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THE GREAT RECESSION and DEVELOPING COUNTRIES

ECONOMIC IMPACT AND GROWTH PROSPECTS

Surprising Resilience but Challenges Ahead

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In the past 20 years, Vietnam has implemented comprehensive reforms. These reforms, together with an open-door policy to attract foreign direct investment (FDI) and trade liberalization (culminating in its World Trade Organization [WTO] accession in 2006), have created a growing and dynamic private sector. Since 2000, the government has pursued expansionary policies with extensive investment and has overseen a huge credit expansion, especially after the 1997–98 Asian financial crisis. These policies have helped Vietnam achieve high GDP growth rates since 1990.

But the situation has changed dramatically in recent years. In early 2008, concerns about an overheating economy forced the Vietnam government to shift priorities from high economic growth to stabilization,

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leading it to raise interest rates and cut government spending. By the end of 2008 and into 2009, Vietnam was faced with new problems and challenges caused by the global financial and economic crisis.

To date, the repercussions of the global financial and economic crisis have been felt all over the world. Economic growth has slowed in many developed countries, including the United States, countries of the European Union (EU), and Japan. In response, governments of developed countries have adopted economic stimulus packages to rescue their economies. These packages include such measures as writing off bad assets in the banking system, cutting taxes, investing in infrastructure, and paying out more social security benefits. Central banks in many countries have adopted a lax monetary policy, drastically cutting interest rates to levels not seen in many years and even using unconventional monetary tools to expand liquidity in the banking system. In developing countries—including Vietnam—the crisis has reduced investment inflows and lowered global commodity prices and trade. As a result, demand for Vietnamese exports and capital inflows have declined substantially. The government of Vietnam responded as many other countries did: by reversing its tight monetary policy stance and the fiscal austerity implemented in 2008. To stimulate the economy, the government also adopted a large fiscal stimulus package.

Although the global crisis originated in the developed world, it will have far-reaching consequences for the growth and development of developing countries for the foreseeable future. Since the recession hit Vietnam in December 2008, the government has focused on how to boost domestic demand in the short run and on how to deal with the immediate economic and social disruptions created by the crisis. Much less attention has been paid to the medium- and long-term implications of the crisis for growth, poverty reduction, and, more broadly, economic development.

In this chapter, we consider how the ongoing crisis, the policy responses to it, and the postcrisis global economy will shape the medium-term growth prospects of Vietnam. We first review the economic reforms and policies that Vietnam has pursued since mid-1990s and examine the economy's current economic performance. We examine how the global financial crisis has affected Vietnam, as well as the government's responses and their effectiveness. We assess the emerging patterns of the

postcrisis world and their implications for Vietnam's development policy. We then provide medium-term projections for Vietnam's growth path until 2015 and discuss the crisis's implications for Vietnam in the postcrisis era.

Economic Reform and Development in Vietnam

The failure of the centrally planned model that Vietnam followed to develop its economy after national reunification in 1975 forced it to undertake comprehensive economic reforms. The first serious reform, in 1986, was known as the *Doimoi;* it was followed by more radical market-oriented reforms in 1989, which marked a turning point in the history of Vietnam's economic development. After some initial success, complacency built up and the reform process slowed during 1996–99, especially after the Asian crisis. But since 2000, the authorities have renewed their commitment to reform, and some progress has been achieved—especially with regard to the development of the private sector and trade liberalization.[1]

In the years immediately after the initiation of economic reform, the government focused on macroeconomic stabilization and price liberalization.[2] It introduced several measures to establish market institutions, including the recognition of a multisector economy in which the private sector exists alongside the state-owned sector, and protection of private property rights.

In agriculture, decollectivization took place and the farming household was recognized as a basic economic unit. Land was redistributed to households and output contracting arrangement whereby farmers were allowed to keep the surplus output beyond the contracted output was introduced. A particularly important reform was the new land law, introduced in 1987 and amended in 1993, which increased the security of land tenure and allowed the transfer of land use rights to others.

In the industry and services sectors, the government has been seeking measures to develop the private sector, while state-owned enterprises (SOEs) are either being equitized[3] or given more autonomy in business. The emergence of the private enterprise sector is an important development, and in 1991 the government introduced the company law and private enterprise law (later amended in 1994). These two laws, together

with the adoption of the new land law in 1993 and a new labor code in 1994, have been important in stimulating the development of the private sector. However, the most significant reform in the development of private business came in 2000, with the new enterprises law. During 2000–04, about 90,000 private enterprises were registered under the new law (double the number of companies registered during the nine years under the two previous laws), with combined capital equivalent to about US$13 billion.[4] The private business sector, thanks to its increased freedom from the restrictions encumbering it under central planning, is making rapid gains in terms of its contribution to Vietnam's output growth. The one-tier banking system was replaced by a two-tier system that allows the State Bank of Vietnam to assume traditional central bank functions. Other major policy changes include the elimination of price controls, liberalization of foreign exchange, and the removal of barriers to the movement of labor and goods among regions in Vietnam.

Vietnam has substantially liberalized its trade and investment policies since the late 1980s. During the early years of economic reform, liberalization of the trade regime was achieved by the signing of trade agreements with about 60 countries. Vietnam has also implemented a preferential trade agreement with the EU since 1992 and it has actively sought membership in regional and global organizations.[5] Vietnam became a member of the Association of Southeast Asian Nations (ASEAN) in June 1995 and of the Asia Pacific Economic Cooperation in 1998. In 2000, Vietnam signed a historic comprehensive trade agreement with the United States to normalize trade relations between the two countries. And recently, by its membership within the ASEAN, Vietnam has joined regional integration clubs such as ASEAN—the China Free Trade Area and the ASEAN–Japan Comprehensive Economic Partnership. Most recently, in 2006, Vietnam became a member of the WTO.[6]

The Law on Foreign Direct Investment—first promulgated in 1987 and amended in 1990, 1992, 1996, and 2000—has helped Vietnam attract a large volume of foreign capital when domestic savings were insufficient to meet the country's investment needs.[7] Before 1987, there was virtually no private sector in Vietnam. By allowing FDI, Vietnam in effect imported/implanted a private sector of its own for the first time after its unification. Since then, FDI has become an integral part of the

Vietnamese economy and an important factor in the country's economic growth during the 1990s. In 2006, to create a more level playing field and ensure that its laws gave favorable treatment to FDI enterprises before Vietnam's accession to the WTO, Vietnam promulgated two important laws, the Investment Law and the new Enterprise Law,[8] which created a corporate-law regime for both foreign and domestic enterprises.

After 20 years of reform, Vietnam has put in place the fundamentals of a market economy and has opened up the economy to international flows of capital and trade in goods and services. The emergence of a market-based economy, with market-oriented institutions, a stable macroeconomic environment, and government support for business development, has allowed Vietnam to

- unlock the potential of its agriculture sector, turning Vietnam from a food-hungry country to the world's third-largest rice exporter;[9]
- encourage the development of a vibrant domestic private sector;
- attract substantial FDI; and
- realize its comparative advantages and gain more benefits from international trade.

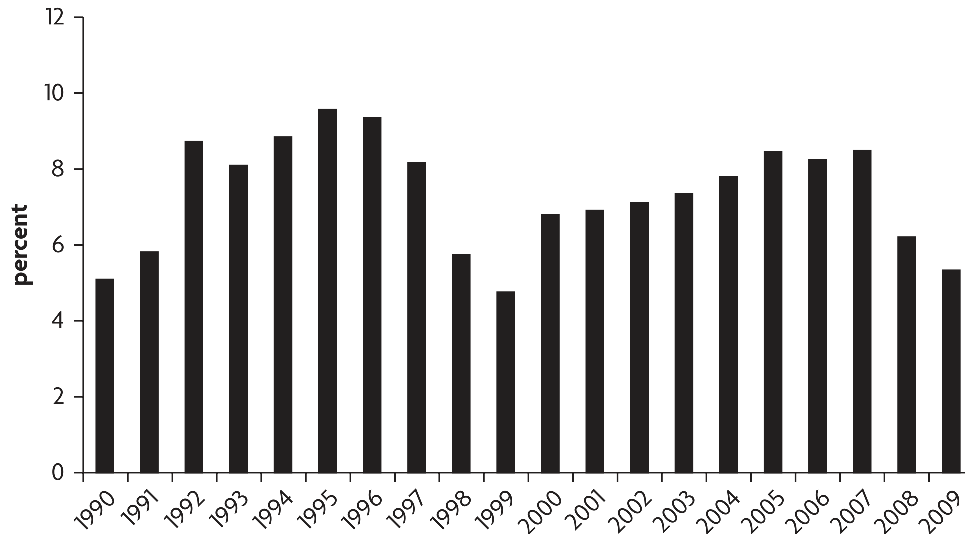
These factors underlie the economic success that Vietnam has been experiencing since the early 1990s.

Economic Performance

Since the 1989 reforms, Vietnam has made remarkable achievements in terms of GDP growth, macroeconomic stabilization, export expansion, and poverty reduction. The country is now recognized as being among the most successful developing countries in terms of economic growth and poverty reduction. During 1990–2008, the annual GDP growth rate averaged more than 7 percent, and Vietnam's growth rates today remain among the highest in the region (second only to China's). The average annual GDP growth was about 5–6 percent during 1990–91 and climbed to and then stayed at about 8 percent during 1992–97 (figure 12.1). GDP growth, however, declined during 1998–99, partly because of the Asian crisis and the dissipation of the effects of reform.

Since 2000, the economy has regained its momentum. Its annual growth rate exceeded 7 percent—reaching 8.5 percent in 2007—then dropped back to an estimated 6.2 percent in 2008, owing to the effects of

Figure 12.1. Vietnam GDP Growth Rate, 1990–2009



Source: Vietnam General Statistics Office (GSO) , http://www.gso.gov.vn.

the global recession. High and continuous GDP growth rates and successful economic development from 2000 to 2008 have resulted in significant improvements in the population's welfare and in substantial poverty reduction. According to the Vietnam Household Living Standard Survey, the total poverty incidence declined from 58 percent in 1993 to 37 percent in 1998, 29 percent in 2002, 19.5 percent in 2004, and 16 percent in 2006 (SRV 2003; Nguyen 2009). In addition, improvements have been made in other aspects of human welfare—such as the sharp rise in the percentage of literate adults (to over 90 percent), longer life expectancy (over 70 years), and a lower mortality rate for children less than five years old (40 per 1,000 live births in 2003).

During the course of transition to a market economy, Vietnam's economy experienced gradual changes in terms of sectoral and ownership structures. During this period, the focus of the economy shifted toward industrialization and modernization (table 12.1). The proportion of agriculture, forestry, and fisheries in GDP declined from more than 27.2 percent in 1995 to 22.1 percent in 2008. At the same time, the share of industry and construction in GDP rose from about 28 percent in 1995 to 40 percent in 2008. The share of the manufacturing subsector (within the industry and construction sector) increased from 15 percent

Table 12.1. GDP Structure by Sector and Ownership, 1995–2008
(% using current prices)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
GDP structure by economic sector														
GDP	100	100	100	100	100	100	100	100	100	100	100	100	100	100
Agriculture, forestry, and fisheries	27.18	27.76	25.77	25.78	25.43	24.53	23.24	23.03	22.54	21.81	20.97	20.4	20.34	22.10
Industry and construction	28.76	29.73	32.07	32.49	34.49	36.73	38.13	38.49	39.47	40.21	41.02	41.54	41.48	39.73
Manufacturing	14.99	15.18	16.48	17.15	17.69	18.56	19.78	20.58	20.45	20.34	20.63	21.25	21.26	21.10
Services	44.06	42.51	42.15	41.73	40.07	38.73	38.63	38.48	37.99	37.98	38.01	38.06	38.18	38.17
GDP share by ownership														
GDP	100	100	100	100	100	100	100	100	100	100	100	100	100	100
State sector	40.18	39.93	40.48	40.00	38.74	38.52	38.40	38.38	39.08	39.10	38.40	37.39	35.93	34.35
Nonstate sector	53.51	52.68	50.44	49.97	49.02	48.20	47.84	47.86	46.45	45.76	45.61	45.63	46.12	46.97
Collective sector	10.06	10.02	8.91	8.90	8.84	8.58	8.06	7.99	7.49	7.09	6.82	6.53	6.21	6.02
Private sector	7.44	7.40	7.21	7.24	7.25	7.31	7.95	8.30	8.23	8.49	8.89	9.41	10.19	10.81
Household sector	36.02	35.25	34.32	33.82	32.93	32.31	31.84	31.57	30.73	30.19	29.91	29.69	29.72	30.14
Foreign invested sector	6.30	7.39	9.07	10.03	12.24	13.27	13.76	13.76	14.47	15.13	15.99	16.98	17.96	18.68

Source: GSO, http://www.gso.gov.vn.

in 1995 to 21 percent in 2008, while the share of the services sector has remained at about 30–40 percent in recent years.

