi-ha-tang-mang-do-viet-nam-san-xuat-20200117154246744.htm>

25 Source: <http://dangcongsan.vn/xay-dung-dang/bo-chinh-tri-ban-hanh-nghi-quyet-ve-cuoc-cach-mang-cong-nghiep-lan-thu-tu-537518.html>

seeking to develop technological capabilities in this growing field.

Third, as mentioned in Section 2, global productivity has slowed down despite the emergence of digital disruptive technologies. The share of the ICT sector in GDP remains modest in most countries.²⁶ The penetration of digital technologies is slower in some sectors than others. To raise economywide productivity growth, strengthening the analog foundation in tandem with the pace of the digital revolution is needed to incentivize firms, workers and people to make better use of digital platforms and other digital technologies. In our terminology, it is important to put in place policies and institutions that support the mutually reinforcing interaction between technological and digital transformations with other transformations.

Fourth, policy makers need to formulate policies and create institutions in support of ecosystems that encourage all firms to adopt and absorb technology and engage in innovation of various types, not just regional or global frontier technologies. Ecosystems include fundamentals such as macroeconomic stability to ensure that firms, talent and capital do not shift to speculative activities. They also include the supply of inputs for technology and innovation related activities including talent, skills and long-term financing. The East Asian experience shows that the absence of a well-developed corporate bond market limits access of firms to long-term finance for expansion and innovation (Gill et al., 2007).

Furthermore, the Government should consider modern industrial policies to help Viet Nameese firms accelerate technological and digital transformations. Such policies are needed because of the dominance of foreign firms, both with and without a presence in Viet Nam – the latter through increasing cross-border supply of data and other high value services, in a lucrative market with a population of 96 million. Most digital platforms with large pools of users are owned by foreign firms and consequently the big data generated are controlled by firms from other countries.

As discussed throughout this report, the growth of exports is the best indicator of which technologies and firms are worthy of public support. The ability to penetrate export markets is a reliable gauge of competitiveness and capacity to approach the technological frontier. The sheer size of export markets presents opportunities to realize economies of scale that are not present in the domestic market. As a foreign exchange-constrained developing country, Viet Nam need to maintain a high rate of export growth to finance imports of advanced technology, intermediate goods and other goods that cannot be produced domestically in a sustainable manner.

Fifth, given the many unknowns and the pace of change, anticipatory, adaptable and agile governance is needed to make Industry 4.0 growth inclusive and sustainable. This entails developing the capacity within government to anticipate and adapt to the complexity of Industry 4.0 by applying an experimental approach to policy making, developing “grey policies” to promote innovation among relevant actors; and testing regulatory reforms that facilitate scaling up (UNDP, 2019b).

²⁶ The share of the ICT sector in GDP is around six percent in OECD member countries and considerably less in developing countries (*World Development Report 2016*, 2016).

Social transformation

Viet Nameese society has changed in fundamental ways over the last few decades. The most dramatic change has been the historic fall in the share of the population living in poverty and vulnerable to poverty (Table 7). As recently as 2008, 78% of the population lived on less than \$5.50 per day, a level commonly used as a measure of economic security in upper middle-income countries.²⁷ By 2016, this figure was below 30%, falling further to 23% in 2018. The share of the population living below the \$1.90 poverty line was less than two percent in 2016, lower than in Indonesia and the Philippines, much richer countries measured in terms of per capita income.

The share of vulnerable employment in the labour force fell from 66% in 2007 to 54% in 2018, and informal employment declined from 85% to 77% in the same period. The share of the labour force in the informal sector has not changed much since 2015, remaining within a narrow band despite rapid growth of employment. Real wages increased by 8% and 5% per year for formal and informal workers, respectively, during the 2015-2018 period. The slow pace of formalization of the labour force is a concern, as informal workers have little or no job security, access to basic work benefits and are not covered by minimum wage regulations. The experience of Covid-19 demonstrated how difficult it is to reach informal workers in times of crisis. The dominance of informal employment also narrows the tax base and forces the government to rely on more regressive forms of revenue like consumption and trade taxes.

Table 7. The population structure by income group, 2012-2016 (%)

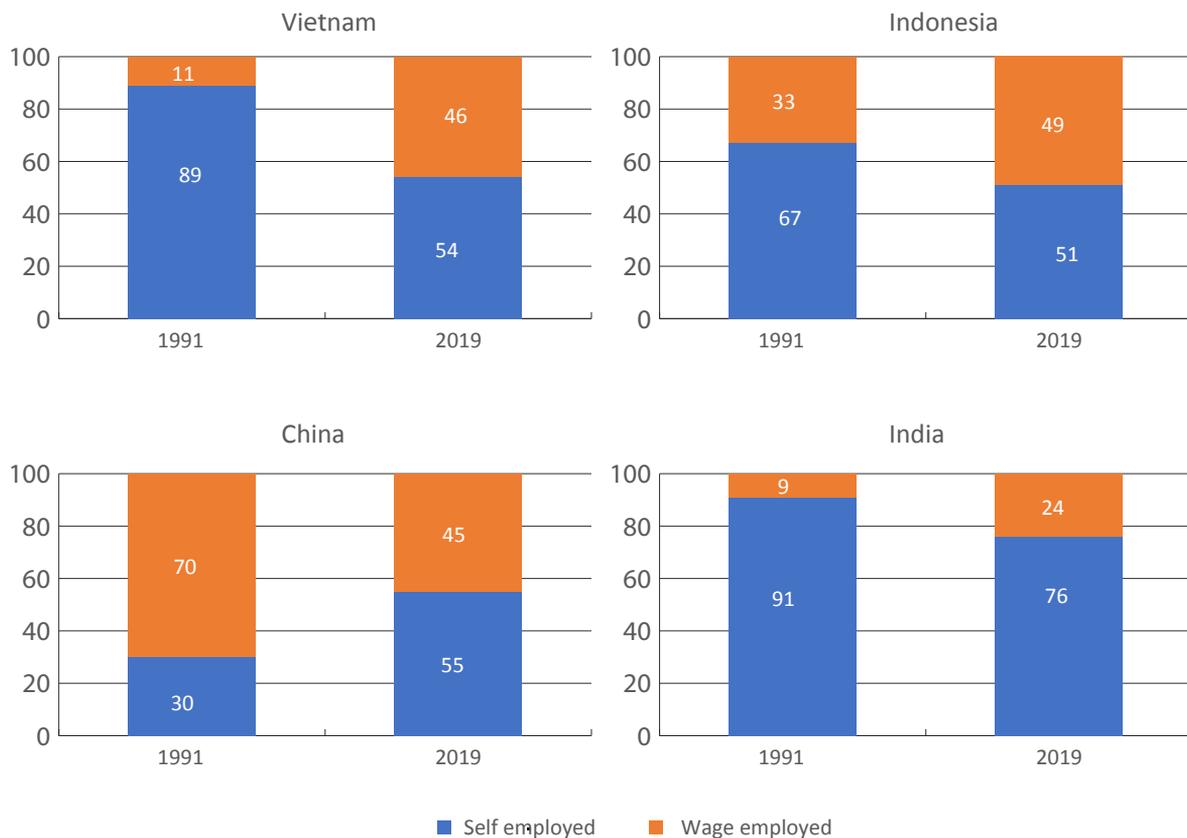
Economic groups	Ethnic minorities		Kinh majority		All	
	2012	2016	2012	2016	2012	2016
Extremely poor (under US\$1.9/day)	16.3	11.5	0.6	0.1	3.1	2.0
Poor (from US\$1.9 to US\$3.1/day)	31.6	25.1	6.0	2.0	10.0	5.9
Vulnerable (from US\$3.1 or US\$5.5/day)	34.1	37.9	29.2	18.5	30.0	21.8
Economically secure* (from US\$5.5 to US\$15.0/day)	16.7	22.5	55.1	64.0	49.0	57.0
Middle class (over US\$15.0/day)	1.4	3.0	9.2	15.4	7.9	13.3
All	100	100	100	100	100	100

Source: (UNDP, 2018c)

²⁷ The World Bank currently uses \$5.50 per day (in constant 2011 purchasing power parity dollars) to measure poverty in upper middle income countries.

