

II. ECONOMY IN TRANSITION

Viet Nam has recorded one of the best performances internationally in terms of economic growth, increased household welfare, and poverty reduction during the last two decades. Real Gross Domestic Product (GDP)³ grew at a compound annual rate of 7 percent. GDP per capita increased more than four times, from US\$146 in 1990⁴ to US\$630 in 2005.⁵ This rapid economic growth has been accompanied by a sharp reduction in poverty. The poverty rate has declined substantially from 58 percent in 1993 to 19.5 percent in 2004⁶. Key human development indicators such as life expectancy and educational and health data have also improved significantly.

A wide range of transitional reforms has been carried out in Viet Nam, including a greater reliance on market forces in the allocation of resources and in the determination of prices with a corresponding reduction in the command structures for allocating resources. In the financial sector, important changes have been introduced to the structure, the regulatory system, and the operations of banks. Banks have been gradually strengthened and are beginning to develop a credit culture. They are undergoing a multi-year restructuring and recapitalization program. These bank reforms are expected to give businesses expanded access to finance, in turn facilitating the overall economic development. State-Owned Enterprises (SOEs) have also been undergoing a more gradual restructuring process, paving the way for the development of a multi-sectoral economy. As a result, the number of SOEs has been reduced considerably to about 3,000.⁸ However, even when SOEs are equitized, the State still holds a majority of the ownership. Private enterprises have been formalized and are growing at an accelerating pace, especially since the Enterprise Law was introduced in 2000 and many business licensing restrictions were removed. The number of private firms now stands at about 200,000.⁹

In parallel with domestic reforms, Viet Nam has undergone a process of opening its economy to regional and global economic forces. Viet Nam joined the Association of South East Asian Nations (ASEAN) in 1995 and became a member of the ASEAN Free Trade Area (AFTA). It is also a member of the Greater Mekong Subregion (GMS) Economic Cooperation Program and of the Asia-Pacific Economic Cooperation (APEC), the summit of which Viet Nam will be hosting for the first time in autumn 2006. Viet Nam has also successfully concluded bilateral negotiations with all concerned trade partners in preparation for its accession to the WTO, which is now only a matter of time and formalities. In line with commitments made under these international agreements, significant progress has been made in liberalizing foreign trade and promoting Foreign Direct Investment (FDI). As a result, the dollar value of exports has increased from nearly US\$0.9 billion in 1986 to US\$36.5 billion in 2005,¹⁰ marking an annual compound growth rate of 21.6 percent. Foreign investors have been attracted in increasing numbers and FDI commitments and disbursements have seen a steep rise.

3 GDP is the total market value of all final goods and services produced in the domestic economy in a given period of time, generally one year. Real GDP is GDP measured at constant prices, i.e. at a specific year's prices. Real GDP thus allows comparison of the volume of output over time as the inflation effects have been removed.

4 The GDP per capita of 1990 has been converted into equivalent values using 2005 prices so that the comparison will then reflect the real changes, i.e. changes in real purchasing power. The actual per capita income in 1990 was US\$98 which, when adjusted to 2005 prices, amounted to US\$146 per capita.

5 For purpose of comparison, the World Bank currently compiles Gross National Income (GNI) per capita for reporting countries and, according to this indicator, Viet Nam ranks 168 out of 208 countries with US\$540 in 2004. In the World Bank's Purchasing Power Parity (PPP) comparison, Viet Nam ranks higher at 149 with a PPP income of US\$2,700 per capita. PPP per capita is based on the cost of a standard basket of goods, priced in each country.

6 Poverty data was taken from the Viet Nam Household Living Standard Survey (VHLSS) by the General Statistics Office (GSO), which has been carried out three times, in 1992/93, 1997/98, and in 2004. These specific figures were taken from World Bank (2005a).

7 More information can be found in UNDP (2001) and World Bank (2005a).

8 During 1989-1993, the number of SOEs was halved from 12,000 to 5,800 (World Bank, 2001) and was since further reduced to below 3,200 by the end of September 2005 (World Bank, 2005a).

9 Source: Ministry of Planning and Investment, taken from "Testing Times" in Viet Nam Economic Times, May 2006.

10 Sources: IMF and Vietnamese authorities' estimates taken from Fforde and de Vylder (1996) and staff estimates for 2005. The actual value of convertible exports in 1986 was US\$0.5 billion, which, when converted to 2005 prices, amounted to US\$0.9 billion.