The second important structural shift has been the change in the ownership structure of the economy. This shift remains slow as reflected in the relatively stable and significant share of GDP owned by the state sector and partly explained by the slow progress of equitizing SOEs. The share of the state-owned sector has decreased from more than 40 percent in 1995 to 34 percent in 2008, whereas the FDI sector has steadily raised its share from 6.3 percent in 1995 to 18.7 percent in 2008 (table 12.1), demonstrating its increased role as an integral component of the economy. The private sector has also increased its role, accounting for more than 10 percent of the economy in 2008. Business households remain an important sector of the economy, accounting for 30 percent of GDP. However, in terms of growth, the domestic private sector and the FDI sector have the highest growth rates, typically over 10 percent per year.

Decomposition of GDP

Breaking down Vietnam's GDP to its demand components for the period 1996–2008 reveals the important and increasing role of domestic demand for growth (table 12.2). The most important component is domestic consumption. The second most important component is investment, which has grown consistently since 2000. More often than not, external demand contributed negatively to GDP growth during these years.[10]

After a dip in 1999 and 2000, domestic consumption has kept rising, serving as the single most important component of GDP growth. Total consumption in Vietnam has been growing at a considerably faster rate than GDP. Its contribution surged from 29.3 percent in 1999 to 89.6 percent in 2007 and to 106 percent in 2008. Private consumption growth clearly dominates total consumption growth, accounting for the lion's share of total consumption. Another interesting development in the last few years has been the rapid rise in stocks (inventory) from 8.32 percent in 2005 to 21.11 percent in 2007 when the economy overheated in 2005, 2006, and 2007 (table 12.2).

Vietnam has also seen a steady growth in its international trade over the period. The average annual growth rate of exports and imports was about 20 percent. The total value of international trade over GDP (trade-to-GDP ratio), an indicator of economic openness, soared to

Table 12.2. GDP Decomposition, 1996–2008
(% using current prices)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Expenditure on GDP	9.34	8.15	5.76	4.77	6.79	6.89	7.08	7.34	7.79	8.44	8.23	8.46	6.18
Share of GDP by component (%)													
Total	100	100	100	100	100	100	100	100	100	100	100	100	100
Gross capital formation	28.10	28.30	29.05	27.63	29.61	31.17	33.22	35.44	35.47	35.58	36.81	43.13	41.13
Gross fixed capital formation	26.32	26.70	27.02	25.70	27.65	29.15	31.14	33.35	33.26	32.87	33.35	38.27	36.00
Changes in stocks	1.78	1.60	2.03	1.93	1.96	2.02	2.08	2.09	2.21	2.71	3.46	4.86	5.13
Final consumption	82.79	79.90	78.51	75.43	72.87	71.19	71.33	72.58	71.47	69.68	69.38	70.81	73.42
State	8.35	8.13	7.62	6.79	6.42	6.33	6.23	6.32	6.39	6.15	6.03	6.05	6.15
Private	74.44	71.77	70.89	68.65	66.45	64.86	65.1	66.26	65.08	63.53	63.35	64.76	67.26
Trade balance (goods and services)	–10.97	–8.14	–7.30	–2.85	–2.46	–2.28	–5.17	–8.36	–7.55	–4.18	–4.56	–15.85	–16.54
Statistical discrepancy	0.08	–0.06	–0.26	–0.21	–0.02	–0.08	0.62	0.34	0.61	–1.08	–1.63	1.91	2.00
Contribution to GDP growth rate (%)													
Final consumption	77.63	56.82	59.62	29.35	36.29	49.62	75.24	77.87	66.52	62.65	72.39	89.63	106.17
Private consumption	71.13	52.88	55.30	38.35	31.29	43.23	70.19	71.46	60.00	56.30	65.66	82.76	98.18
Government consumption	6.50	3.94	4.31	–9.00	5.01	6.39	5.05	6.41	6.52	6.35	6.73	6.88	7.99
Investment	41.48	32.72	63.02	7.70	44.06	47.65	56.82	53.79	46.93	46.99	52.42	119.33	44.74
Gross fixed capital formation	38.12	33.05	58.12	9.48	41.71	44.62	54.02	50.81	43.79	38.67	40.76	98.23	24.46
Increase in stocks	3.36	–0.33	4.90	–1.78	2.34	3.03	2.81	2.97	3.15	8.32	11.66	21.11	20.28
Net exports	–12.62	13.95	–20.84	63.15	17.65	–3.23	–51.65	–43.73	5.06	18.58	–18.9	–156.37	–52.48
Export						71.61	90.74	113.61	152.25	69.4	112.73	91.88	57.72
Import						–4.85	–142.39	–57.34	–47.19	–0.82	–31.63	–248.24	–110.20
Errors	–6.49	–3.48	–1.81	–0.19	1.96	5.97	19.59	12.08	–18.52	–28.21	–5.93	47.36	1.49

Source: GSO, http://www.gso.gov.vn.
Note: Blank cells = not available.

150 percent in 2007 from 61 percent in 1994. Net exports accounted for only a small fraction of overall GDP growth.

The decomposition of GDP by demand factors using the traditional method is said to underestimate the contribution of exports to GDP growth. Therefore, we instead decompose the contribution of exports separately in order to determine the contribution of this component. The export component has been a significant contributor to GDP growth during the past 10 years, especially since 2000 (table 12.2). This reflects the trade liberalization and export-led growth policies pursued as part of the government's economic reforms. During the past 20 years, average annual export growth has stayed at about 20 percent.[11]

Investment and capital formation have played a key role in Vietnam's successful economic growth strategy. The investment-to-GDP ratio has increased considerably; during the 1990s, the ratio fluctuated around 28 percent before it started rising (beginning in 2000) and then peaked at 43 percent in 2007—after which it dropped moderately to 41 percent in 2008 (table 12.2). This is a high investment level, especially for a low-income country. According to the World Bank (2007), the large and increasing share of investment in GDP partly explains Vietnam's high and accelerating growth rate since 2000.[12]

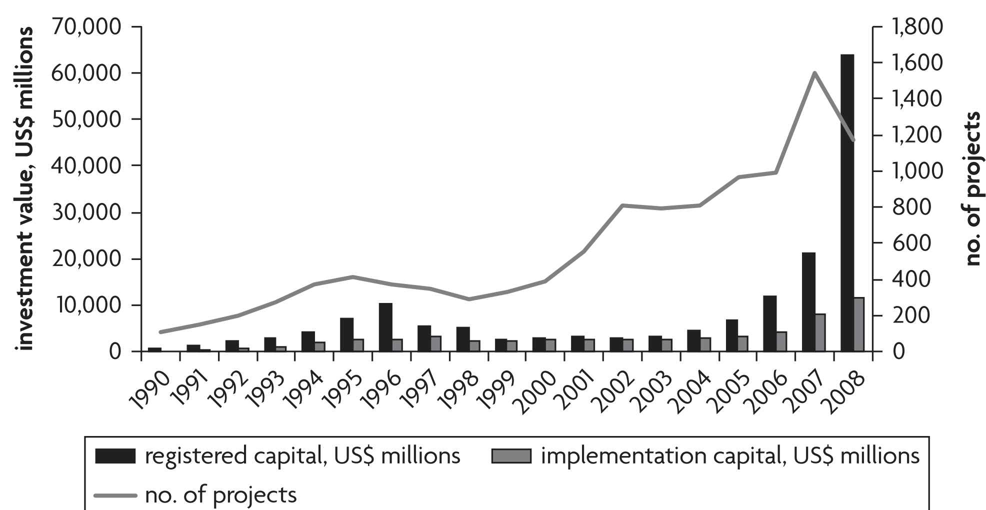
Until 2006, the state sector was the most important source of investment in Vietnam. State investment is made either directly in public infrastructure or through loans to SOEs, or in the form of grants to municipalities and private enterprises. But the state's share in investment has declined from 60 percent in 2001 to 29 percent in 2008 as private domestic investment and FDI have increased. The recent decline in the state's share in GDP is due more to increased private investment than to new inflows of foreign investment. The nonstate domestic sector has increased steadily to become a key source of investment. Private sector investment increased from 27.6 percent in 1995 to 40 percent by 2008.[13] The increased saving and investment by Vietnam's private sector, along with the continued involvement of the state, have contributed to Vietnam's continuing high economic growth rates.

The share of the FDI sector in total investment during the 1990s and in early 2000 experienced a downturn. FDI accounted for 30 percent of investment in the mid-1990s, but fell to 20 percent in the wake of the Asia financial crisis. Since then, the share of FDI in total investment

continued falling until 2006. In 2007–08, however, FDI inflows increased substantially, fueled partly by government reforms associated with WTO accession (figure 12.2), which created a buzz among international investors about Vietnam's prospects.[14] The reforms relaxed rules restricting FDI and made Vietnam a more attractive FDI destination. Indeed, in these two years, FDI became the country's most important source of investment. Notwithstanding Vietnam's success in attracting FDI, the actual benefits of FDI are subject to controversy. Previous studies have found little evidence of technical spillover from FDI enterprises to local counterparts (Nguyen et al. 2008). In addition, the country has become heavily dependent on FDI for sustaining its economic growth.

The high level of investment may also be partly attributable to the state and its expansionary policy adopted in response to the Asian crisis (table 12.3). The government maintained investment levels, and increased its share in GDP, to minimize the effects of the crisis and avoid recession. As a result, Vietnam continued to experience growth and was less affected by the crisis than most of its neighbors. In particular, during 2000–04, the authorities implemented a demand stimulus policy to revitalize the economy while upholding their commitment to reform. The demand stimulus included such measures as public investment in infrastructure projects, financial support to help SOEs deal with their

Figure 12.2. FDI in Vietnam, 1990–2008



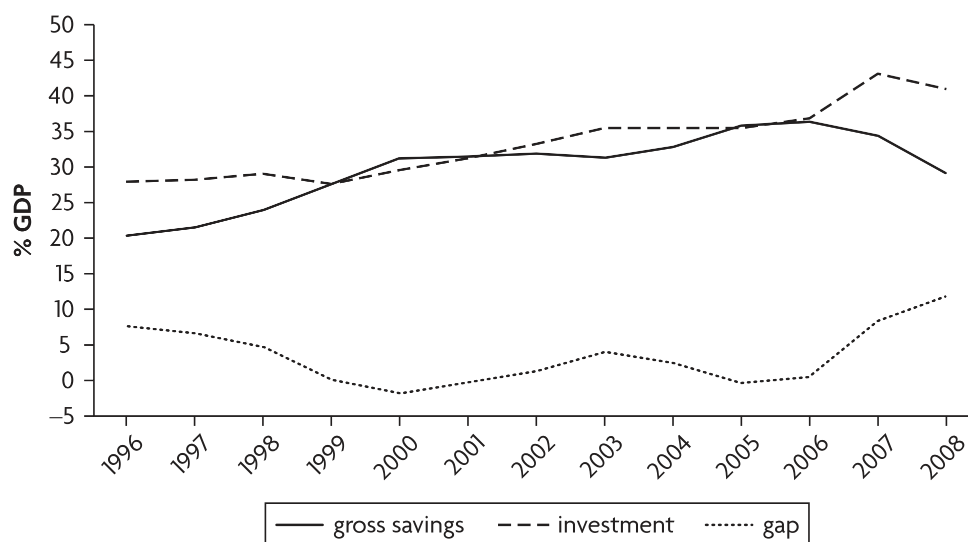
Source: GSO, http://www.gso.gov.vn.

Table 12.3. Structure of Investment by Ownership, 1995–2008
(% using current prices)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Total	100	100	100	100	100	100	100	100	100	100	100	100	100	100
State sector	42.03	49.08	49.43	55.52	58.67	59.14	59.81	57.33	52.90	48.06	47.11	45.74	37.21	28.55
State budget	18.74	22.36	21.75	22.45	24.21	25.80	26.74	25.09	23.82	23.79	25.63	24.76	20.17	16.18
State credit	8.37	9.47	11.72	15.71	18.83	18.37	16.85	17.46	16.30	12.25	10.48	6.63	5.73	4.10
Owned equity of SOEs	14.92	17.24	15.96	17.36	15.63	14.97	16.22	14.78	12.78	12.03	11.00	14.35	11.31	8.28
Nonstate sector	27.61	24.94	22.61	23.73	24.05	22.88	22.59	25.29	31.09	37.73	38.00	38.05	38.47	39.96
Foreign invested sector	30.37	25.97	27.96	20.75	17.28	17.97	17.60	17.38	16.01	14.21	14.89	16.21	24.32	31.49

Source: GSO, http://www.gso.gov.vn, and authors' calculations.
Note: Data for 2006 adjusted by Vietnam Development Bank.