An important transformation in Viet Nam is the rapid increase in the share of the labour force categorized as wage or salary workers relative to those grouped among the self-employed or family workers (Figure 47). The pace of change in Viet Nam is much faster than in neighboring countries, including China. The growing importance of wage employment has far-reaching implications for economic and social policy. Minimum wages, social protection and working conditions—for example, health and safety, working hours, sick leave and protection from sexual harassment—are now the principal determinants of living standards for millions of people. Strengthening channels for wage and salary workers to express grievances and preferences will help avoid potential conflict and facilitate dialogue.

Figure 47. Wage employment as share of total labour force

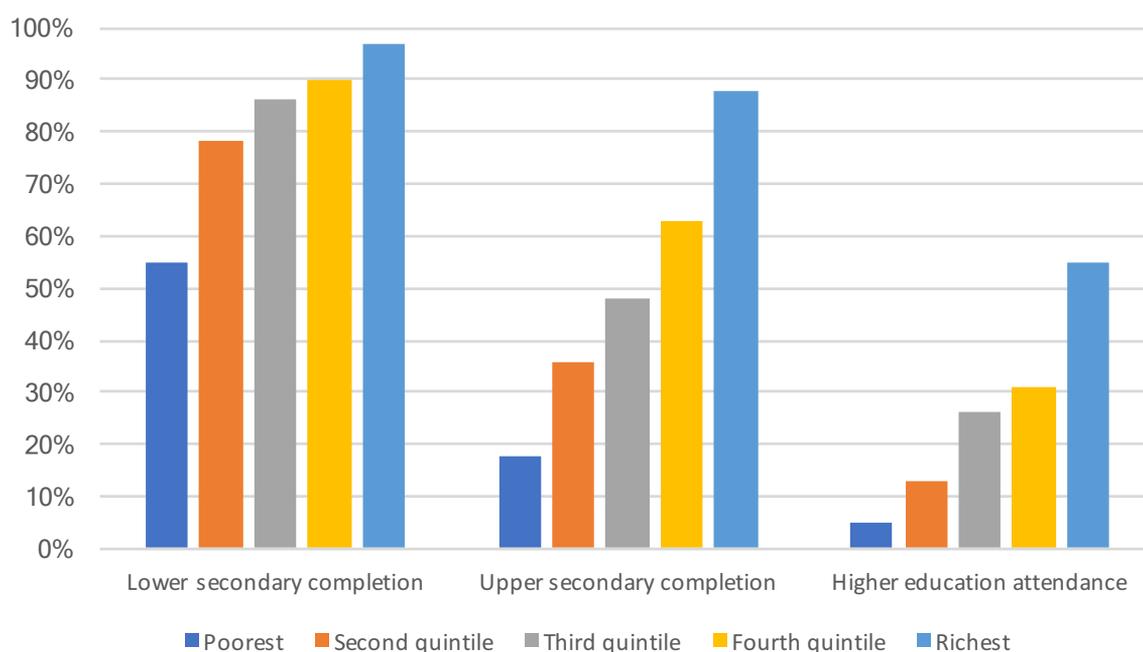


Source: International Labour Organization

Viet Nam has achieved remarkable progress in human development. In 2020, Viet Nam was listed among the High Human Development countries in UNDP’s annual Human Development Report for the first time (UNDP, 2020). The multidimensional poverty index (MPI) also confirms progress in various dimensions of wellbeing. Viet Nam’s MPI is 0.019, ranked 29th among 102 countries. Viet Nam’s Multidimensional poverty headcount is 4.9%, the third lowest among comparator countries (ASEAN countries – excepts Singapore and Brunei – China and India). Within this group, the intensity of deprivation and inequality among the poor is the lowest.

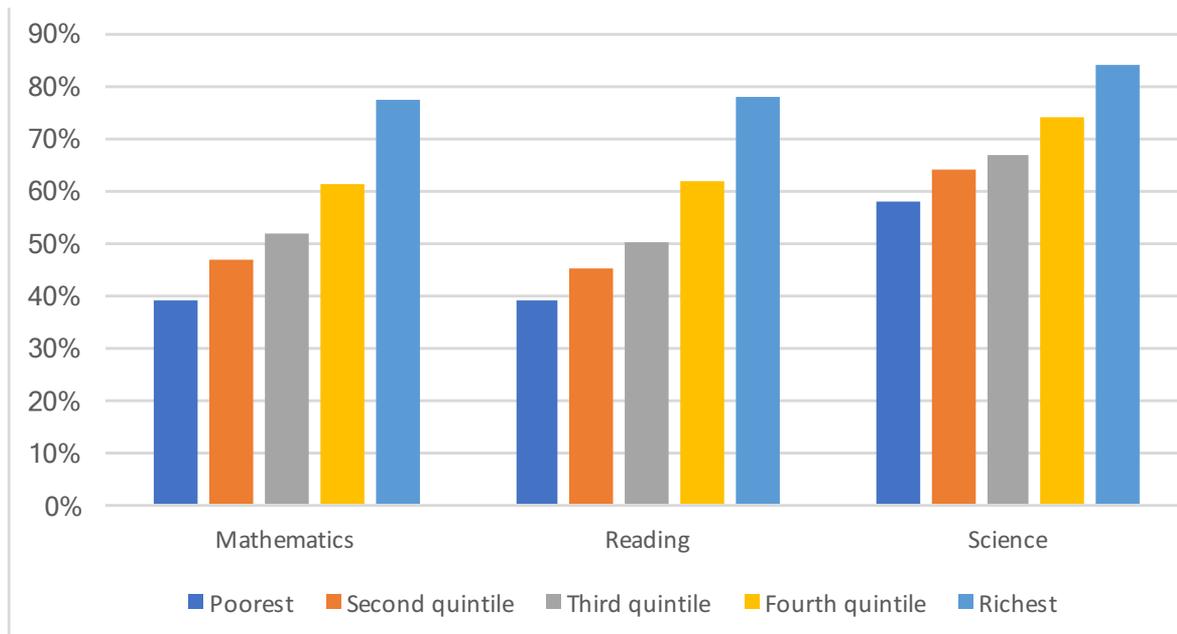
However, disparities remain in the education system, with less than 20% of children from the bottom quintile of the population completing upper secondary school, compared to 88% among children in the richest quintile. While more than half of young adults from the richest households have an opportunity to attend university or other tertiary institutions, only 3% of children from the poorest quintile can do so (Figure 48). Among children who attend upper secondary school, those from better-off households record higher achievement levels. Less than 40% of children from the poorest quintile achieved at least Level 3 (out of five) in mathematics and reading, compared to more than 75% of children from the richest quintile in the 2015 Program for International Student Assessment (PISA). The difference was less pronounced in science, in which 84% of the richest students achieved level 3 compared to 58% of children from the poorest quintile (Figure 49). These disparities indicate that the quality of education available to children from wealthier households is higher than children from less well-off backgrounds.