Progress since the Beginning of *Doi Moi*

During the main transition years, 1988-1991, when the economy was undergoing fundamental changes and was exposed to external shocks¹¹, growth was still positive and at a relatively high level of 5.4 percent per annum. The positive response of the supply side to the various reforms under *Doi Moi* was impressive. As prices were liberalized and competition introduced, agricultural production picked up rigorously, especially in 1989, rising at 7 percent. The services sector, also benefiting from liberalization measures, was booming and recording an average growth rate of 8.5 percent between 1988 and 1991. Industrial production, which had been supported by large-scale Soviet aid, initially stagnated. In 1990, however, it started expanding and accelerating to nearly 8 percent growth in 1991. The resilience of industrial output was significantly aided by the development of oil production. But even without the oil factor, Viet Nam's industrial sector would have still performed much better than that of other transition economies.¹²

In the subsequent period, 1992-2004, growth was reflected throughout the economy. Industry was the leading sector, growing at 11.1 percent per annum. The industry's rapid expansion was due to its ability to take advantage of improvements in the business environment brought about by *Doi Moi*, including greater autonomy in production as well as, increased access to the global market, foreign capital, and technology. Labor-intensive, export-oriented industries such as garments and footwear were thriving. Services also grew steadily at more than 6.9 percent per annum. For example, the opening of the economy enabled tourism-related service industries to emerge and flourish.

Spurred by land reforms and price liberalization, the agricultural sector registered a solid average annual growth rate above 4 percent, which was impressive compared to both historical trends and international experiences. In addition, agricultural production was being diversified towards higher value-added products such as coffee, cashew and higher quality rice. The Vietnamese agricultural sector made an important shift from the household subsistence economy to commercial production and export market orientation.¹³ The agricultural growth and transformations not only helped ensure national food security, which had been a concern in the 1980s, but also contributed substantially to exports and rural incomes. In the 1990s, Viet Nam became the world's second largest rice exporter and one of the major exporters of several other agricultural commodities such as coffee and pepper.

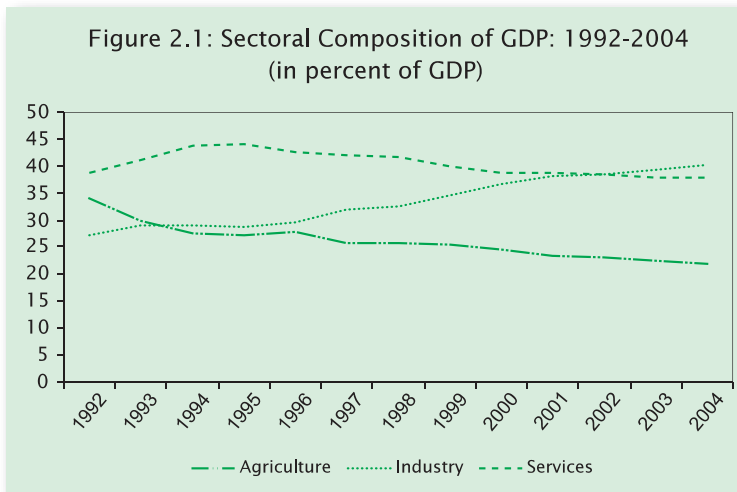
¹¹ The CMEA-based trade system collapsed and Soviet aid was abruptly cut off.

¹² See Dodsworth et.al., (1996) for a more complete analysis of Viet Nam in the early transitional period.

¹³ For a full discussion of patterns and trends in agricultural diversification in Viet Nam, see Volume 4 of the World Bank report "Accelerating Vietnam's Rural Development: Growth, Equity and Diversification" on Agricultural Diversification in Vietnam, available at <www.worldbank.org.vn>.

The differential sectoral growth rates have contributed to a positive shift in the structure of the economy. At the outset of the transition, Viet Nam was a largely agricultural economy with agricultural production accounting for 40 percent of GDP in 1987. Although the agricultural sector continues to utilize the majority of the labor force, it has been gradually losing its share of total GDP, from 33.9 percent in 1992 to 21.8 percent in 2004. During the same period of time, industry has been gaining increased importance in the economy with its GDP share rising from 27.3 percent to 40.2 percent. Economic restructuring seems to have mainly occurred between the agricultural and industrial sector, while the share of the service sector of total GDP has remained rather stable, as shown in Figure 2.1. This trend

appears to be in line with what is expected from a country in the early stage of industrialization, i.e. moving away from agricultural production towards industry and services.