Figure 12.3. Vietnam Investment-Savings Gap, 1996–2008



Source: World Bank Data Catalog.

mounting inventories, budget allocations for poverty reduction programs, raising wages and salaries, encouraging people to consume, and providing partial support to help enterprises expand their exports. This stimulus had a positive impact on the economy, minimizing deflation and economic stagnation.[15]

Vietnam's saving-investment gap has undergone considerable change (figure 12.3). In the mid-1990s, the gap was as large as 7.6 percent of

GDP. The gap then narrowed during the late 1990s and early 2000s but has widened since 2002, and in 2007–08 it became very large—9.8 percent. To meet the county's investment needs and its growth target, the authorities would have had to mobilize foreign savings equal to about 10 percent of GDP if the domestic savings-to-GDP ratio did not improve. Relative to other countries—especially China, where the savings ratio reached 50 percent of GDP—Vietnam's saving ratio remains low. The ratio of saving to GDP tends to level off, thus widening the gap between domestic saving and investment.

Growth Accounting

Economic growth in the neoclassical framework derives from two sources: factor accumulation and productivity growth. Using a growth accounting framework, we break down GDP growth during 1986–2008 into three components: capital (*K*), labor (*L*), and total factor productivity (TFP) (*A*) (table 12.4).[16] The objective of this method is to determine how much economic growth is due to accumulation of inputs and how much to technical progress.

The data reveal an interesting TFP pattern for Vietnam. During the early economic reform period, TFP growth—and, hence, its contribution to GDP growth—was relatively high. However, in the years after the Asian crisis, the country's TFP almost ceased growing; it picked up after 2000 but then dropped again in 2008 during the global crisis, and posted negative growth in 2009. The growth accounting calculation also confirms the importance of investment to GDP growth in Vietnam. This

Table 12.4. Growth Accounting, 1986–2009

Year	GDP (constant 2000 US$ millions)	GDP growth (%)	Labor force, total	Labor growth (%)	Investment (constant 2000 US$ millions)	Gross capital stock (K/Y = 2)	Capital growth (%)	Growth rate of TFP (%)
1986–90	13,499	5	29,506,375	3	1,865	25,220	2	3
1991–96	19,809	8	33,840,536	2	4,279	29,811	6	5
1997–2002	30,595	7	38,071,353	2	9,167	54,555	11	2
2003–07	45,071	8	42,635,146	2	16,540	95,013	11	3
2008–09	57,279	6	22,803,368	2	25,233	138,709	13	0

Source: World Bank Data Catalog; GSO, http://www.gso.gov.vn; authors' calculations.

should be no surprise, as it is consistent with the decomposition previously discussed, where investment constitutes a large part of GDP for a sustained period.

The Run-Up to the Global Crisis

The years 2007–09 marked a memorable period for Vietnam. After a long-standing effort to achieve a high rate of economic growth for the first time in 2008, the government publicly conceded the trade-off between economic growth and macroeconomic stability. Vietnam had experienced a huge credit expansion in 2007, which, together with rising world energy and food prices, led to mounting inflationary pressures. In addition, in response to the heavy capital inflows (both FDI and portfolio investment), the government inappropriately attempted to absorb this inflow while maintaining a fixed exchange rate.

Given these problems, the Vietnamese government was forced, in 2008, to shift its priority from economic growth to stabilization; this meant a tight monetary policy and a cutback of public spending on large projects.[17] The policy worked and brought down inflation, but it also stalled the housing market and popped the financial bubble. While the macroeconomic situation improved by the end of 2008, the global crisis and recession took a heavy toll on the economy. As pointed out by the World Bank (2009), the policies implemented in 2008 were in a way good for Vietnam. But the economy was not well prepared for the crisis, given that it was suffering a self-induced recession in early 2008.[18] Thus, at the beginning of 2009, the global crisis compounded Vietnam's difficulties.

Box 12.1. Food-Fuel Crisis in Vietnam, 2007–08

The years 2007–08 saw unprecedented soars in world food and fuel prices, creating a global crisis and causing political and economical instability and social unrest in both poor and developed nations; Vietnam is not an exception.

In mid-2008, the food prices rose by about 60 percent and the fuel price index leaped 20 percent compared with the previous year. Rising prices of foods and fuels generated increases in the prices of most of other products and this, in turn, pushed the inflation up, even approaching the dangerous levels Vietnam's inflation rate topped to 21.4 percent in 2008. In order to stabilize prices, the State Bank of Vietnam tightened its monetary policy raising the prime interest rate to 14 percent in 2008, effectively raising the commercial lending rate to the prohibitive rate of 21 percent, resulting in nearly a liquidity crisis in 2008.

Source: Complied by the authors from various sources, primarily from http://www.vneconomy.vn.

Effects of the Global Crisis and Government Responses

As noted earlier, Vietnam's strong economic performance has been highly dependent on external demand, with the export-to-GDP ratio reaching 70 percent in 2007, and the FDI-to-GDP ratio reaching almost 10 percent. Although the country has witnessed strong domestic consumption growth in recent years, Vietnam's economy has continued to be driven by high external trade and increased FDI. The country's total trade is now equivalent to about 150 percent of GDP, which is the second highest in the region after Malaysia. Vietnam has also been one of the largest recipients of FDI in the world, relative to the size of its GDP. Therefore, the country was particularly vulnerable to the unexpected global economic slowdown and capital outflows.

The Effects of the Global Crisis

Up to the first half of 2008, Vietnam was relatively unaffected by the financial turmoil; but the financial and economic environment worsened in the final quarter of 2008 and first quarter of 2009 (table 12.5). The weak performance in the first quarter of 2009 confirmed fears that Vietnam was facing a full-blown recession for the year 2009.

The crisis has exposed Vietnam's vulnerability in its dependence on external stimulus. In the fourth quarter of 2008, Vietnam's exports fell substantially, due to the direct and immediate effects of the global crisis. According to official statistics from the country's General Statistics

Table 12.5. Basic Quarterly Macroeconomic Data during the Crisis

	2008Q3	2008Q4	2009Q1	2009Q2	2009Q3	2009Q4
GDP (% yoy)	6.5	5.7	3.1	4.5	5.8	7.7
Industrial production (% yoy)	15.8	14.1	2.9	6.8	10.7	14.0
CPI, end of quarter (% yoy)	27.9	19.9	11.3	3.9	2.4	6.9
Trade balance (% GDP)	–5.5	–5.9	8.5	–15.2	–19.7	–18.6
International reserves (US$ bn)	24.1	24.2	23.3	19.0	18.0	16.0
Policy rate, end of quarter (%)	14.0	8.5	7.0	7.0	7.0	8.0
5-year yield, end of quarter (%)	15.9	10.0	9.2	9.4	10.1	11.7
Dong/U.S. dollar, end of quarter	16,600	17,483	17,797	17,798	17,841	18,479
Dong/euro, end of quarter	23,572	24,301	23,492	24,917	26,048	26,425

Source: GSO, http://www.gso.gov.vn.

Office (GSO), over the first 10 months of 2009, Vietnamese exports fell 13.8 percent relative to 2008, with the full-year decline registering –8.9 percent. The export decline was the result of two developments:

- Decreased aggregate demand for its exports
- A substantial fall in the prices of its export commodities, especially crude oil and other primary commodities

Although some of Vietnam's major export products—such as coffee, rice, pepper, rubber, crude oil, and coal—showed volume increases in 2009, their lower prices raised concerns that Vietnam might even exceed the revised negative growth rate. For a country with annual growth in export values of about 20 percent, this is a serious setback. As the year 2009 closed, exports showed some signs of recovery, due to a global demand revival, but export values amounted to just US$56.6 billion—10 percent lower than in 2008.

A recent study by the Vietnam Academy of Social Sciences (VASS) finds that although several export manufacturing sectors—such as textiles, garments, leather, and seafood processing—were hit hard by the crisis, these industries are highly resilient and are capable of bouncing back once the world economy improves. This is because demand for the products of these industries is highly inelastic. On the other hand, several sectors or segments of the economy—such as furniture, electronics, and village crafts—are not resilient and may take longer to improve because world demand for these products is not inelastic.

In 2008, the heavy flows of registered FDI capital into Vietnam reached US$64 billion (triple the registered FDI capital in 2007), while flows of implementation capital totaled US$11.6 billion—versus US$8 billion in 2007.[19] In 2009, however, FDI inflows slowed because of capital constraints and the tightening of the world credit market. In the first eight months of 2009, Vietnam managed to attract about US$10.4 billion of registered capital, well below the figure for 2008. Actual disbursements for investment projects were about US$6.5 billion, also lower than in 2008. The slowdown of FDI inflows in 2009, with the expectation of continued lower levels in the years to come, will have serious consequences for Vietnam, especially in terms of its exports. According to official statistics, FDI has accounted for more than 50 percent of the country's exports over the past six years.

We might thus expect Vietnam's labor force to be highly vulnerable to the global financial crisis, given its heavy dependence on exports and relatively mobile international investment. Data on the impact of the crisis on the labor market and employment, however, are limited and not reliable, complicating the assessment of the social impact of the growth slowdown.[20] As the World Bank (2009) observes, current data show a mixed picture, and the effects are heterogeneous across enterprises and provinces. According to a survey conducted by VASS,[21] the effects have not been as bad as feared. Despite numerous job losses, frequent reductions in working hours and wages, reduced remittances, and increased reliance on informal sector jobs, major negative effects—such as rising poverty, food shortages, the need to pull children out of school or to sell land, or becoming homeless—have been relatively uncommon.

In addition to its impact on trade, FDI, industrial production, and the labor market, the global crisis has had implications for Vietnam's capital inflows, exchange rate, and stock market. Like other Asian countries, Vietnam suffered capital flight starting in the second quarter of 2008. Banks and financial institutions in the United States and the West reduced their international businesses and focused on their home markets. As a result, funds flowing into Vietnam fell sharply. In response to the booming stock and housing markets during 2006–07, short-term inflows had surged to high levels. The crisis then led to a reversal of these inflows. The reversal of portfolio capital flows significantly affected the stock market, with the VN-Index falling to a record low of about 300 points in 2009 from its high of over 1,000 points in early 2007.[22] Although the Vietnamese dong has long been pegged to the U.S. dollar, capital flows have had a major impact on the dong, with several small adjustments of the trading bands and devaluation. Generally, capital outflows depress the dong's value; indeed, since the beginning of 2009, the dong has lost up to a dozen percentage points in its value against the dollar.[23] Declines in exports, as well as in remittance and foreign capital inflows, have reduced the supply of foreign exchange, while expansionary monetary and fiscal policies have increased demand for it. Consequently, there has been a shortage of foreign exchange in the formal market, and the dong's exchange rate against the U.S. dollar has been transacted at the upper bound of its trading band.[24]

We now summarize the effects of the global crisis on Vietnam's economy (table 12.6). Before the crisis (2003–07), the economy was growing

Table 12.6. Summary of the Global Economic Crisis on Vietnam's Economy

	1997–2002	2003–07	Change from 1997–2002 to 2003–07	Highest 2-year average value before crisis	Expected potential value just prior to the crisis	2008	Forecast/ estimate 2009	Total loss during 2008–09 compared to potential
GDP growth (%)	6.58	8.05	1.48	8.45	7.5–8	6.18	5.32	–2.18
TFP growth (%)	1.66	2.99	1.33	3.21	2.75	0.20	–0.33	–3.08
Exports growth (%)	17.77	12.91	–4.86	27.74	0.25	5.05	–0.10	–0.26
Exports/ GDP (%)	50.73	68.98	18.25	75.25	0.65	78.21	0.62	–0.03
Investment (% GDP)	29.83	37.29	7.45	39.97	37.00	41.13	42.80	5.80
Capital inflows (% GDP)	0.054	0.048	–0.006	0.078	0.070	0.104	0.098	0.028
Fiscal deficit (% GDP)	—	0.051	—	0.055	0.050	0.041	0.070	0.020

Source: GSO, http://www.gso.gov.vn; World Bank Data Catalog; Ministry of Finance; authors' calculations.
Note: The potential GDP for Vietnam is expected to be in the range of 7.5–8 percent per year. In calculating the global crisis impact on Vietnam, we use the lower bound in order to be conservative. — = not available.

at an average annual rate of over 8 percent. We believe that this rate was the upper bound of the country's growth potential as signs of overheating emerged; specifically, the inflation rate was high by the end of 2007 and in early 2008, and investment in stock and inventory as a percentage of GDP was very high (more than 42 percent). We expect the potential growth rate for Vietnam to be between 7.5 percent and 8 percent. If we take the lower bound of 7.5 percent, the total loss during 2008–09, in terms of GDP growth, would be 2.18 percentage points. (In addition to the GDP loss, table 12.6 shows losses for TFP, exports, and other items.)

In addition to the direct effects of decreased exports and FDI inflows, the global crisis has reduced aggregate demand sharply, through the employment and income channels. The drop in domestic demand was the result of falling employment and delayed consumption and investment by domestic consumers and investors.