Figure 48. Lower and upper secondary education completion rates and attendance at tertiary institutions by expenditure quintile, 2014



Source: UNICEF Multi-Indicator Cluster Sample (MICS)

Figure 49. Percentage of students achieving at least level 3 in mathematics, reading and science



Source: OECD Program for International Student Assessment (PISA)

Gender equality is a pivotal issue in the unfinished social transformation agenda. Viet Nam records high levels of female labour force participation, and women and girls have closed the gap in educational attainment. Lower secondary completion rates are now marginally higher for girls than boys. However, less progress has been made in other areas of gender equality. Women are under-represented in senior government and private sector positions. In 2020, there were no women in a cabinet of 21 ministers, and women comprised only about one-quarter of the National Assembly. In the corporate sector, 36% of senior management positions are filled by women, which is relatively high for the Asian region but far from parity.²⁸ A recent study conducted by the United National Population Fund found that 63% of Viet Nameese women were subjected to violence by a male partner in their lifetime, and that 32% were currently experiencing some form of violence. Violence against women is rooted in attitudes and beliefs that assign more power and control to men (UNFPA, 2019). The government has shown a commitment to changing gender norms, including laws on Gender Equality (2006) and Prevention of Domestic Violence (2007). Yet more needs to be done, with the absence of women in senior public sector positions an immediate concern.

Institutional Transformation

Within the development community, thinking about economic institutions has moved on from the one-size-fits-all approach dominant in the closing decades of the 20th century. It is now widely recognized that development is not a simple and inevitable result of market liberalization, enforcement of property rights and the rule of law. The experience of the successful developing countries of East Asia has shown that the role of government extends beyond the administration of justice and the provision of essential public goods. There is also growing recognition the

²⁸ See www.grantthorton.com.vn/press/press-release-2019/women-in-business.

appropriate policy mix varies with social, political and economic structures, natural endowments, demography and specific historical legacies that shape development opportunities and obstacles. Institutions transplanted from Europe or North America—or even from Korea and Taiwan—will not always generate the expected outcomes elsewhere, and in some cases mechanical replication of institutional forms can have adverse consequences (Rodrik, 2006) but over what will replace it. An important marker in this intellectual terrain is the World Bank's Economic Growth in the 1990s: Learning from a Decade of Reform (2005).

Viet Nam has approached institutional change incrementally since the launch of the *doi moi* reforms in 1986. The government's preference for gradual change and experimentation has served the country well. Continuation of the process of institutional experimentation that began in the 1980s is necessary to sustain growth at the pace required to reach this target.

With respect to institutional change, much of the discussion in Viet Nam has focused on market institutions such as property rights, land and securities markets, competition law, and corporate governance. These institutions are important, especially at lower levels of income. As a middle-income country, Viet Nam will face additional constraints on growth. This section will focus on three institutional challenges specific to Viet Nam: i) institutional reform to facilitate the mobilization of capital for long-term investment; ii) the rationalization of public investment to focus on projects that have the greatest impact while reducing waste and duplication; and iii) institutions relevant to the acquisition of knowledge and its application to technological innovation. It is our contention that Viet Nam's capacity to develop these institutions will be pivotal to growth, equity and sustainability over the coming decades.

Institutional Transformation for Long-Term Finance

Developing countries typically face two separate but related financial constraints. The first is a shortage of long-term financing for infrastructure and other slow-gestating projects. Because commercial banks are funded by deposits, most of which are cash or short-term, they are reluctant to finance long-term projects. Governments have used various mechanisms to increase the supply of long-term credit, including loan guarantees, recourse to ODA funding and the creation of public sector development banks that lend money directly to projects and guarantee lending from commercial banks.

The second constraint is the need to acquire sufficient supplies of foreign exchange to finance necessary imports. Sustaining a high rate of investment raises demand for foreign exchange for imports of capital goods, technology and intermediate goods that are not available domestically. Rapid growth of exports is closely associated with economic growth because exports are a more sustainable method of relaxing the foreign exchange constraint than borrowing. Borrowing dollars to invest in projects that generate revenues in domestic currency may increase economic risks associated with exchange rate instability, as the region experienced in the East Asian Financial Crisis of the late 1990s.

The long-term finance and foreign exchange constraints are related to the extent that foreign borrowing is seen as a viable source of long-term credit. On the surface, the terms of foreign loans and bonds are attractive if abstracted from foreign currency risk. As discussed in Section 2, private foreign debt in Asia rose by 15 per annum from 2005-2018, even with the decline in lending during the Global Financial Crisis.

Corporate bond issuance is growing at historically rapid rates as investors in the advanced countries seek out new markets that yield a positive rate of interest in a world of excess liquidity. Additional rounds of quantitative easing during the Covid-19 pandemic will fuel lending to private companies in Asia, especially countries with sound macroeconomic fundamentals like Viet Nam.

Even when foreign loans are denominated in domestic currency, or exchange rate risk is hedged, they can be a risky proposition because foreign investors are extremely sensitive to movements in exchange rates and interest rates. Monetary policy can quickly become a hostage to the preferences of foreign investors for a stable USD-VND exchange rate, even when the US dollar is appreciating against the currencies of other trading partners. When, for example, the US dollars strengthens against the RMB, the State Bank of Viet Nam faces the dilemma of either appreciating against the RMB, which would invite a flood of imports from China, or depreciating the VND against the US\$, risking an outflow of foreign capital.

Foreign borrowing can be useful but should largely be confined to projects that are self-liquidating in the sense that they generate foreign exchange earnings or savings to repay the loans. Thus, projects that promote exports or the production of import substitutes can be financed by foreign borrowing in a sustainable manner. It is also appropriate to finance imports of capital goods produced abroad (and that cannot be produced domestically) with foreign borrowing because there is no other way to obtain these technologies. What is to be avoided is the use of foreign loans to finance projects that consist mostly of domestic expenditures (for wages and salaries and domestically produced goods) and that generate domestic currency revenues. Using foreign loans to build small, rural roads falls into this category, as does borrowing dollars to finance projects that consist of local salaries and procurement of domestically produced goods.

As discussed in Section 2, Viet Nam needs to sustain a high rate of investment for the next 25 years to achieve its objective of attaining rich country status by the time of the nation's centennial in 2045. In addition to developing essential infrastructure and productive capacity, Viet Nam must also invest billions of dollars in climate change mitigation and adaptation and shifting from hydrocarbons to renewable energy sources. The overwhelming majority of the financing required to undertake these investments will be from domestic sources and denominated in Viet Nam dong. At present, investment is still heavily dependent on self-financing, domestic bank lending and government bonds. The challenge facing Viet Nam is to upgrade existing financial institutions and develop new ones that will increase the supply of long-term domestic financing for public and private sector projects. This includes reform of the Viet Nam Development Bank or the creation of a new national development bank; the development of the domestic corporate bond market; and the development of contributory social insurance programs. The rest of this section briefly addresses these three institutions in turn.

Development banking institutions directly address the first financial constraint faced by developing countries by providing long-term loans and loan guarantees to projects that deliver positive social and economic benefits but cannot attract sufficient financing because they are large, slow-gestating or both. Multilateral institutions like the World Bank and the Asian Development Bank leverage their capacity to borrow at low rates on international bond markets to offer long-term loans (in US dollars) to developing countries. Domestic development banks fulfill