Source: General Statistics Office (GSO)

In terms of ownership, early growth was largely driven by the household sector which assumed a dominant role in the economy and expanded vigorously in the late 1980s and early 1990s. The number of household businesses increased from about 840,000 in 1990 to 2.2 million in 1996.¹⁴ This marked expansion of household businesses enabled the domestic private sector to absorb most employment growth including a number of workers laid off from the State sector. Households were however engaged mostly in agriculture, handicrafts and limited retail trade services.

While the contribution of agriculture and the household sector to economic growth and poverty reduction in the initial years of *Doi Moi* was impressive, it was generally in the form of low productivity and low income employment and cannot be a major source of continued growth. The GDP share of the household sector started to fall from 36 percent in 1995 to 30.2 percent in 2004. The private sector was then seen as a potential vehicle to increase employment and income. Nevertheless, despite its rapid growth in response to gradual removal of regulatory barriers in the 1990s, and especially since 2000, the private sector remained small with an average size of a few dozen employees and about US\$3,300 capital per worker.¹⁵ Its GDP share has been increasing from 3.1 percent in 1995 to 8.5 percent in 2004 and, accordingly, remains very small.

The State sector still accounted for a significant and fairly stable GDP share of about 40 percent. It also claimed a larger share of the savings channeled through banks, more than 50 percent of outstanding bank credit. However, the State sector absorbed a very limited proportion of the labor force. In fact, State sector employment was declining even in absolute terms, from 4.1 million in 1987 to nearly 3.3 million in 1997, which was less than 9 percent of all jobs in the economy.¹⁶

¹⁴ See Chapter 11 of Van Arkardie and Mallon (2003) for a more comprehensive analysis of household and private sector development in Viet Nam. Also according to Van Arkardie and Mallon (2003), prior to *Doi Moi*, the household sector was then considered more acceptable than the private firms that employed a larger number of workers.

¹⁵ Source: Dapice (2006).

¹⁶ While total labor force increased from 28 million in 1987 to 37 million in 1997, State sector employment fell from 4.1 million to nearly 3.3 million. This means over 100 percent of new jobs created between 1987-1997 were in the private sector (Dapice, 2006).

Viet Nam has also recorded a high rate of capital accumulation which has made a significant contribution to its impressive economic performance during the last two decades. The gross capital formation as a percentage of GDP rose from 17.6 per cent in 1992 to 35.6 per cent in 2004.¹⁷ More important than capital accumulation, however, is the allocation of investment. In this respect, Viet Nam deserves high marks for providing public investment priorities to infrastructure improvements. According to a recent study by the World Bank on Viet Nam's infrastructure, total investments in infrastructure have been close to 10 percent of GDP in recent years. This level of investment in infrastructure is very high by international standards and is expected to provide substantial support to economic growth and poverty reduction in the longer term, given that those investments are undertaken in an effective and efficient manner.

Recent Developments

Real GDP growth picked up in 2005 to reach 8.4 percent, the highest rate since 1997. The strong performance of the economy was driven by exports and domestic demand, which more than offset the adverse impacts of renewed outbreaks of the avian flu,¹⁸ serious drought in the first half of the year, and increases in the prices of important imported inputs including fuel and steel.

The total value of exports of goods and services, calculated in dong, increased by 23 percent year-on-year. Viet Nam's garment exports faced challenges because they remained subject to quotas in the U.S. market while China as a WTO member benefited from the removal of textile and garment export quotas at the beginning of 2005. However, the continued strong performance of many other exports, especially crude oil, computers, and electronics helped sustain the high growth of total exports.

With regard to domestic demand, consumption rose by 14.4 percent, supported by the 30 percent wage increase for the civil service in October 2004, vigorous inflows of remittances from overseas Vietnamese, and higher incomes of farmers due to rising international prices of agricultural products. Strong consumption growth was also reflected in accelerated retail sales, which increased almost 21 percent in 2005.

Inflation accelerated to 8.1 percent from an already high level of 7.8 percent in 2004. Inflation in 2005 was largely driven by rising food and fuel prices and facilitated by an accommodative monetary policy. The prices of food and foodstuffs increased by 11 percent. Domestic petroleum prices were adjusted to international prices, though with lags and not to full extent, and were raised three times in 2005, exerting upward pressures on most goods and services. Transport costs, for example, were pushed up by about 8 percent in 2005. The increases in civil service wages in October 2004 exerted additional inflationary pressures.