An indirect (but critical) effect of the global crisis on Vietnam has been the government's efforts to mitigate the impact on the domestic economy and stimulate short-term growth. These efforts may take the form of delaying or canceling some structural adjustment policies (reforms of SOEs and the banking sectors, as well as improvements in the business environment). These structural adjustments, however, are critical for sustainable growth. For example, to stimulate short-term economic growth, the Vietnamese government may resort to refinancing the inefficient banking sector, subsidizing loss-making state-owned conglomerates, and reviving real estate investment. Although these measures are useful and effective for stimulating short-term economic growth, they cannot ensure long-term sustainable growth and may in fact generate new risks. Therefore, the Vietnamese government should speed up structural adjustments to help to transform the country's growth model.

Remittances have long been seen as important sources of capital for Vietnam, and the crisis is expected to lower the inflow of this key source of capital. Other impacts include the decline in tourism and lower income for farmers, due to lower commodity prices.

Although the crisis has led to a steep fall in exports, it has also led to a more manageable trade deficit as of early 2009 (World Bank 2009). But the trade deficit is expected to grow significantly once the economy recovers. This is because of the import-export structure of Vietnam:

- Exports rely heavily on agriculture and raw commodities, and most manufacturing products still embody low value added.
- Imports of intermediate products and machinery for domestic production and export may rise more rapidly once the economy recovers.
- Overseas final-product imports, particularly luxury items, have high value, as they appeal to Vietnam's middle-income consumers.

Government Responses

The government of Vietnam quickly and decisively responded to counter the negative effects of the global crisis.[25] It reversed the course of the monetary tightening and fiscal austerity policy implemented in 2008 by announcing a US$6 billion stimulus package.[26]

As to monetary policy, the government aggressively loosened its stance by cutting the annual base rate from 14 percent to 7 percent within a few months. Ceiling lending interest rate (1.5 times base rate) offered by commercial banks was lowered accordingly, from 21 percent to 10.5 percent for productive activities. Lending interest rates for credit card and consumption are negotiable and fluctuating between 12 percent and 15 percent. The government also announced and implemented its plan to provide a 4 percent interest subsidy for working capital and short-term loans for enterprises; the subsidy cost totals US$1 billion.

Vietnam announced its fiscal stimulus in January 2009. The objective, of course, was to mitigate the impact of the global crisis on the economy and the population and prevent a general slowdown of economic activity. The initial US$6 billion figure was later revised to US$8 billion; this has raised some concerns about unsustainable spending.[27]

To put Vietnam's stimulus package into perspective, we compare it to the values of stimulus packages adopted by other ASEAN countries to fight the global recession (table 12.7). Based on a simple budget deficit metric, the budget plan of late 2008 put the Vietnamese stimulus package in the top tier within its region.

We also consider the fiscal stimulus package breakdown in terms of measures and in terms of how the fiscal stimulus package was financed (table 12.8).

The package includes a number of components, such as tax breaks and public investments in infrastructure, social transfers, and interest

Table 12.7. Proportion of Stimulus Package to GDP

Country	Stimulus package (US$ bn)	Proportion to GDP (%)
China	586.0	12.0
Indonesia	4.5	0.9
Malaysia	18.1	10.0
Philippines	6.1	4.0
Singapore	13.8	10.7
Thailand	8.3	3.3
Vietnam	8.0	10.0

Source: CIMB Research House; Ministry of Planning and Investment (MPI).

subsidies (table 12.8). For example, the stimulus package includes one-off support of Dong 200,000 (equivalent to US$12) per capita for the poor on the last New Year's holiday; a 30 percent reduction in corporate income taxes; an extension of nine months for the submission of 2009 tax payables; a temporary refund of 90 percent of value added tax for exported goods with "justifiable payment documents"; a personal income tax exemption for the first six months of 2009; and an extension of the 4 percent interest subsidy for long-term loans of up to two years for investment in agriculture and other productive activities.

Some researchers (Pincus 2009) have pointed out that the policy options available for Vietnam's government are much more limited than

Table 12.8. Vietnam's Fiscal Stimulus Package

Policy measure	Amount
Interest subsidy (for working capital loan)	D 17,000 billion
State development investment	D 90,800 billion
Tax holiday and exemption	D 28,000 billion
Other spending for social security and economic downturn prevention	D 9,800 billion
Total	D 145,600 billion (equivalent to US$8 billion)
Components and size (values in D trillions unless otherwise noted)	**Amount**
Revenue forgone	25.4
Corporate income tax	10.4
Personal income tax	6.5
Value added tax	7.4.0
Licenses and fees	1.1
Additional expenditures	117.6
Interest rate subsidy	17.0
Budget advanced from 2010	37.2
Government bond carried over from 2008	7.7
Investments funded by additional bond issuance	20.0
Expenditures carried over from 2008	22.5
Deferral of repayment of budget allowance for 2009	3.4
Social spending	9.8
Overall fiscal stimulus	143.0
% GDP	8.5

Source: Ministry of Finance; Ministry of Planning and Investment; World Bank; International Monetary Fund (IMF).

those for China or other neighboring countries. While China and other Asian neighbors have maintained current account surpluses and sound fiscal balances for several consecutive years, Vietnam has been plagued by twin deficits: a large current account gap of 12 percent of GDP in 2008 and double-digit fiscal deficits. The fall in world oil prices also constrained the Vietnamese government's fiscal policy, because 16 percent of government revenue comes from oil exports. A World Bank study (2009), however, suggests that there is still fiscal space for a stimulus policy in Vietnam and that the fiscal position of the country remains strong.

The Stimulus Package and Economic Recovery

According to the GSO (2009), signs of economic recovery in Vietnam emerged as early as August 2009. These signs were combined with the global recession bottoming out and recovery in other Asian countries. Domestic industrial production and GDP growth picked up in the third quarter of 2009; and in the fourth quarter, the year-on-year industrial production and GDP growth rates reached 14 percent and 7.7 percent, respectively (table 12.7). Some have attributed the economic recovery to the government's stimulus, but we see a number of factors at work here: the timely implementation of the stimulus, the intrinsic resilience of the economy, and—most important—the recovery of global demand for Vietnam's exports and the resumption of FDI inflows.[28]

Evaluating the effectiveness and efficiency of the government stimulus package is a daunting task in the absence of reliable data. We will therefore present only patchy evidence of the effectiveness of the stimulus package. The most obvious impact of the stimulus may be its having kept credit flowing to the economy and helping enterprises clean up their balance sheets. The government helped repair balance sheets by replacing the high-interest-bearing loans incurred during the turbulent year of 2008 (when the interest rate reached 21 percent) with interest rate–subsidized loans under an accommodative monetary policy. This reduced the financial burden of borrowing by easing costs during a period of economic pressure and enabled businesses to maintain production and jobs. According a government report, by September 2009, the government had spent Dong 17,000 billion (equivalent to US$1 billion) for interest rate subsidies, which led to Dong 405,000 billion (equivalent to

US$23.8 billion) worth of loans (for working capital); of this total, 16 percent went to SOEs and 84 percent to the nonstate-owned sector. Spurred by the introduction of government interest rate subsidies, the growth of credit and the money supply accelerated in the first half of 2009. The growth of total liquidity (M2) rose to 35.8 percent in the second quarter of 2009, up from 20.3 percent in the fourth quarter of 2008.

As noted earlier, the government also adopted an expansionary monetary stance to support economic activity. The growth of liquidity and credit, however, was relatively modest during the first quarter of 2009, owing to some lag. As time passed, economic activities increased; and, once the government's determination to boost growth rates became clear, bank lending picked up again. Any attempt to separate out the effects of monetary and fiscal policies on credit growth would be superficial, as monetary and fiscal policies in Vietnam are not independent of one another. The government thus adopted an unorthodox policy, using the fiscal budget to implement monetary policy (the interest rate subsidy). The interest rate subsidy under the stimulus package, together with the accommodative monetary policy, helped inject credit into the economy during this difficult time. Another effect of the package was to restore business confidence, as reflected in part by a rally in the stock market in mid-2009.[29]

The stimulus package has also helped mitigate the impact of the financial crisis on workers. In a recent study, Manning (2009) suggests that the impact on labor has been milder than might have been expected for a country so heavily exposed internationally. This can be partly attributed to the government's timely stimulus package.[30] In addition, the market for semiskilled and skilled workers recovered well after the Tet break (March 2009).[31] This is consistent with evidence from a rapid assessment survey conducted by VASS in May 2009, which found evidence of "green shoots," with enterprises receiving orders and recruiting more employees. The multiplier effect of the package may also help in the face of falling aggregate demand.

We now turn to the agricultural sector, which employs more than two-thirds of the country's population and accounts for most of Vietnam's exports. Needless to say, the sector has been hit hard by the global downturn, although the impact on rural areas has been limited.

In April 2009, the government introduced a series of stimulus measures targeting the rural economy. The new policies include interest-free loans for purchases of farm equipment and subsidized loans for fertilizer and other agricultural inputs. However, in the first stimulus package, farmers, who account for 70 percent of the population, were able to access only US$48 million of credit, too small a share of the total package of about US$22 billion disbursed.

In addition to the stimulus package, the resilience of the business sector appears to have been a major driver of the recent recovery. The stimulus has been seen as a "rescue remedy" to help enterprises access loans to get back on track, remain in production, and create jobs. It has been important in improving the liquidity of the banking system and maintaining debt payments. After all, it is the business sector that takes the risk in responding to the stimulus, and it is its investments that keep aggregate demand from falling too far. Another key factor in facilitating the recovery is the revival of world demand for Vietnam's exports and inflows of foreign investment.

Medium-Term Projections

The current global financial and economic crisis is the worst since the Great Depression, and Vietnam is being hit much harder than it was by the Asian financial crisis. But the crisis is also giving Vietnam an opportunity to review and redesign its economic development policy to sustain rapid growth, protect the country from future external shocks, and strengthen internal sources of growth.

The economic development policy that Vietnam pursued during the past 20 years has three important characteristics:

- Gradual domestic reforms: developing private businesses while maintaining a dominant role for the state sector
- Dependence on external stimulus: increasing export growth and attracting FDI
- Overreliance on investment as a source of economic growth

Over these years, the government tried to increase employment and eradicate poverty with a strategy of export-led, investment-based growth—with state intervention. The state developed five-year plans and an

industrial policy based largely on the above features. This approach, however, must be reevaluated. Alternative strategies are needed to prepare for what could be a prolonged period of lower demand for Vietnam's exports, lower inward FDI, and shifting patterns of global economic growth. Adopting an updated and effective strategy to drive economic growth will be difficult, however, because it requires that some of the assumptions that have traditionally driven policy making be reexamined or replaced.

The global financial crisis and resulting recession will have profound long-term implications for many developing countries, including Vietnam. How will the Vietnamese economy fare in the medium term? What course of economic development will it follow?

One of our main tasks in this chapter is to apply the lessons of past experience to the new and changed postcrisis world so as to analyze the likely course of the Vietnamese economy. Much of what has happened in the past, however, will only have limited value for predicting the future. This is particularly true if we think of the recent crisis as causing a structural break that heightens the risks associated with projections using past trend data. Therefore, although we use contextual information and concentrate on the issues, factors, and trends that have some forward-looking elements, our projections may suffer from subjective bias and judgment. We next provide our projections for Vietnam's economic growth from both the demand and supply sides, using our forecasts for global external factors as well as key domestic factors.

Projections of Global Exogenous Factors

We now turn to assessing medium-term prospects for the Vietnamese economy, based on the performance of its export sector and capital inflows.

Demand for Exports. As discussed earlier, Vietnam is highly dependent on exports for growth. In 2009, although some of Vietnam's major export products (such as coffee, rice, pepper, rubber, crude oil, and coal) showed increases in volume, depressed world prices led to marked decreases in export values. In the first quarter of 2010, exports registered a positive growth rate of 3.8 percent.[32] Although this is modest relative to the yearly average growth rate of about 20 percent during the past

decade, we expect that Vietnam's export performance will soon recover and may return to precrisis growth levels after 2012. There are a number of reasons for this belief.

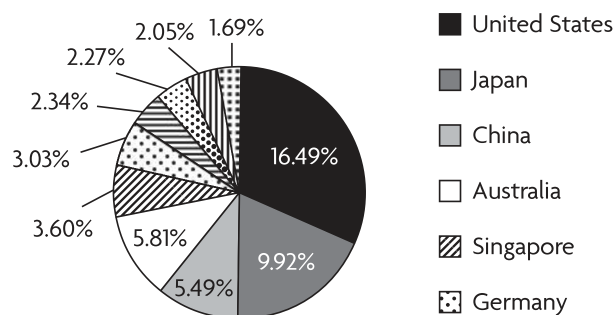
First, as pointed out by the World Bank (2010), China's stimulus package has helped trade in Asia recover faster than elsewhere. According to recent official statistics (figure 12.4), China is the third-largest importer of Vietnam's products (after the United States and Japan) and we thus expect that Vietnamese exports to China will increase. And once economic recovery takes hold in the United States and Japan, exports from Vietnam to these large markets will also improve.