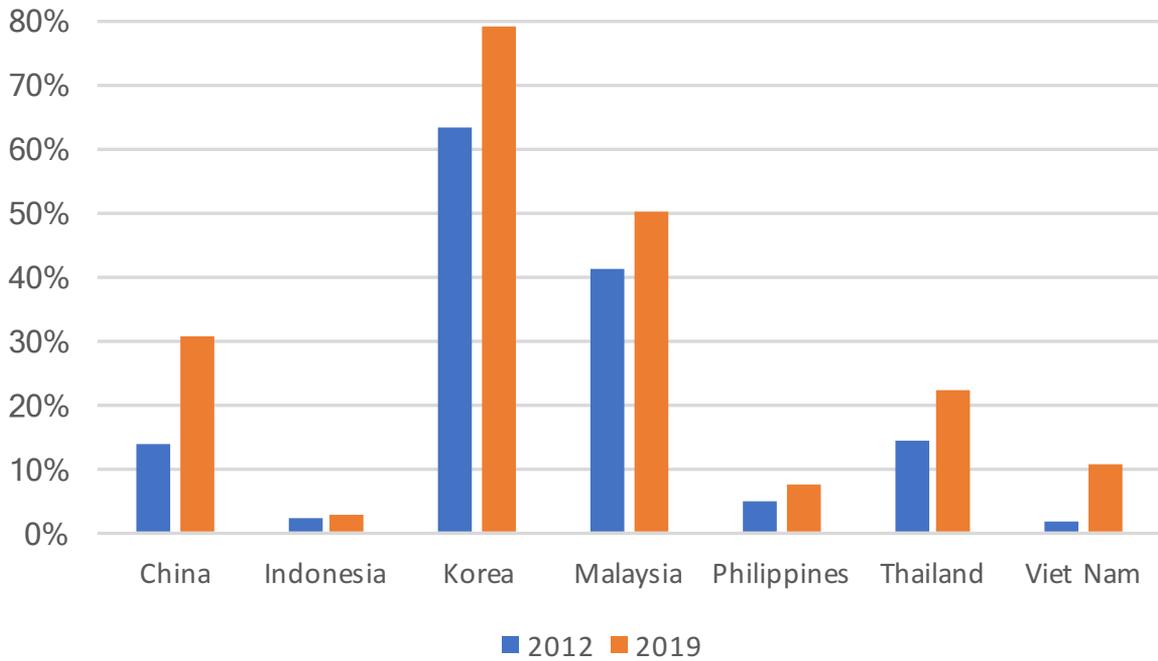
the same function in domestic currency, and thereby reduce currency risk for public and private sector borrowers. Domestic development banking has attracted renewed attention in recent years as the initial euphoria around the development impact of financial liberalization has waned. The elimination of interest rate ceilings and directed lending did succeed in increasing the supply of short-term lending and consumer credit but did not relax the constraint on long-term financing. Nor was it associated with an acceleration in the rate of economic growth, mostly because liberalized financial systems are prone to crisis (Griffith-Jones et al., 2018).

National development banks now play a vital role in financing development. A recent survey estimates that total assets controlled by these banks was about US\$5 trillion in 2015, considerably larger than the assets of all of the multilateral development banks combined (Gallagher & Sklar, 2016). According to a World Bank survey conducted in 2017, although most of these institutions were one hundred percent state owned, one-fifth had minority private ownership (World Bank, 2018). They are funded by the host government and on national and international private capital markets, and offer long-term loans and loan guarantees, usually co-financed by private lenders, to extend loan maturities. Examples of institutions that have played a central role in national development include China Development Bank, Germany's KfW, and Brazil's BNDES. These institutions have the scale and sophistication to finance large, complex and technically advanced infrastructure projects that involve multiple contractors, operators and end users. Because these projects are subject to a variety of technical, financial, ecological and social risks, development banks build capabilities and experience in handling complexity and mediating among the various interests involved (Stuart & Ramos, 2018, p. 140).

Viet Nam has two policy banks: the Viet Nam Development Bank (VDB) and the Viet Nam Bank for Social Policies (VBSP), with the latter specializing in microfinance and loans to small and medium-sized enterprises. VDB mobilizes funds from government-backed bonds and official donors to finance infrastructure, exports and strategic industries. It offers long-term loans and guarantees commercial bank lending. From 2006-2016, VDB mobilized US\$22.5 billion, including \$9 billion for electricity generation and distribution (UNESCAP, 2017a). (Escap 2017). With assets on this scale, VDB is a small development bank relative to the size of the economy. Moreover, 75% to 80% of lending was directed to state owned enterprises in 2011 (Binh & Quang, 2015). While more recent data are not available, this suggests that VDB is not fulfilling its potential as a vehicle to finance infrastructure and private sector projects.

The corporate bond market is another important source of long-term financing that has increased in importance over the past decade. Credit is still dominated by bank lending, but the growing need for long-term VND credits has focused attention on bonds. From a standing start in 2005, the market is now equivalent to ten percent of GDP (Figure 48). The first non-bank corporation to issue a ten-year bond was Masan Consumer Holdings in December 2014. Other companies have followed as government bond yields declined, attracting the attention of long-term investors like insurance companies seeking fixed rate VND assets. The main obstacle is the absence of reliable information in the market, most importantly a credible ratings agency. In the absence of reliable ratings, investors cannot price bonds and the secondary market cannot develop. Accurate and timely reporting of bond trading data is needed to increase transparency and liquidity in the market.

Figure 50. Size of the corporate bond market as share of GDP, end 2012 and 2019



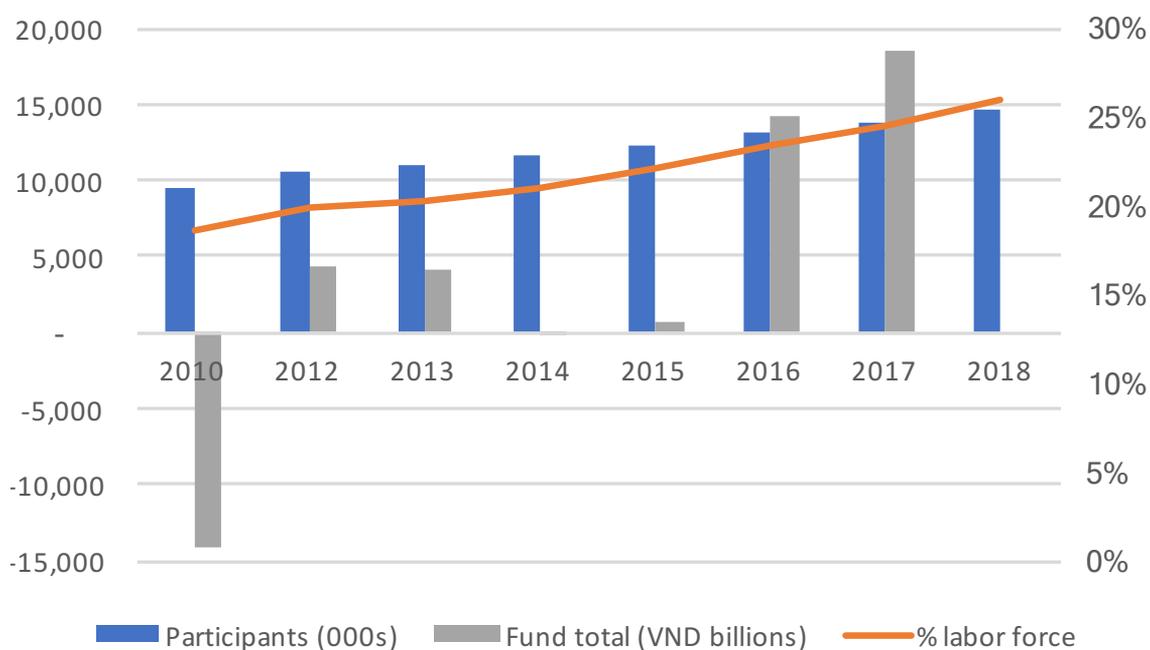
Source: Asian Development Bank

The social insurance system is potentially another important source of long-term finance. Participation in Viet Nam Social Insurance (VSI) is mandatory for all legally contracted employees, who are covered for old age, disability, health, work injuries and occupational diseases. Others, including farmers and informal sector workers, may also participate on a voluntary basis. All participants are covered by the same fund, although benefits differ depending on the category of employment. In 2020, employees pay 8% of their salary into the social insurance system and employers are responsible for 17.5% (an additional 1.5% and 3% are contributed for health insurance, and one percent each from employees and employers for unemployment insurance).