Second, higher export prices in 2010 (relative to 2009) will lead to higher export values.

Third, Vietnam's export sector also shows potential for dynamism. During the crisis year of 2009, Vietnam still managed to diversify away from its traditional export markets, and it is these markets that sustained Vietnam's export growth in 2009 (figure 12.5). If Vietnam manages to maintain and expand its newfound nontraditional markets while benefiting from recovery in its traditional markets, its export performance will strengthen in the next few years.

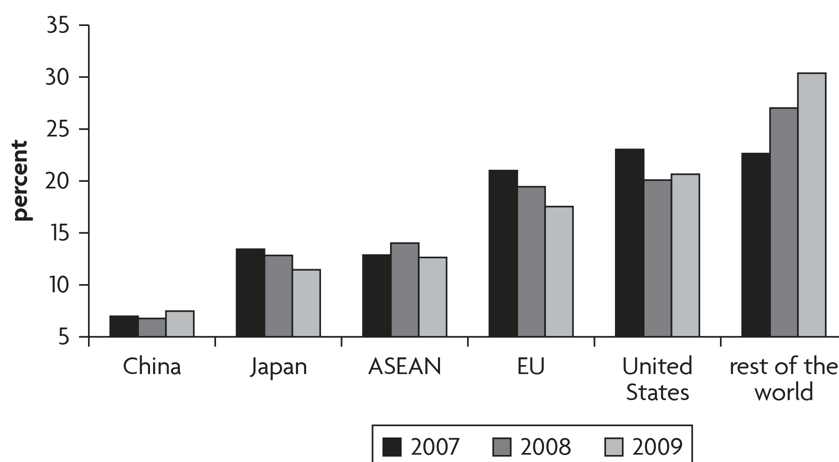
Based on these considerations, we expect Vietnam's export performance to be stronger than the average growth rates for Asia and the Pacific estimated by the World Bank (2010). In particular, we expect that Vietnam's export growth will return to its precrisis growth rate of 20 percent earlier than 2015. According to the latest statistics issued by the GSO, the export growth rate of Vietnam in the first half of 2010 was over 15.7 percent. We believe that this would be the growth rate in 2010,

Figure 12.4. Main Export Markets, 2008



Source: GSO, http://www.gso.gov.vn.

Figure 12.5. Diversification of Export Markets



Source: GSO, http://www.gso.gov.vn.

which is then expected to increase gradually to 16 percent in 2011, 17 percent in 2012, and 18 percent in 2013, and we expect it to return to the long-term rate of about 20 percent by 2014.[33]

Capital Flows and Access to International Finance. In 2007–08, Vietnam experienced new and large FDI inflows—partly because of reforms committed to as part of WTO accession, which relaxed rules restricting FDI and made Vietnam a more attractive FDI destination. Indeed, in those two years, FDI became the most important source of investment in Vietnam.[34] But in 2009, FDI inflows slowed due to the constraints of available capitals and the tightening of the world credit markets. In the first eight months of 2009, Vietnam attracted about US$10.4 billion of registered capital, much lower than in 2008. Also, although actual disbursements under investment projects exceeded US$6.5 billion, this figure was also lower than that for 2008.

The World Bank (2010) expects external financial inflows to developing countries to decline over the medium term, depending on the type of capital flow. The study suggests that the decline in FDI inflows into developing countries will be less than for other types of finance. FDI as a percentage of GDP is thus expected to decline from 3.9 percent to about 3 percent, a decrease of 30 percent. Traditionally, Vietnam has been able to attract more FDI than its proportionate share. During 2003–07,

for example, Vietnam attracted a large inflow of FDI equivalent to 7.3 percent of GDP. Although we expect FDI flows into Vietnam to be higher than the world average over the medium term, the country will also suffer from the general global decline. We project that, over the medium term, Vietnam will attract FDI inflows equivalent to 5.1 percent of GDP (a decline of 30 percent). With regard to portfolio investment, the World Bank study (2010) expects it to be severely constrained. To be safe and relatively conservative, and since portfolio investment in Vietnam is fairly small relative to FDI, we project that portfolio investment into Vietnam in the medium term will be negligible.

During the past decade, remittances from overseas Vietnamese have played an increasingly important role, both in terms of macroeconomic stability as well as constituting a cheap source of financing. During the crisis, although remittances fell from a high of US$7.2 billion to US$6.8 billion, the decline was not as bad as many expected. To make some projections about future remittances (table 12.9), we rely on the scenario developed by the World Bank, in which the growth rates for remittances are given.

Medium-Term Projections for Key Domestic Variables

During the early 2000s, Vietnamese inflation rates were relatively low (under 10 percent). But because of sustained debt-financed investment by the government combined with accommodative monetary policy, inflation accelerated in 2007 and peaked at over 23 percent in 2008. In switching from a high-growth strategy to one of stabilization, the government tightened monetary policy in 2008 (in combination with nontraditional and administrative methods) to curb the accelerating inflation rate. As a result, inflation in 2009 fell back to less than 10 percent. The government's ability to control inflation in 2009 was made easier by the lower commodity prices (especially oil) associated with the crisis.

To counter the effects of the global crisis, however, the government reversed the course of monetary tightening. Money supply and credit expansion, together with the large stimulus package, have put renewed pressure on inflation. As the economic recovery began toward the end of 2009, there were worrying signs of accelerating inflation.[35] The government has openly set the inflation target at about 8 percent for 2010. Thus, on the one hand, we expect that for now the lessons of high inflation in

Table 12.9. Projections of Key External Variables
(current US$ millions)

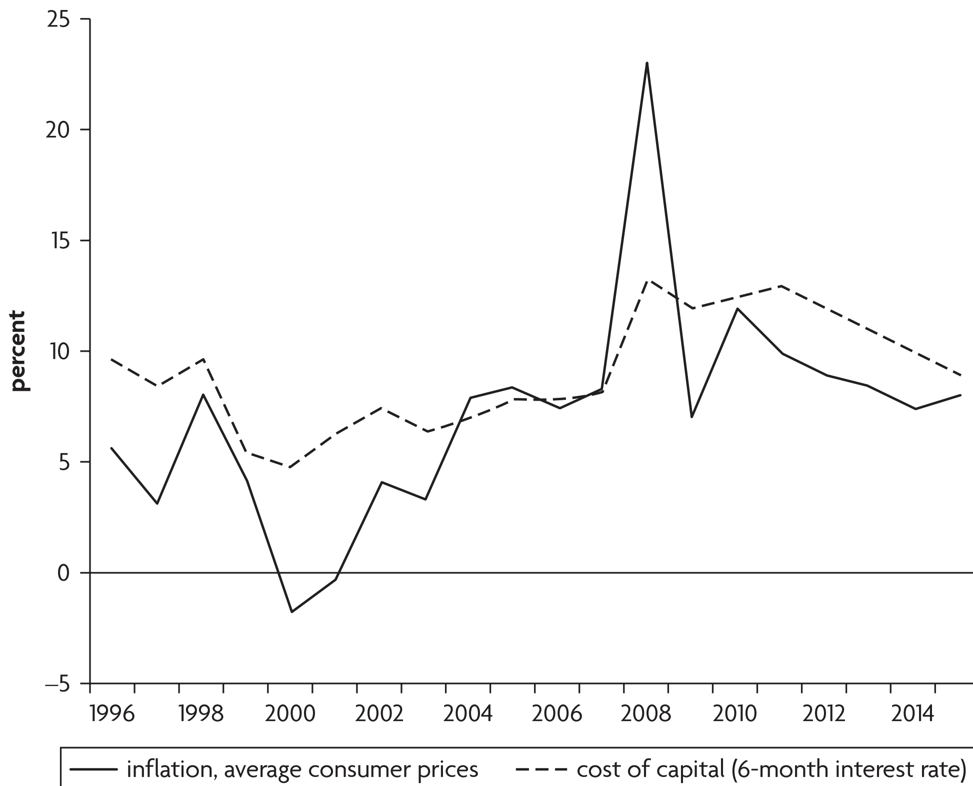
	Actual				Projected					
	2003	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
Vietnamese exports	23,045.9	52,769.2	70,891.2	63,802.1	73,372.4	85,112.0	99,581.0	117,505.6	141,006.8	169,208.1
Exports growth (%)	20.0	11.3	5.1	–10.0	15.0	16.0	17.0	18.0	20.0	20.0
Foreign direct investment	1,450.0	6,516.0	9,279.0	9,514.7	9,999.9	10,509.9	11,045.9	11,609.2	12,201.2	12,823.5
Portfolio investment	0	6,243	–578	—	—	—	—	—	—	—
Total capital flow	1,450.0	12,759.0	8,701.0	9,514.7	9,999.9	10,509.9	11,045.9	11,609.2	12,201.2	12,823.5
Remittances	2.6	5.5	7.2	6.8	7.0	7.1	7.3	7.5	7.7	7.8

Source: World Bank Data Catalog; GSO, http://www.gso.gov.vn; authors' calculation.
Note: — = not available.

2007 will be a good reminder of the costs and difficulties associated with controlling high inflation. On the other hand, the government is under great pressure to boost economic growth in the absence of an independent central bank. On balance, we see a low likelihood of double-digit inflation in the next few years, as the government tries to check inflation pressures. But we see much uncertainty in achieving the government's inflation target of 8 percent for 2010. We project that inflation will be about 10–12 percent in the next few years, before the government is able to reduce it to 7–8 percent (figure 12.6).

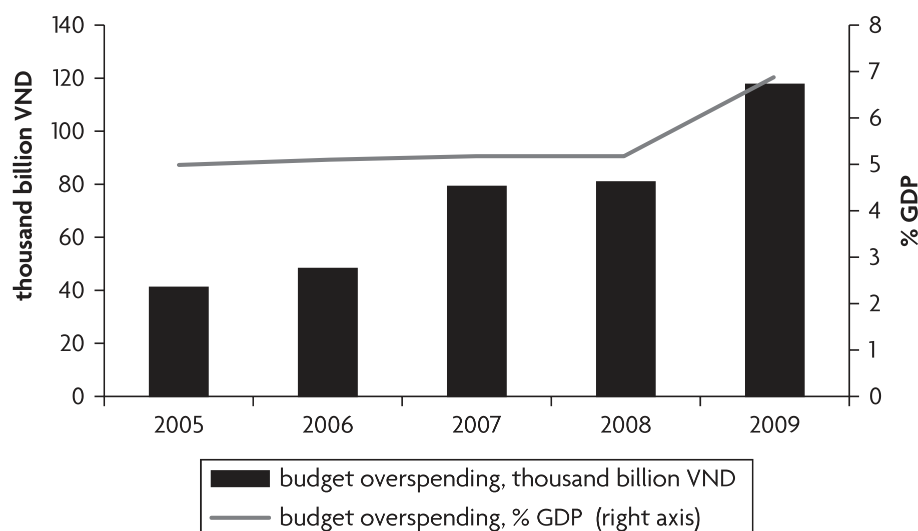
Although the decisive implementation of Vietnam's economic stimulus package is encouraging, the government's aggressive approach has also raised concerns about its impact on public finances. Since 2000, the government's operating expenditures have risen more sharply than its tax revenues (figure 12.7). Vietnam has a narrow tax base, and most of the working population are low wage earners; thus, only a small segment

Figure 12.6. Inflation and Cost of Capital, Actual and Projected to 2015



Source: World Bank Data Catalog; Asian Development Bank (ADB) Key Indicators; authors' calculations.

Figure 12.7. Budget Collections and Expenditures



Source: Ministry of Finance.

of the Vietnamese working population pay income tax. Owing to the fiscal stimulus package, the deficit in 2009 is much higher than in previous years; the deficit in 2010 is expected to be 6 percent of GDP and, according to a recent report by the Ministry of Planning and Investment, could reach 6.5 percent.[36] The implication is that with a large budget deficit, there is less fiscal space for the government to make direct investments in the economy—and this raises the cost of funding. At present, the government has to deal with a difficult balancing task: controlling inflation while also stimulating economic growth. With the expanding budget deficit and public debt, it will be hard for the government to obtain funding at low interest rates. Therefore, we expect interest rates to be somewhat higher than in the precrisis period, peaking by 2011 at about 13 percent before falling to 9 percent in 2015 (figure 12.6).