Invested capital was less than 0.5% of GDP at the end of 2017, the latest data available from GSO. Ninety percent of reserves are held in the form of government bonds. The small size of invested reserves represents a missed opportunity to mobilize domestic capital for long-term investment. Although Viet Nam operates a pay-as-you-go (PAYG) system, the additional individual savings accounts backed by government would provide additional protection to workers and would generate a pool of capital for long-term investment.

A key objective is to increase participation from 25% (in 2018) to achieve the government's goal of 60% by 2030 (Figure 49). With 10% of the population covered by social assistance programs, approximately two-thirds of the labour force does not have access to any form of social protection. Informality is the main obstacle to raising the level of participation, with low rates of participation among rural workers, migrants, seasonal workers and the self-employed. Universal coverage of employees under the social protection system would pool risk and facilitate redistribution from higher paid to low-wage workers.

Figure 51. Participation in social insurance and size of fund at year's end



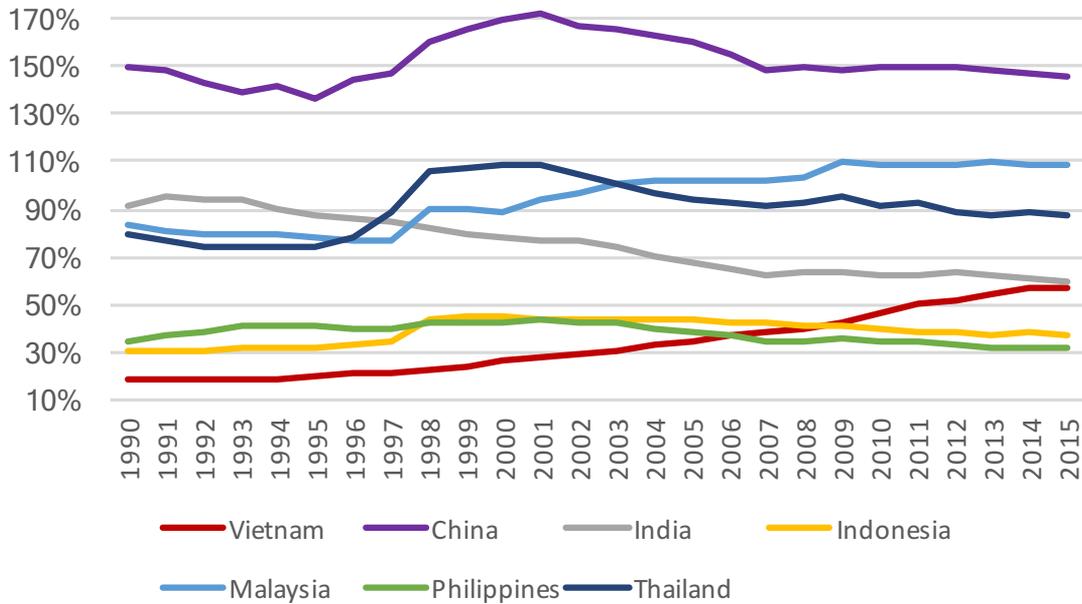
Source: General Statistics Office

Institutional Transformation and Public Investment

Infrastructure is a binding constraint on economic growth and poverty reduction. Considerable progress has been made since 1990, with the public capital stock tripling as a share of national output and recording consistent improvements in various international assessments of infrastructure services (Figure 52).²⁹ However, Viet Nam still lags Thailand and Malaysia and will need to increase public investment levels to avoid a situation in which infrastructure becomes a constraint on growth.

²⁹ For example, the World Bank's Logistics Performance Index (<https://lpi.worldbank.org/>) and the World Economic Forum's Global Competitiveness Report (http://www3.weforum.org/docs/WEF_TheGlobalCompetitivenessReport2019.pdf).

Figure 52. Public capital stock as a percent of GDP

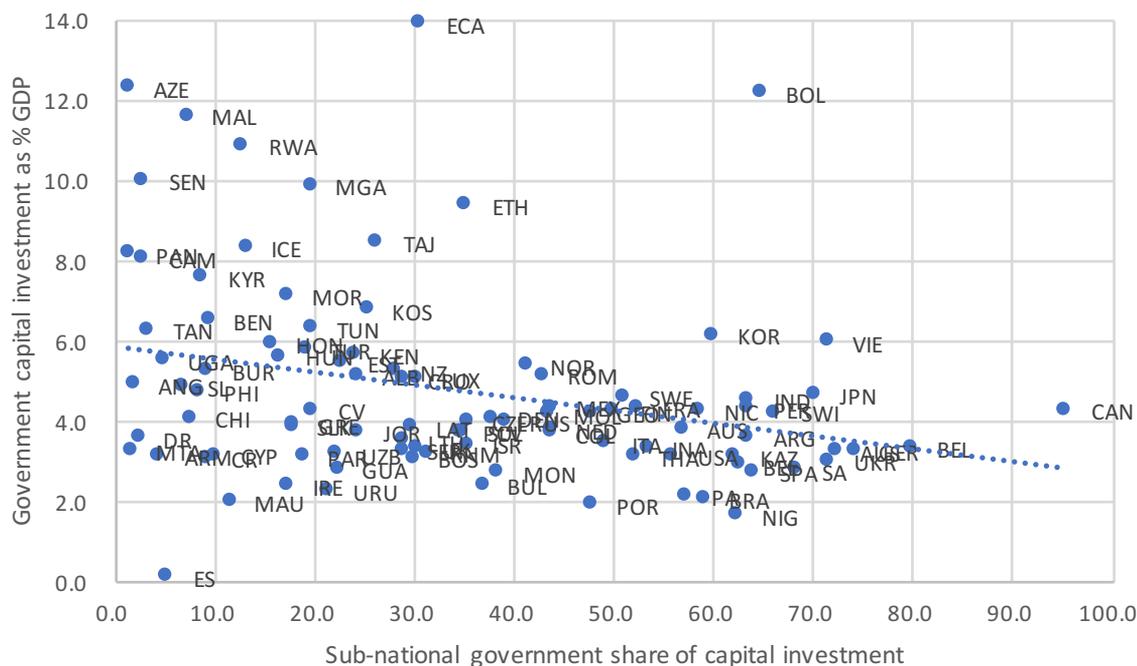


Source: IMF Investment and Capital Stock Database

Planning and implementation of public investment projects has become more fragmented as the locus of decision making has been decentralized to local authorities and ministries. The fragmentation of the planning system has had two negative effects. First, local and sectoral projects are planned and approved in isolation and without sufficient reference to national strategic priorities. Weak coordination among projects in the same region and even the same sector increases costs and reduces net social benefits. Second, the splintering of the public investment program into many hundreds of small projects increases implementation costs and slows delivery. Decentralization has led to a slowdown in disbursement and realization of projects, including projects of national economic importance.

Figure 53 presents data on public investment as a share of GDP and the role of sub-national government. Viet Nam is an outlier in the sense that an unusually large share of public investment is under the control of local government. Viet Nam is one of the most decentralized countries in the world, with more than 71% of disbursement under local control. Provinces and ministries are now the main driver of investment planning, allocation and implementation of public investment. This change has wide ranging implications for the efficiency and effectiveness of the public investment program.

Figure 53. Public Investment as % GDP and Sub-national government as share of total public investment, 2016



Source: OECD-UCLG World Observatory on Subnational Government Finance and Investment

As the figure shows, there is a clear, negative relationship between the degree of decentralization and the level of public investment. Local government units are generally too small to realize economies of scale and scope and therefore favor smaller investment projects. Local government is also constrained by the amount of funding it can raise for large-scale projects, and financing projects is generally more expensive at the local level. Local public investment is more pro-cyclical because it relies on revenue sources that are tied to the level of economic activity and because local governments are more likely to face limits on borrowing to finance budget deficits (UNDP, 2018a). Therefore, more radically decentralized systems tend to sustain lower levels of public investment.