Along with the fiscal deficit, Vietnam faces a chronic current account shortfall, which has led to episodes of near crisis in the balance of payments in recent years. The trade and current account deficits have reached levels that are much higher than the level of 5 percent of GDP that is commonly believed sustainable. The continuing current account deficit has been mainly driven by the growing domestic credit associated with financing the fiscal deficit, the increase in private consumption by households, and an overvalued currency (partly because of a rigid

exchange rate policy) and loss of competitiveness. As noted earlier, in 2009 declines in exports, remittances, and foreign capital inflows reduced the supply of foreign exchange, while expansionary monetary and fiscal policies increased demand for it. Consequently, there has been a shortage of foreign exchange in the formal market, and the dong's exchange rate against the U.S. dollar has been transacted at the upper bound of its trading band. Rapid credit growth—together with an expansionary fiscal policy—led to a sustained increase in imports and a widening trade deficit in the first quarter of 2010, with the dong depreciating to a record low of Dong 19,000 per U.S. dollar. The general belief is that the dong should be allowed more flexibility to depreciate further.

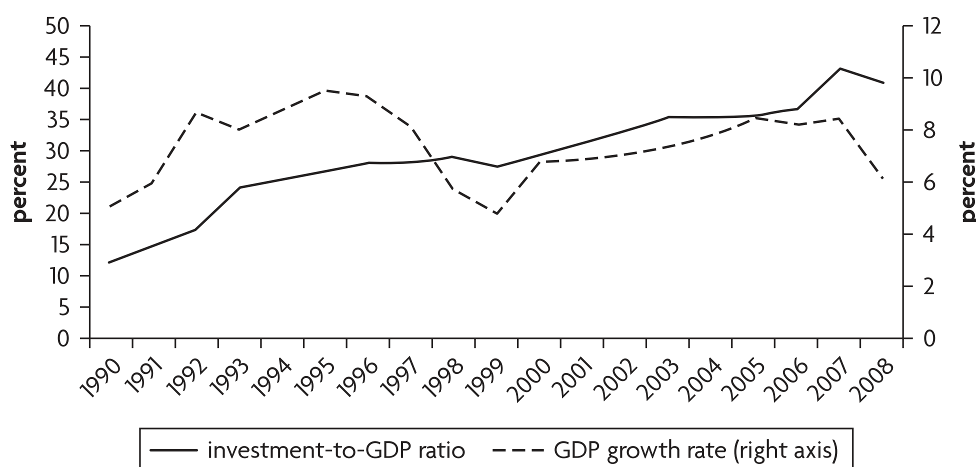
We expect that as the dong depreciates, the trade deficit will improve—together with increased FDI inflows and remittances—when the world economy recovers, lessening pressure on the dong. However, it will take some time for the government to wind down its expansionary program (the government has a growth-driven target in mind). We expect the dong to depreciate by a few more percentage points in the next few years before it stabilizes. As the dong depreciates, it will reduce the current account deficit—but we do not expect the deficit to shift into surplus in the medium term. Rather, we expect that in 2010–11, Vietnam will still have a large current account gap (equal to about 5 percent of GDP), but the situation should improve by 2015.

Table 12.10. Inflation, Interest Rate, Current Account, and Exchange Rates, Actual and Projected to 2015

	Actual				Projected					
	2003	2007	2008	2009	2010	2011	2012	2013	2014	2015
Inflation, average consumer prices (%)	3.2	8.3	23.1	7.0	12.0	10.0	9.0	8.5	7.5	8.0
Cost of capital (6-month interest rate, %)	6.5	8.2	13.3	12.0	12.5	13.0	12.0	11.0	10.0	9.0
Current account balance (US$ bn)	–1.9	–7.0	–10.7	–8.9	–9.8	–9.3	–8.8	–7.9	–7.1	–6.4
Exchange rate (Dong per US$)	15,509	16,105	16,302	19,000	19,570	20,549	21,576	22,223	22,668	22,894

Source: World Bank Data Catalog; authors' calculations.

Figure 12.8. GDP Growth and Investment



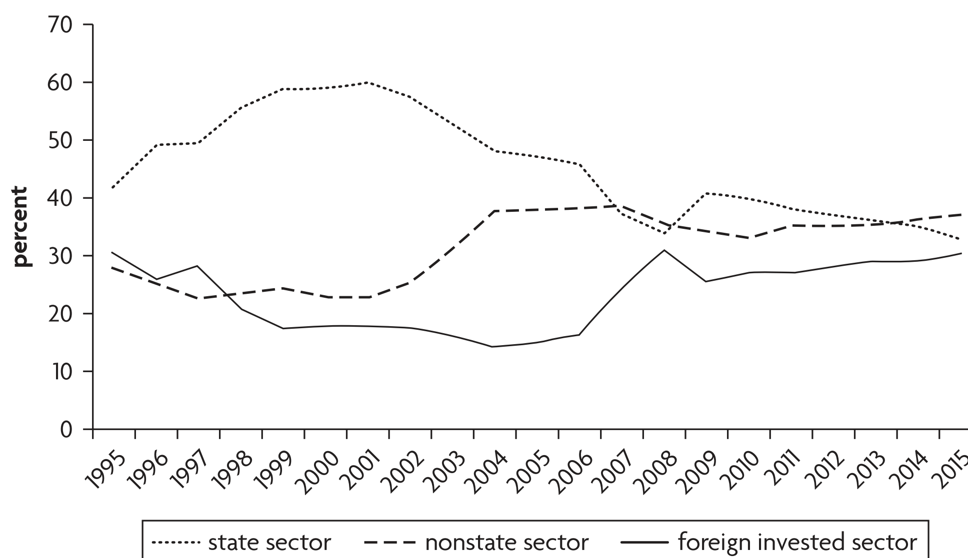
Source: World Bank Data Catalog; authors' calculations.

Projections for Investment. The investment ratio and GDP growth in Vietnam go hand in hand for the period under study (figure 12.8). This suggests that investment is critical for any medium-term GDP growth projection. Actually, according to the World Bank (2007), the large and increasing share of investment in GDP partly explains the growth rate acceleration since 2000.

Vietnam's economic growth strategy, which relied on extensive investment, was made possible by increasing government debt and heavy inflows of foreign savings (FDI and official development assistance [ODA]). FDI inflows have been an important source of funds for investment in Vietnam, accounting for over 30 percent of total investment.[37] Since the early days of economic reforms in the 1990s, Vietnam has enjoyed considerable transfers of resources in the form of ODA, most of which was in the form of nonrefundable grants or loans on highly favorable terms (with a large grant component). ODA has facilitated the construction of important infrastructure projects, rural development, education, training, and administrative reform. In the foreseeable future, given the commitments of donors, ODA will remain available, but the terms of ODA loans are bound to become less advantageous as Vietnam grows.

Unlike the situation in other countries, the private sector in Vietnam plays an important—but not a dominant—role in investment; instead,

Figure 12.9. Investment Structure by Ownership



Source: GSO, http://www.gso.gov.vn; authors' calculations.

the state sector has played the most significant role of the three sectors (figure 12.9). Until 2006, the state sector was the most important source of investment, but its share in investment has declined from 60 percent in 2001 to 33.9 percent in 2008, before rising again to more than 40 percent because of the fiscal stimulus package.[38] By the end of the past decade, the three sectors—state-owned, domestic nonstate-owned, and FDI—were more or less equal in terms of investment shares in the economy.

The general declining trend of the state sector is irreversible and contrasts with the increasing roles of the private domestic and FDI sectors. During the crisis, the investment share of the state sector recovered, but we do not expect the state's role to rise over the long term. Our projections for the three economic sectors are for the general declining trend of the state sector to continue and for the shares of FDI and domestic private sectors to increase—with the domestic private sector becoming the most prominent.

The question Vietnam faces now is whether it can still rely on the old strategy of investment-based development. The answer depends in part on its ability to sustain the inflows of foreign savings and on how the country uses such inflows. In the face of the government's growing need to secure additional funding, ODA takes on greater importance. This is

especially true when FDI inflows and export earnings are falling. On this front, the Japanese government has resumed its ODA for Vietnam; the Asian Development Bank granted Vietnam budget support of US$500 million; and, most recently, the government has secured an unprecedented level of ODA—US$8 billion—from international donors. While we expect that such cheap ODA funding will still be available in the medium term, ODA funds will become more expensive over the long term, and Vietnam may have more difficulty competing for them as its economy develops.

Given the worsened fiscal balance, owing to the fiscal stimulus and reduced future revenues caused by weaker economic activity, Vietnam will find it more difficult to sustain high economic growth with expansionary policies. But relative to the level of public debt among other ASEAN countries (ranging from 30 percent for Indonesia, over 42 percent for Thailand and Malaysia, 56 percent for the Philippines, and 113 percent for Singapore), Vietnam's public debt, at (44.4 percent of GDP), is moderate and expected to be sustainable. The debt level is similar to those of other ASEAN countries. Therefore, we expect that a moderate fiscal stimulus package would not cause serious fiscal impairment. Furthermore, joint IMF–World Bank analysis (2009) suggests that there is scope for further fiscal policy maneuvering in Vietnam, as the fiscal position remains strong.[39] We therefore project that in the medium term, the government may continue its investment-based growth strategy of incurring more debt and that the public-debt-to-GDP ratio will keep increasing.

As noted earlier, we expect that FDI inflows, although possibly lower than in precrisis years, will still be higher than the world average. Domestic interest rates may be a bit higher than in other countries, given the potential high return to investment in Vietnam. But we do not expect a sharp decrease in domestic private investment. Overall, we expect that in the next few years, the growth of investment in Vietnam will be slower than in 2009. According to the latest statistics from GSO, the investment growth rate in the first half of 2010 was 13.4 percent, lower than the 15 percent growth rate in 2009. We suspect that the growth rate will slow down gradually toward the 11 percent level during 2012–15.[40]

Medium-Term Growth Projection and Recovery Path

To assess Vietnam's recovery path after the global crisis, we use projections for various factors to derive the GDP growth path to 2015. On the

demand side, what would be the growth trajectory for Vietnam in the next few years to 2015? To answer this question, we look at the trends of the main components of aggregate demand—consumption, investment, and net exports. We do not expect consumption to change abruptly or significantly. However, the consumption level in Vietnam is already relatively high, particularly for the last few years, a condition we consider to be unsustainable. We thus expect that although consumption will keep growing, or even accelerating its medium-term growth rate will be around 7 percent by 2015, returning to the precrisis (2004–05) levels. However, in the meantime, the actual consumption growth rate would deviate from 7 percent. According to the latest statistics released by the GSO, the retail sales and private consumption increased by 16.4 percent in the first six months of 2010. This figure is used in our projection for private consumption growth in 2010. We expect that this figure would decline toward 7 percent by 2015.

Based on our projections about investment growth above, we are also able to project the investment trajectory for Vietnam to 2015. The last and most uncertain component is net exports. Vietnam has more than a decade-long trade deficit, which has worsened recently—due mainly to budget deficits and the overvalued exchange rate. As the share of investment by the state sector is expected to decline over the medium term, together with the expected depreciation of the Vietnam dong, in theory we would expect the trade balance to improve. But the trade balance may get worse before improving. As discussed above, the global crisis may help improve the trade deficit but the shortfall may worsen once the economy recovers. Since the beginning of the year, the economy is doing quite well and a number of international organizations have revised their estimate of Vietnam's GDP growth rate upward. Goldman Sachs revised up Vietnam's GDP growth rate to 8.2 percent in 2010 from its earlier estimate of 6.7 percent.[41] Similarly, in June 2010 the IMF revised its estimate to 6.5 percent from its earlier 6 percent in 2010, arguing that such projection is supported by a continued recovery in private investment, consumption, and nonoil export growth.[42] The government, however, has been even more ambitious, sketching a plan to achieve a GDP growth rate in the range of 7.5–8.5 percent from 2011 to 2015 while the growth rate for 2010 is targeted to be 6.5 percent.[43] The discussion above suggests that Vietnam may soon enjoy solid growth rates in

Table 12.11. Medium-Term Growth Demand-Side GDP Projection
(percent)

	Actual							Projected					
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Private consumption growth	8.0	7.1	7.3	8.3	10.8	9.2	8.4	16.0	11.0	10.0	9.0	8.0	7.0
Government consumption growth	7.2	7.8	8.2	8.5	8.9	7.5	9.0	7.0	7.0	6.0	5.0	5.0	5.0
Investment growth	11.9	10.5	11.2	11.8	26.8	6.3	15.0	13.4	12.0	11.0	11.0	11.0	11.0
GDP growth	7.3	7.8	8.4	8.2	8.5	6.2	5.3	7.5	8.0	8.2	8.3	8.5	8.5

Source: ADB Key Indicators; World Bank Data Catalog; GSO; authors' calculations.

the years to come provided the trends stay favorable (see table 12.11 for our medium-term projections).[44]

On the supply side, using the growth accounting framework, we also derive the potential GDP growth path for Vietnam up to 2015. In estimating potential output, we assume that the TFP growth rate will stay at about its annual average precrisis rate of 2.85 percent. Similarly, we assume employment growth of 2.28 percent per year, equivalent to the average of the last five years. Vietnam's potential output will then be about 8 percent per year (table 12.12). According to our projection, the economy of Vietnam will need another two years before it fully recovers from the crisis.