Over the past two decades Viet Nam has decentralized the planning, allocation and implementation of public investment. Plans are compiled from lists of projects submitted by ministries and provinces and appraisal and approval are also in the hands of project owners for most classifications. Because approval is separated from financing, many projects are never completed because of funding shortfalls or implementation delays. National priority projects are approved by the National Assembly with support from MPI but local leaders also exert influence over these decisions because they make up a majority of members of the legislative body. Monitoring and evaluation are carried out by ministries and provinces with limited reporting responsibilities to MPI and MOF.

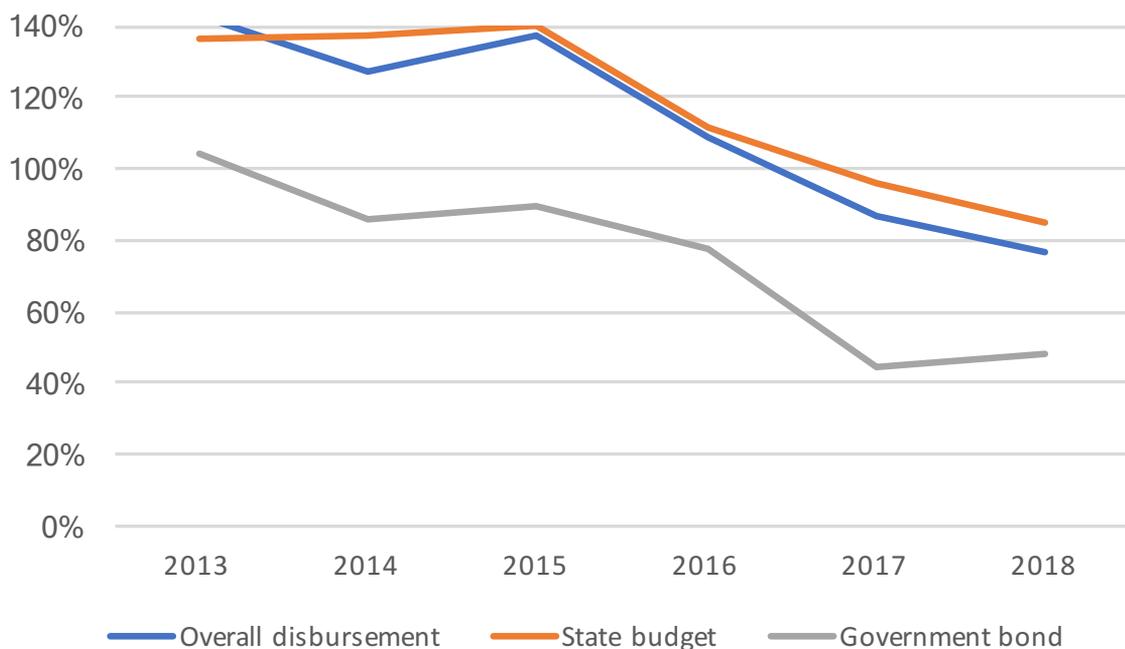
Fragmentation of the planning system has dramatically reduced the impact of public investment in every sector. Rather than develop integrated logistics systems that channel trade to two or three large ports serviced by long-distance freight services, Viet Nam has built hundreds of small ports connected to industrial areas by local

roads (Blancas et al., 2014). Every province has plans for an airport, a port and several industrial estates. Industrial activity is geographically dispersed, reducing the scope for agglomeration effects in export industries.

Fragmentation also causes delays in implementation as provincial government lacks capacity to manage large-scale public investment projects. Disbursement of public investment has declined as the system has become more decentralized (Figure 54). Although there are many reasons for the slowdown in project realization, weak planning and insufficient vertical coordination with line ministries and financing agencies are frequently to blame (UNDP, 2019c). Even national priority projects like the North-South Expressway and the Long Thanh Airport have been held up by capacity constraints at the local level. Land compensation procedures and negotiations are a common cause of delays.

The Planning Law of 2017, which came into effect in 2019, was meant to solve some of these problems. The law calls for the creation of regional planning bodies to improve coordination among provinces. If the regional planning bodies are given the authority to override local decisions, this could help reduce fragmentation in the planning of public investment projects. However, the Public Investment Law does not permit much flexibility in adjusting development plans, since the final list of projects must be approved by the National Assembly and only be amended by that body.

Figure 54. Public investment realization against capital allocation plan



Source: Ministry of Finance

The system at present has not yet established a practical division of labour assigning authority and responsibility to levels and branches of government appropriate to the scale and importance of investment projects. Projects of national importance, and projects that serve more than one province, should be planned and implemented by national agencies, with financing organized by the central government. The capacity of MPI to appraise, monitor and evaluate investment should be enhanced to ensure that the ministry possesses the expertise and experience to restructure public investment. MPI should also be empowered to conduct independent reviews of projects as specified in the Law on Public Investment but not yet carried out. In addition, MPI should establish a management information system to collect and process information on project identification, appraisal, selection, resource allocation, implementation and monitoring and evaluation, and to make this information available to stakeholders.

The central government has lost control of approvals and allocation of financing under the decentralized system. With too many projects in the pipeline, resources are rationed based on requests from project owners. Underfunding results in project delays and hoarding of capital by projects that cannot disburse but that want to retain access to funds. Thus, while the caps imposed by the medium-term budget framework are honored, allocation of capital between projects is unrelated to need and performance. Meanwhile, the requirement that adjustments to the medium-term investment program must be approved by the National Assembly has introduced rigidities into the planning and implementation system that reduce efficiency and impact. While it is appropriate for the legislative branch to exercise oversight, micromanagement of investment by lawmakers undermine efforts to increase the professionalism of investment planning and implementation.

Institutional Transformation and the National Innovation System

Traditionally economists have seen market competition as the main driver of innovation. Markets incentivize firms to discover information from diverse sources and to deploy it in profit-seeking ventures. In theoretical models, market signals are more efficient as a guide to the trajectory of technological development than economic planning because planners make decisions based on partial or obsolete information (Hayek, 1992). Yet these models abstract from conditions in the real world because they assume no or low barriers to entry, constant returns to scale, costless information and competition among numerous small firms, none of which are large enough to influence market prices. If these assumptions do not hold, the conclusion that markets to are a perfect guide to technological innovation cannot be sustained.

The accumulation of market power and technological capacity in global corporations is one of the defining characteristics of the 21st century. The dominance of a handful of firms is most obvious in the IT sector, where companies like Google, Apple, Samsung, Microsoft and Facebook, which are valued at between \$500 billion and \$2 trillion, control from one-quarter to 90% of their respective markets. The pace of mergers and acquisitions, and therefore the concentration of financial and technological power, has been no less rapid in other sectors, with a few megafirms capturing the bulk of final demand in industries ranging from footwear and fashion to pharmaceuticals, automobiles and aircraft. These firms are locked in a technological arms race, in which profitability and even the existence of the firm depend on constant innovation of products and production methods. Their size and market position enable them to realize economies of scale in research and development,

production and marketing.

The emergence of these global “system integrator” corporations at the top of the industrial structure produces a “cascade effect,” in which leading firms increase pressure on their suppliers to realize technological innovation and cost savings. With no place else to sell their output, supplier companies have no choice but to meet the demands of their corporate customers. The predictable response of supplier firms is consolidation. The market power of the top six automobile assemblers, for example, has led to a wave of mergers and acquisitions in the automotive parts industry. The transition to electric vehicles, which will require massive investment in R&D, has accelerated this trend, with the largest mergers taking place in the power train and electronic systems subsectors. Similar patterns can be discerned in industries ranging from electronics and computing to aircraft and elevators. But it does not stop there. Consolidation of first tier suppliers increases demands on second tier suppliers, and onward down the supply chain, creating larger firms, more technologically sophisticated firms at every level of the supply chain (Nolan et al., 2007).