Policy Implication and Conclusion

Thanks to Vietnam's rapid economic growth over the past 20 years, it is expected to join the middle-income country group in the next year. The country's past success has been fueled partly by a series of gradual reforms and expansionary investment. But it must now decide how to sustain economic growth and avoid the "middle-income trap" in which many countries in the regions are stuck. The experience of China and other East Asian countries suggests that high growth rates can be sustained for more than 20 years, but other South-East Asian countries have shown that high economic growth cannot be sustained for so long.

In 2008, as the global financial crisis unfolded, its severe effects were felt on all continents, including in Vietnam. The crisis, together with the

Table 12.12. Medium-Term Potential Output Projection

Year	GDP growth (%)	Labor growth (%)	Investment (constant 2000 US$ millions)	Gross capital stock (K/Y = 2)	Capital growth (%)	Growth rate of TFP (%)
Actual						
2003	7.34	2.32	12,892	76,500	10.67	2.24
2004	7.79	1.82	14,251	84,802	10.85	2.96
2005	8.44	2.16	15,840	93,965	10.81	3.40
2006	8.23	2.38	17,715	104,167	10.86	3.02
2007	8.46	2.20	22,000	115,632	11.01	3.32
2008	6.18	2.45	23,872	130,694	13.03	0.20
2009	5.32	2.34	26,594	146,724	12.27	–0.33
Projected						
2010	8.20	2.18	28,987	164,515	12.12	2.90
2011	8.07	2.28	31,596	183,631	11.62	2.85
2012	8.08	2.28	35,160	204,209	11.21	2.85
2013	8.09	2.28	39,126	227,116	11.22	2.85
2014	8.10	2.28	43,539	252,615	11.23	2.85
2015	8.10	2.28	48,451	280,998	11.24	2.85

Source: World Bank Data Catalog and authors' calculations.

recent turbulence of macroeconomic development in the past two years, has revealed several economic weaknesses in Vietnam and raised the question of whether the country can continue on its current course of economic development in a changing world.

Rebalancing

With the current global imbalances, characterized by a huge deficit in the United States and surpluses in many Asian countries (especially China), the issue of rebalancing must be addressed. Although global rebalancing implies strengthening domestic demand in Asian countries, the optimal policy mix for rebalancing will necessarily differ across countries. As in other Asian countries, the issue of rebalancing growth has been hotly debated in Vietnam; the debate centers on whether the country should shift its focus to raising domestic demand instead of external demand. The following arguments have been put forward in favor of shifting toward domestic demand:

- For an export-oriented economy, a decrease in external demand would be more deflationary to the domestic economy than a similar decrease in domestic consumption.
- Given the United States' huge current account deficit, the export-led countries—such as China and Japan—should be less willing to finance U.S. imports.
- Vietnam is potentially a huge market for its own production given its large population (approaching 86 million), its high economic growth rate, and its becoming a middle-income country (Ohno 2009).

Admittedly, in view of the current global crisis, Vietnam inevitably will have to readjust its short-term growth strategy and shift away from its emphasis on export-oriented growth, especially if the crisis is prolonged. But Vietnam cannot rely on domestic consumption for long-term economic growth in the face of its already high level of consumption. Although domestic demand is currently substantial and keeps growing, household income is still low. Furthermore, unlike such large countries as the United States, China, and India, where domestic markets are large enough to sustain economic growth and absorb excessive production capacity, Vietnam has a domestic market that is much smaller. On the other hand, compared to China, Japan, and other large exporters, Vietnam is a small, open country and has the scope to increase its exports without worsening global imbalances. Moreover, in recent years, Vietnam has accumulated a large current account deficit.[45] Therefore, if Vietnam decides to sustain high economic growth in the medium term, it should continue with its export-oriented development strategy.

The above argument does not mean, however, that Vietnam's domestic market will play a less important role in the long run. Indeed, the government should emphasize some elements of domestic consumption—for example, it should provide more public goods, particularly those affecting the well-being of individuals—and address such economic bottlenecks as a lack of skilled workers and inadequate health care system. Global growth rebalancing will also affect Vietnam's macroeconomic variables; the country could see an increase in its saving rate as well as decreases in domestic consumption and investment.

Shifting Consumption Patterns

One of the often-cited structural causes of the global crisis is the unsustainable global imbalance between overconsumption in the United States (as reflected in its large current account deficit) and over-saving in China and other emerging East Asian countries (with large current account surpluses). Such unsustainable global imbalances will necessarily be rebalanced, either with a gradual adjustment or a sudden sharp adjustment caused by, for example, a global crisis. As a result, either the world consumption map may evolve into a multipolar one (featuring the United States, the European Union, Japan, and emerging consumer nations in Asia), which is the more likely scenario, or it may evolve into an Asia-centered, unipolar map.

In either case, the emergence of a consumption center in Asia (China, India, and other current account surplus countries) may have important implications for Vietnam's export strategy. With already high consumption and a low saving rate, Vietnam may not be able to become part of the consumption center. Instead, it may need to foster more domestic saving and rein in domestic consumption. In this case, resources would be shifted from manufacturing industries that are concentrated on exports to developed countries to industries and services that serve markets in China, India, and other emerging Asian countries.[46]

Another important consequence of China's rising wage is that the lower-end manufacturing is beginning to shift into other countries that are lower on the development ladder such as Bangladesh, Cambodia, Vietnam. The lower-end products include cheaper, labor-intensive goods like garments, toys and simple electronics that do not necessarily require skilled workers and can tolerate unreliable transportation systems and electrical grids.[47] This would surely create an opportunity for Vietnam to fill the vacuum left by China. However, this may not come automatically and may require active policy from the government (See also Nguyen and Nguyen 2010).

Economic Reform: Unfinished Agenda?

Vietnam's recent economic growth has its roots in policies of economic openness, with trade liberalization at center stage in recent decades. Since its joining the WTO in 2006, the country has experienced tremendous economic changes and fluctuations. Although it has received a large amount of FDI and (presumably) technology transfer, as a result of its

cheap labor cost and abundant natural resources, Vietnamese products and services are still less internationally competitive than regional competitors (See Nguyen and Nguyen 2010), due to high transaction costs.

Vietnam's WTO accession and membership is neither the beginning nor the end of the country's international integration. But the question is: Will traditional trade liberalization and openness policies still drive—and ensure—Vietnamese growth in the future? For many researchers and policy makers in Vietnam, economic reform based on traditional trade liberalization theory seems to have lost its momentum, as most of the country's tariff and nontariff barriers have already been removed. Finding a new engine for growth is a high priority. This is even more important in a time of crisis when the economy's competitiveness and advantages, relative to its trading partners and competitors, are most openly visible.

The following challenges, old and new, thus face Vietnam in the postcrisis era:

- *Infrastructure limitations:* The absence of good infrastructure could potentially obstruct the country's economic growth. One of the most pressing risks is a potentially serious power shortage, in which the national electricity system is unable to cope with the increased power consumption in the near future.
- *The need for a more skilled workforce:* A slow pace of human capital development can put an end to fast economic growth. The domestic supply of skilled labor remains a constant challenge and is mainly the result of a weak education system whose outdated curricula do not meet current work requirements.
- *The need to reform the state-owned enterprise sector:* The reforms of the SOEs have not seen much progress and recently slowed down significantly due to the global crisis. To improve the efficiency of the sector as a whole, particular attention should be paid to the contingency liabilities risk of SOEs. It is undeniable that guaranteeing these enterprises' borrowing is a good and efficient way of supporting them because it is less costly than a direct subsidy. However, by doing this, governments have to suffer potential risks such as having to pay the outstanding loans when borrowers default. The most recent case of near-collapse of a giant shipbuilder Vinashin testifies this risk (see Nguyen and Nguyen 2010).

Macroeconomic Stability and Crisis

Crises are very costly to long-term growth and development. Our previous calculations show that the current crisis is imposing heavy economic costs on Vietnam and that it will take until 2011 for the country to fully recover. Macroeconomic stability is very important in preventing potential crises, and Vietnam macroeconomic indicators are not good at present:

- Although inflation remains stable, it can get out of control once the world economy recovers.
- Trade deficits have recently been a recurrent problem for Vietnam and have reached unsustainable levels. Although most of the widening of the trade deficit is due to purchases of intermediate goods and capital equipment, many imported items have been semi-finished products and luxury consumption goods.
- The government has continued to run a budget deficit for many years. In 2009, the deficit is estimated to have increased because of the stimulus package. But even more worrying is the substantial off-budget spending in Vietnam.
- The volatile inflow of hot money into real estate and stock markets is cause for concern.
- Vietnam is hindered by the weakness of risk management and financial capacity supervision in many companies and financial institutions.
- Finally, Vietnam's inadequate system of gathering and analyzing information on financial market fluctuations and the lack of a reasonable roadmap for capital account liberalization remain challenges for its policy makers.

Notes

1. During 1980–88, some spontaneous microeconomic reforms such as the "output-based illicit contracting" in agriculture and "fence breaking" in the manufacturing sector were introduced (as early as 1981). These microreforms revitalized the economy and helped raise the production during 1982–85. However, such reforms were not sufficient to sustain economic growth, owing to the fundamental problems of resource misallocation and macroeconomic imbalances. In the mid-1980s, the inflation rate accelerated to several hundred percent, forcing the government to change the denomination of its currency. The privatization

process was accelerated in 2006 when the government allowed some large monopoly firms in the banking, insurance, petroleum, and telecommunication sectors to be privatized.

2. As other economies in transition, Vietnam has had to deal with three key sets of reforms: liberalization and stabilization; institutional changes that support market exchange and encourage private ownership; and the establishment of social programs to ease the pain of transition (World Bank 1996). The implementation has been successful, resulting in price stabilization and reduction of the fiscal burden. In 1989, inflation was under control and has remained low, except for 2004 and 2008.
3. The word "privatization" is often avoided in the context of Vietnam SOE reform. Instead, the conversion of state-owned enterprises into public limited liability companies is referred to as equitization.
4. Some evidence suggests that the private sector may not be quite as healthy and robust as the numbers imply. See the paper by the International Finance Corporation (IFC), "Beyond the Headline Numbers: Business Registration and Startup in Vietnam," http://www.ifc.org/ifcext/mekongpsdf.nsf/AttachmentsByTitle/PSDP-20/$FILE/PSDP-No-20-EN.pdf.
5. International integration efforts picked up beginning in the early 1990s, after the collapse of the Berlin wall and several years after Vietnam lost its traditional markets in Eastern Europe and the Russian Federation. The U.S. trade embargo against Vietnam was lifted only in 1994, and the relationship with the United States was normalized in 1995. Also, since 1993 Vietnam has began receiving official development assistance (ODA), which has contributed to the substantial increase in financial resources for investment in Vietnam's development.
6. In a recent paper, Abbott, Bentzen, and Tarp (2009) observe that each time Vietnam reached a significant bilateral agreement, trade flows with that partner surged.
7. Apart from FDI, Vietnam also started receiving ODA from international donors, and the amount committed and disbursed has been increasing since then. These capital sources have helped advance infrastructural construction in such areas as transportation and communication, information, agricultural and rural development, public health, education and training, administrative reform, legislation, and structural reform.
8. Specifically, on November 29, 2005, the National Assembly of Vietnam adopted the Law on Investment No. 59/2005/QH11 ("New LOI") and Law on Enterprises No. 60/2005/QH11 ("New LOE"), which apply to all enterprises established by domestic foreign investors.
9. Che, Kompas, and Vousden (2003) report that market reform leads to increases in rice productivity, pointing to the importance of market competition, secured property rights, and efficient use of resources. See http://www.crawford.anu.edu.au/degrees/idec/working_papers/IDEC03-7.pdf.

10. There are some limitations to this decomposition method as pointed out by Kranendonk and Verbruggen (2008). This method underestimates the importance of exports to the growth in GDP and overestimates the importance of domestic expenditure categories. The authors suggest an alternative method called "import-adjustment." However, owing to time limitations, we use the traditional method and estimate the contribution of exports and imports to GDP separately instead of using net exports.
11. The structure of imports and exports has been substantially changed over the course of development. Vietnam has exported oil and various manufacturing and agriculture processing products, and imported not only consumption goods, but also (and mainly) raw materials for domestic production, and initially progressive techniques and technology to promote the growth and efficiency of the economy. The composition of Vietnamese exports has gradually reflected the success of the industrialization process. The share of manufactured products—particularly labor-intensive products like textile and garments, footwear, and seafood—has been increasing and these now have replaced traditional agricultural products. In 2005, the share of manufactured handicraft products alone accounted for more than 40 percent of total export values (CIEM 2005).
12. The efficiency of the high level of investment has been questioned by various researchers owing to the high integrated capital-output ratio relative to other economies, such as Taiwan, China, or the Republic of Korea, when these economies were at the same stage of economic development. See also Rebalancing Growth in Asia by Prasad (2009).
13. Jensen and Tarp (2006) point out that private savings to fund private investment come as much from retained earnings of firms as from savings by households. Reinvestment of corporate profits appears to be an important means of maintaining high rates of investment and growth.
14. Vietnam requires registration of intended FDI, and not all such registrations are implemented.
15. In the debate about the current economic stimulus package, there has been little reference to the previous prolonged demand stimulus implemented in 2000–04.
16. A Cobb-Douglas function, $Y = AK^{a}L^{1-a}$, is assumed. L = employment or labor force (depending on whether or not employment data are available) and K = capital stock, computed using a perpetual inventory method. As there are no data on capital stock for Vietnam and these are needed to estimate TFP, we need to build a time series on capital stock for Vietnam using available information and some common assumptions. In Vietnam, although there are no capital stock data, investment data are available. We construct a capital stock series based on the following assumptions:
    (i) The capital stock in the initial year is proportional to output (GDP) in that year, that is, $K_0 = \lambda Y_0$. The parameter λ is referred to as the capital-output ratio. This assumption follows from the Harrod-Domar model, which

argues that there is a stable relationship between output and capital stock depending on the structure of the currently used technology.

(ii) The capital stock can be estimated using the perpetual inventory method, that is, $K_t = K_{t-1} - \delta K_{t-1} + I_{t-1}$, where δ is the depreciation rate and I is the gross investment during period $t - 1$. Usually, the depreciation rate is assumed to be about 6 percent a year. In our estimation, the initial year is 1986, and we assume that the capital output ratio is 2. We acknowledge that different capital output ratio would lead to different results.

17. For further details, see World Bank (2008).
18. Some would go further to say that without the global crisis, Vietnam would still have fallen into a recession on its own.
19. When investing in Vietnam, foreign investors are required to register their planned total investment capital (often referred to as registered investment capital), which in practice may differ substantially from the actual amount invested (implementation capital).
20. See also a study by UNDP (2009). Other effects include lower demand for Vietnamese workers in other countries, such as Malaysia; Taiwan, China; and Middle East countries.
21. Since early 2009, VASS conducted repeated Rapid Assessment Surveys to assess the impact of the global crisis on Vietnam. The first survey, in early 2009, found that job losses were widespread in industrial zones (both in the North and the South), but few took the form of open layoffs. Nonrenewals of contracts and incentives for voluntary departures were more common. Job losses were frequent among seasonal workers and those on short-term contracts. Some enterprises attempted labor-hoarding measures to retain their skilled employees. Unemployed immigrants were highly vulnerable, owing to the lack of social security and nonreversibility of immigration (the immigrant workers largely come from areas where arable land is scarce and other opportunities are few). Another survey of the impact of the global financial crisis on labor in industrial parks was conducted by the Central Institute for Economic Management (CIEM). Evidence from this survey suggests that job losses were widespread in industrial parks in late 2008 and early 2009. Remittances to families staying in rural areas suffered as a result.
22. The Vietnamese banking system has suffered only indirectly from the crisis. This is because the financial and banking sector was not fully integrated with the global network. Furthermore, the absence of such regulation as mark-to-market has helped the banking system in a time of crisis.
23. This decline in the dong's value is due mainly to the declining demand in exports and to portfolio outflows. The depreciation of the dong may help to improve Vietnam's export performance, limiting the negative impact from the global recession. However, a study by Jongwanich (2010) of a group of nine Asian countries finds a very weak link between the real exchange rate and export performance in these countries. On the contrary, world demand and production capacity play a more important role in determining exports of these groups of Asian economies.

24. The dong has been devalued by 2 percent by the widening of the trading band, to ±5 percent from ±3 percent around the central bank reference rate. Rapid credit growth, together with an expansionary fiscal policy, have led to a sustained increase in imports and a widening trade deficit. A larger demand for foreign exchange by importers, combined with market expectations that the dong would be devalued, led to a shortage of foreign exchange that was particularly severe in May–July 2009, and again in November 2009, imposing significant costs on enterprises. On the one hand, the shortage of foreign exchange in the formal market has helped narrow the trade deficit, but it has also created difficulties for businesses at a time when the government would most like to stimulate business activities.
25. The effectiveness of the fiscal stimulus packages that countries, developed and developing alike, are implementing is questioned by Foster (2009), http://www.heritage.org/Research/Economy/bg2302.cfm.
26. In some respects, the large state-owned sector has made the task of stimulating the economy much easier.
27. Since the first announcement of the stimulus package, several additional stimulus polices were adopted or announced, creating some confusion and prompting understandable concern about potentially unsustainable government spending.
28. See www.vneconomy.vn/20090828091054122P0C10/kinh-te-8-thang-buc-tranh-dang-sang.htm. In order to assist the economy further, the government is considering the second stimulus package; see http://vneconomy.vn/20090901102716178P0C5/he-mo-kha-nang-tao-buoc-dem-cho-nen-kinh-te.htm.
29. While most have agreed that the prompt introduction of the stimulus package provided quick protection for the economy, some debate continues about whether or not the package was able to target the most effective businesses and sectors. An overall and full assessment of the stimulus package may be necessary, but this falls outside the scope of this discussion. But another important impact, not often mentioned, of the strong response by the government was to restore the confidence of the business sector.
30. Other factors include the tight labor market before the crisis, the competitive nature of Vietnam's key exports, and the private sector's capacity to compete globally, despite cutbacks in demand for key export commodities (Manning 2009).
31. Tet break is Vietnam's traditional New Year holiday.
32. Positive growth of 3.8 percent is attributable to price increases and (re)export of gold. If gold (re)export is excluded, Vietnam would register negative export growth of 1.6 percent.
33. Our scenario proposed here resembles the last episode that Vietnam suffered in 2000.
34. Although Vietnam has been successful in attracting FDI in recent years, the real benefits from FDI still appear to be controversial. Previous studies have found little evidence of technical spillover from FDI enterprises to local counterparts (Nguyen et al. 2008). In addition, the country has become heavily dependent on

FDI capital as an important way to sustain economic growth. In 2008, FDI into Vietnam reached US$64 billion of registered capital (triple the registered FDI capital for 2007) and US$11.6 billion of implementation capital (versus US$8 billion in 2007).

35. Vietnam's economy depends heavily on imports (especially intermediate goods); therefore, once the world economy recovers, higher prices for Vietnam's key imports should lead to higher pass-through of import inflation. On top of that, the depreciation of the dong would lead to further pressure on inflation.
36. In Vietnam, increasing government spending at a time of recession with contracting revenues poses complicated questions. The national budget, which was already in deficit, was put under further strain by a marked reduction in revenue (lower revenue from lower economic activities attributable to the global crisis, and lower crude oil royalties owing to falling prices). When the crisis hit in 2008, the national budget was already under strain by a marked reduction in revenue. In the recent past, crude oil royalties have been an important source of revenue (and export earnings) for the government—with 16 percent of government revenue coming from oil export—but with global oil prices falling sharply from the highs reached in 2008, the government's revenue position is weak, leaving less scope for generous spending plans. In 2009, the government actually used up Dong 37.2 trillion (US$2.2 billion) from the budget for 2010 (budget advancement). This is not a healthy fiscal practice, and some expect it to lead to under-reporting of the budget deficit.
37. The current financial crisis has put Vietnam in a delicate position. On the one hand, it now would like to be more selective in attracting FDI; but on the other hand, it still needs to compete against other countries for the smaller pool of capital. The comparative advantages offered by Vietnam's abundant, cheap, skillful, and compliant labor force has largely disappeared and will become less important. Vietnam cannot rely on an unskilled-labor advantage to compete for FDI as it could in the past 20 years. Therefore, rather than seeking greater investment for its own sake, policy makers should concentrate on building a climate conducive to efficient investment. Vietnam still lags far behind other countries in the region in this respect. The supporting domestic manufacturing sector has not emerged.
38. State investment is made either directly into public infrastructure or through loans to SOEs, or in the form of grants to municipalities and private enterprises.
39. The baseline scenario of the most recent debt sustainability analysis (DSA) by the World Bank and the International Monetary Fund (IMF) estimates public and publicly guaranteed debt to increase from 44 percent of GDP in 2007 to around 51 percent by 2016, and decline slightly thereafter. There are two important aspects of Vietnam's debt. First, the government has a long history of prudent external debt, and a large component of its external debt is highly concessional—with long repayment periods and low interest rates. Therefore, although this increase is large, it is still considered manageable. External debt,

both public and private, is projected to decline somewhat—from a little over 30 percent of GDP to just under 26 percent in 2017. The ratio of external-debt-service payments to exports is estimated to remain about 4 percent during 2007–17. The DSA concludes that Vietnam should thus remain at low risk of external debt distress. Further details of the DSA can be found at http://imf.org/external/pubs/ft/dsa/pdf/dsacr09110.pdf.

40. Except for 2007, when the investment growth rate was 26 percent, owing to large FDI inflows.
41. See http://74.53.24.87/news/articles/economy/111283045.shtml.
42. http://www.imf.org/external/np/dm/2010/060910.htm.
43. http://vneconomy.vn/20100517094952600P0C9920/tang-truong-5-nam-toi-muc-tieu-85-la-chap-nhan-duoc.htm and http://www.maivoo.com/2009/10/20/Dong-thuan-muc-tieu-GDP-nam-2010-tang-6-5-n79242.html.
44. It should be noted that due to large statistical errors in the national account, using projection methods based on components of GDP is difficult. We instead use these trends in informing our subjective judgment.
45. Unlike many export-oriented Asian economies, Vietnam has been running a trade deficit.
46. Global saving glut in the words of Ben Bernanke, the chairman of U.S. Federal Reserve in 2005. See www.brookings.edu/opinions/2009/0802_china_spending_prasad.aspx and http://blogs.harvardbusiness.org/hbr/hbr-now/2009/08/trend-to-watch-shifting-consum.html.
47. See http://www.theepochtimes.com/n2/content/view/39318/.

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Discussant Paper

Comment on "Vietnam: Surprising Resilience but Challenges Ahead"

Sudarshan Gooptu

The authors have carefully reviewed the structural transformation that took place in Vietnam over the past two decades until the global crisis in 2008. They appropriately discussed how the Vietnamese economy was affected by the crisis in spite of the government's sustained and comprehensive policy reforms. These reforms included an "open-door policy to attract foreign direct investment (FDI) and trade liberalization," which was instrumental in creating a "growing and dynamic private sector." The country achieved remarkable poverty alleviation, with the total poverty incidence falling from 58 percent in 1993 to 16 percent by 2006. Literacy and life expectancy were rising and the under-five mortality rate was declining. A stable macroeconomic environment and high GDP growth seemed likely to continue—until 2008. This backward-looking part of the article is highly informative and contains a rich analysis of key economic variables and a lucid, though brief, discussion of the immediate impact of the fiscal stimulus implemented post-2008.

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Among the country case studies in this book, Vietnam's experience stands out in that even before the September 2008 global financial crisis hit, the Vietnamese authorities were implementing stringent fiscal consolidation measures to cope with the effects of the global food and fuel price hikes it faced at the end of 2007. Concerns of overheating had also emerged in early 2008, owing partly to the rapid increase in the role of domestic demand in GDP growth between 2005 and 2007. (Table 12.2 is telling in this regard; it shows the importance of domestic spending on the build-up of gross domestic capital formation, inventories, and a rapid increase in imports in Vietnam's GDP growth decomposition.) Vietnam's fiscal consolidation, together with its reserve build-up (a result of continued high export revenues and FDI inflows) helped the country to cope with the global downturn of late 2008, relative to other developing countries, as it had adequate room to undertake a rapid countercyclical fiscal expansion.

The question remains: how important have total factor productivity (TFP) increases been (especially in agriculture) to Vietnam's growth path? In the section on growth accounting, the choice of the Cobb-Douglas production function assumes that the relationship between output and the capital stock is stable for the period 1986–2008. Does this mean that the structure of the technology in production in Vietnam did not change during this period? Also, it would be useful to compare the growth trends of TFP between Vietnam and its main trading partners and developing countries with similar production structures. This would shed more light on the importance of TFP to Vietnam's growth process relative to, for example, China's.

Where the paper needs a bit more attention is in the forward-looking part, that is, in the discussion of the country's medium-term outlook. Here, the focus should be on the need for better risk management going forward—whether it is the fiscal risks attributable to contingent liabilities of state-owned enterprises or large business houses that dominate Vietnam's economy today, the risk of increasing job losses, or the risk of a drop in foreign demand and/or remittances. Managing these risks will not be easy, especially in a volatile global environment where the shape and speed of recovery in the advanced countries (many of which are Vietnam's trading partners) are being hotly debated today. In forming an opinion about Vietnam's export price outlook, one may need to look a