Concentration of capital and market share raises the stakes of technological innovation, which explains the explosion of R&D spending in recent years, doubling in the first two decades of the new millennium to exceed US\$2 trillion per year. In the advanced countries, the public sector has stepped up R&D spending through various channels, including higher spending on the military technology and other forms of public procurement, support for public and private research institutions and universities, energy policy and support for SMEs. The idea of the “entrepreneurial state” has moved into the mainstream as the pace of technological innovation has accelerated and the social and political costs of falling behind have become more apparent (Mazzucato, 2015).

The central role of technological change in the development (and survival) of firms has rekindled interest in National Innovation Systems (NIS), a broad category consisting of an array of institutions including enterprises (especially in high-tech fields), public and private research institutions, government agencies, universities and other training institutions, banks, investment funds and other private investment vehicles. The roles that these institutions play in specific settings, and the ways that they interact, vary from place to place depending on structural and historical factors. Developing countries can and do borrow institutional forms from successful countries, but these models need to be adapted to local conditions and evolve as the economy develops and technologies change (Lundvall, 2010).

Knowledge may be underproduced by private firms because of the problems of non-excludability (knowledge leaks from the firm) and non-rivalry (the same knowledge can be used by many firms). In other words, the benefits to society of investment in research and development is greater than the payoff to individual companies. The main policy implication of the “market failure” approach is that government should subsidize research to reverse these disincentive effects, encouraging firms to produce more knowledge and innovation than they would in the absence of intervention. However, this strategy will be ineffective if the obstacles to innovation lie on the demand side and not on the supply side. If domestic firms lack the technical and managerial capacity to make use of innovations, increasing the supply will not change their behavior. New institutional forms, whether public research institutions or public-private collaboration, may be needed to build innovation capacity and create the conditions for commercial

application of new technologies.

Stimulating demand for innovation is more challenging than increasing supply, especially in the presence of increasing returns to scale and concentration of market power and technological capabilities. The widening gulf between global leaders and domestic firms can work to consign the latter to the labour-intensive, low value-added segments of supply chains. Subsidization and tax incentives will not induce innovation among firms that do not know how to innovate; what is required instead is the creation of networks of innovators and domestic firms that find ways to match technological capabilities with commercial opportunities, especially in dynamic product and component segments in which mastery of a large backlog of technological knowledge and experience is not a decisive advantage (Lee, 2019).

In Taiwan, public sector research institutes took the lead, focusing on short-cycle technologies and spinning off commercially viable innovations into new firms, or forming partnerships with incumbent firms (Wade, 1990). While some of these new ventures started out small, a crucial factor was the ability to scale up quickly to realize scale economies and invest in R&D (Amsden & Chu, 2003). In both Taiwan and Korea, this required a focus on exports (given the small size of the domestic market) and access to long-term finance and a supportive regulatory environment that did not discriminate against large firms (Lee, 2019, p. 31).

Viet Nam's national innovation system consists of public research institutes, universities, support for high-tech parks, venture capital funds and tax relief for foreign and domestic research and development spending. Science and technology have been identified as a priority in successive five-year Socio-Economic Development Plans and ten-year Socio-Economic Development Strategies. Under the Science and Technology Law enacted in 2013, the national government is required to allocate two percent of its budget to R&D. However, in every year since 2008 the government has fallen short of half that amount (Figure 50). According to UNESCO, gross research and development expenditure was 0.5% of GDP in 2017, higher than the average for lower middle-income countries but one-third of the upper middle income country average, and half the effort of Thailand in the same year (Figure 51). The ambition of achieving a productivity and competitiveness breakthrough through investment in science and technology has not been realized in practice.

In building the national innovation system, the government has emphasized the importance of the market mechanism and the creation of an ecosystem conducive to the proliferation of high-tech start-ups. With support from donors and foreign corporations, central and provincial-level agencies have provided training, set up online portals to share information and grant and loan funding to tech-intensive startup companies. In 2016, the government launched a new project "Supporting the National Innovative Start-Up Ecosystem to 2025" (Project 844), which aims to improve the legal environment and provide funding. By the end of August 2020, the project had supported 2,500 ventures (Onishi, 2020).

Viet Nam has also had success in attracting foreign direct investment in the technology sector, including world-leading companies like Samsung, Intel, Microsoft, Apple, Nintendo, Canon and many others. The supplier firms of these system integrator companies soon followed, creating opportunities for domestic firms to participate in the supply chains of these global giants. The main obstacle is scale: companies operating at a global scale require suppliers that are large enough to provide standardized parts that deliver the requisite quality at a competitive price. Viet Namese technology companies are still too small to produce at this scale, which

leaves global firms to turn to their regular suppliers, which may or may not need to relocate to Viet Nam (Pham, 2019).

Bridging the gap between small-scale startups and global system integrators will require policies that go beyond the building a market-friendly “innovation ecosystem” and promoting SMEs. The scale of public investment in science and technology must be more ambitious and focused on short time-cycle technologies that offer opportunities for rapid growth. Until now, insufficient funding and weak coordination among government agencies has stood in the way of efforts to carve out of more dynamic role for government in science and technology policy (Klingler-Vidra & Wade, 2020). These problems can be overcome with a renewed commitment from the government to make science and technology the centerpiece of industrial policy. Promising sub-sectors can be identified based on patterns of demand from system integrator firms already located in Viet Nam, and to ensure relevance, public money could be made conditional upon matching funds from the private sector. Public sector research centers could also take a financial stake in domestic companies that use their innovations or create private spin-off firms.

Section summary

This section has considered the Viet Nameese economy from the perspective of the transformation of structure and ownership, urbanization, technology, society and economic institutions. The list is not exhaustive: we have not given sufficient attention to important drivers of change like climate, energy, demography, governance and gender equality, just to name a few. Our aim has been to spell out some of the key challenges that the country faces as it makes the transition from an agrarian to an industrial economy; from a rural to an urban society; from a lower middle-income to high income country; from an adopter to a creator of technological innovation; and from an economy dominated by small producers to more diverse economic structure, including large, national (public and private) firms. These various transformations inevitably interact in unpredictable and asynchronous ways. As we noted in the introduction to this report, economic transformation is a complex and unbalanced process, in which new industries co-exist with old, cutting-edge and simple technologies are used in the same workplaces and modern institutional forms collide with traditional practices. While the unevenness of change sometimes conceals its cumulative nature, but as a general rule change does beget change, even if its effects may only be apparent with the passage of time.³⁰

Nor do developing countries change in predictable ways. Viet Nam’s transformation shares many characteristics with the successful East Asian economies: rapid growth of manufactured exports; a large role assigned to public enterprises; sustained productivity growth in agriculture; a high rate of investment; a focus on infrastructure development; the transfer of labour from lower to higher productivity activities; and careful attention to human development. Yet in other ways Viet Nam is unique. Foreign direct investment plays a larger role in manufactured exports than in East Asia, and large, private domestic firms are

³⁰ “Change begets change. Nothing propagates so fast... The mine which Time has slowly dug beneath familiar objects is sprung in an instant; and what was rock before, becomes but sand and dust” (Dickens, 1968, p. 288).

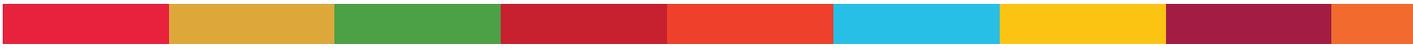
nearly absent from the sector. Viet Nam has decentralized public investment decisions to a greater degree and public sector financial institutions are not important actors in industrial policy.

In this section we have emphasized some of the challenges that Viet Nam will face over the next decade: maintaining financial stability in an unstable world; building cities that use energy and water more efficiently and protect the health of residents; developing domestic sources of long-term finance; and strengthening the national innovation system and the technological capabilities of domestic firms.

We have also highlighted three development problems that demand an institutional response. New sources of financing are needed to meet the country's investment requirements for and other slow-gestating projects. In other developing countries, national development banks have helped fill this gap, providing long-term loans or loan guarantees to public and private sector projects. Development of the regulatory and institutional infrastructure of the domestic corporate bond market is also needed. The state social protection system is another potential source of long-term capital, especially in light of Viet Nam's relatively young demographic structure.

Aside from financing, the development of public infrastructure is constrained by poor regional and sectoral coordination. Decentralization of decision-making to the provincial level and separation of project selection and financing decisions has led to a proliferation of small projects, duplication and missed opportunities to realize economies of scale. Lack of local capacity has resulted in cost overruns and delays. The need for enhanced regional planning is recognized in the Law on Planning enacted in 2017, but there is little evidence of change thus far. Public investment decisions should be more closely integrated into national and regional development plans and strategies, promoting industrial clustering wherever possible to enhance export competitiveness.

Viet Nam's national innovation system is underfunded and not sufficiently well-integrated into the nation's export and industrial strategies. The current mix of research institutes, universities, firms, and financial institutions lacks a clear sense of mission and coherence. The aim of creating a supportive ecosystem for innovation is worthwhile but falls far short of what is needed to build the technological capabilities of national firms. A stronger focus on export growth, particularly in manufacturing, and instruments to increase demand for as well as supply of innovation are needed.



SECTION 5. CONCLUSION

Viet Nam has launched a new ten-year Socio-Economic Development Strategy and five-year Socio-Economic Development Plan at a moment of tremendous global uncertainty. The world is just beginning to emerge from the worst pandemic in one hundred years and the deepest recession since the Great Depression. The year 2020 was the second warmest on record, edged out only by 2019, at the end of a decade that recorded seven of the ten hottest years in history. Extreme weather events have caused devastation on every continent, including record-breaking wildfires in the United States and Australia. Global debt reached an astonishing US\$277 trillion as central banks extended the quantitative easing that began more than a decade ago during the Global Financial Crisis.

The Government and people of Viet Nam's have throughout history demonstrated a remarkable capacity to rise to external challenges. The early and effective response to Covid-19 is just the most recent example. Viet Nam will need call upon this spirit of resilience and determination as the country strives to achieve high-income status by the time of the nation's centennial in 2045 and to do so in a way that achieves inclusive, sustainable development.

Viet Nam's journey from Least Developed to middle-income country was remarkable, but not unprecedented. A small number of countries, mostly in East Asia, followed a similar trajectory in the second half of the 20th century. Although each country's experience is unique, and every era presents a new set of challenges, Viet Nam can learn from the achievements and disappointments of these forerunners, replicating their successes while attempting to avoid some of their mistakes.

This report has reviewed economic issues facing Viet Nam in this critical moment. We have discussed multiple transformations that form part of the journey towards prosperity and realization of the Sustainable Development Goals: i) transformation of economic structures and ownership; ii) spatial transformation; iii) technological and digital transformation; iv) social transformation; and, v) transformation of economic institutions. We do not expect these changes to be smooth or synchronous; indeed, we view unbalanced nature of growth as a driver of change.

Viet Nam is at the threshold of an historic breakthrough in economic growth and structural change. We have reviewed the sources of growth that have brought the country to this point and some milestones on the journey that lies ahead. We have concentrated on policy areas that we see as critical to success in the coming period:

Sustaining the rate of growth of manufactured exports, and supporting national champion firms in their efforts to penetrate export markets;

The costs of policy fragmentation and the imperative of closer coordination of policy formulation and implementation across sectors and between national and local institutions;

Sustaining a high rate of public and private domestic investment to drive productivity growth and competitiveness, and to adapt to and mitigate the effects climate change;

Building national and regional capacity to plan, implement and evaluate public investment projects to reduce fragmentation, tackle critical issues like climate change and disaster resilience, and support the development emerging domestic industries;

Closing the gap between the supply of and demand for long term, VND-denominated finance to finance slow-gestating public and private sector projects;

Reducing dependence on potentially destabilizing external capital flows; and

Strengthening the national innovation system, including public support for research and development, research-focused institutions of higher learning, and partnerships between government and the domestic private sector in emerging technological fields.

Improving coordination among public sector institutions at the national level and between national and local government stands out as a precondition to the other policy reforms discussed in this report. Geographical and sectoral fragmentation of governance—apparent in the proliferation of new institutions and competition among public sector agencies for authority and resources—is still a challenge in Viet Nam. While greater reliance on the market mechanism can solve some problems, overcoming institutional fragmentation requires a strengthening of the authority of central institutions, along with greater transparency and accountability. Indeed, fragmentation of governance impedes the efficient operation of markets because it undermines confidence in the impartiality of government decisions and their enforcement. Creating new institutional layers to address the limitations of existing institutions will not solve the problem.

Developing sources of long-term finance is a key factor in the recovery and in meeting the challenges posed by climate change. While foreign financing is a useful supplement, most of the investment capital required to fulfill Viet Nam's various strategies and plans will be generated domestically. Policy reform is needed to reduce dependence on foreign capital flows, to multiply channels to mobilize domestic savings and to discourage speculation in land and financial assets. Improving the efficiency of public investment will reduce waste and accelerate the development of critical infrastructure.

Technology has changed the way that we produce, create, communicate and entertain ourselves. Accelerating innovation and ensuring that everyone benefits from it is a top development priority. Improving the ecosystem for innovation, especially for small firms and startups, is an important first step, but it does not end there. That no statistical relationship exists between economic growth and rankings on various ease of doing business surveys suggests that innovation does not inevitably follow market liberalization. Governments need a coherent strategy to help domestic firms acquire technological capabilities and commercialize their innovations. Investment in research capacity, particularly in short-cycle

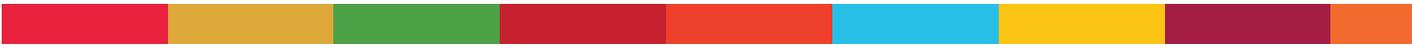
technologies, is a priority, including partnerships between public and private research institutions.

Throughout this report we have emphasized the role of exports, especially of manufactured goods. In Viet Nam as other developing countries, productivity growth is closely associated with both the magnitude and *rate of growth* of manufactured exports. Competition on global markets compels companies to upgrade products and production processes, improving quality, reducing costs, and achieving greater efficiency. All the successful East Asian developing countries recorded high rates of growth of manufactured exports in part through support for national champion firms embedded within well-funded and carefully designed national innovation systems. Linking innovation explicitly to exports and to national research and development capacity helps clarify the objectives and instruments of innovation policy.

Viet Nam's early achievement of the Millennium Development Goals and rapid progress toward realization of the SDGs reflects the government's strong commitment to eliminating poverty and reducing economic inequality. Prosperity will generate the resources needed to ensure that no one is left behind, but policies and programs must evolve to address remaining disparities in a rapidly changing society. Widening access to quality education at the secondary and tertiary levels increases social mobility and eliminates obstacles to formal sector employment that people from low-income backgrounds face in the labour market. Hiring preferences for women and members of ethnic minority communities, especially in the public sector, would reduce disparities and expand the pool of talent for these organizations, leading to more balanced representation in senior positions. The experience of the Covid-19 pandemic revealed gaps in existing social protection and assistance programs which were not able to reach migrants and workers in the informal sector in a timely manner. As most Vietnamese workers are now employees, social protection and assistance programs should be delinked from residence to improve coverage and reduce administrative complications.



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