Investment, in nominal terms, exceeded the overall growth rate, rising at about 17 percent, to reach nearly 300 trillion dong (US\$19 billion).¹⁹ Private sector investment continued to expand rapidly in response to increasingly favorable business environment. About 40,000 new enterprises were registered in 2005, representing a year-on-year increase of 9 percent in number and 45 percent in registered capital.²⁰ FDI

¹⁷ GSO data from various issues of the GSO Statistical Yearbook.

¹⁸ Viet Nam has lost more than 20 percent of its poultry stock, which is worth about 0.2 percent of GDP. Other losses were in the form of lower egg production and reduced distribution activities. Additional costs were the expenses of prevention and control measures. The World Bank has estimated these direct costs at about 1.2 percent of GDP (McCarty, 2006).

¹⁹ Converted at the exchange rate of 15,839 dong to the U.S. dollar.

²⁰ Ministry of Planning and Investment data as quoted in World Bank (2006a).

commitments also recorded a steep rise of 36 percent from the level of 2004, marking the highest annual growth rate since 1997.²¹ Nevertheless, a significant but declining share of total investment still came from the State sector (Table 2.1).

Table 2.1: Investment by Ownership
(percentage of total investment)

	2001	2002	2003	2004	2005
State investment	59.8	56.3	54.0	53.6	51.5
Non-State investment	22.6	26.2	29.7	30.9	32.2
FDI	17.6	17.5	16.3	15.5	16.3
Total investment	100.0	100.0	100.0	100.0	100.0

Source: Ministry of Planning and Investment ²²

On the supply side, industry continued to be the main driver of growth. Real GDP originating from the industrial sector increased by 10.7 percent, with the manufacturing sub-sector rising more rapidly at 13.0 percent. By sustaining a pace of growth relatively higher in comparison to other sectors, the industrial sector has accounted for an increasing share of total GDP, which reached 41.0 percent in 2005. The strength in industry was supported by an increasingly diverse industrial base, improved infrastructure, rising demand for some industrial exports such as coal and processed seafood, and higher domestic demand for consumer goods. Domestic industrial expansion has also resulted in increased import substitution of some inputs and capital goods such as steel and machine tools.

Services sector growth strengthened to record 8.5 percent in 2005. This was the first time the services sector had been able to register a growth rate higher than the overall GDP growth.²³ The main areas of growth in services were retail trade and tourism-related services such as hotels, restaurants, and transport. Growth in these services was mainly aided by the rapid increase of nearly 20 percent in international arrivals in 2005.²⁴ However, important service industries, including finance, banking, and insurance, which have the potential to generate substantial value-added, are currently making up a very small share in total GDP with less than 2 percent. This unfavorable structure of the services sector needs to be taken into due consideration as it might hamper Viet Nam's growth performance in the long-run.

The agriculture sector had a difficult year in 2005, hard hit by drought, a typhoon and the resurgence of avian flu. Total loss resulting from the drought was most serious, estimated by the Ministry of Agriculture and Rural Development at about 0.7 percent of GDP.²⁵ Spurred by rising international prices of agricultural products, the sector managed to overcome these difficulties to register a 4 percent growth in value-added. Nevertheless, the agricultural sector continued to decline in relative terms, with its share of total GDP below 21 percent in 2005.²⁶

²¹ Extracted from CIEM (2006).

²² This data is also taken from CIEM (2006).

²³ This is based on the GSO data series of GDP and services growth.

²⁴ GSO Economic Report December 2005 available at <www.gso.gov.vn>.

²⁵ This was extracted from the Economic Intelligence Unit's (EIU) Viet Nam Country Report July 2005.

²⁶ This reflects a natural process of economic development and productivity trends. In the longer term, those in rural areas move to more productive non-agricultural activities while the productivity of the remaining farms also increases. This development will eventually lead to a small share of agriculture and a high level of productivity comparable with that in developed countries. More discussion on this issue can be found in development economics textbooks such as Todaro and Smith (2003).

Outlook

The outlook for the economy can be based on several assumptions, including Viet Nam's accession to the WTO in late 2006 or early 2007. This prospect is quite certain now given that Viet Nam has successfully completed its negotiations with the U.S. in May 2006, which was the last bilateral agreement required before accession. Most importantly, WTO obligations are expected to push the Government's reform agenda ahead and increase competitive pressures on local firms. This will help the economy to acquire the necessary strength for long-term development.

Viet Nam's economy is expected to continue on a solid expansionary path in the coming years. The pace of growth may, however, slow down to 8.2 percent this year and to about 8 percent in 2007-2008. With these growth rates, GDP per capita is estimated to reach US\$860 in 2008, on track to meet the Government's targets for 2010.²⁷ In terms of expenditure, GDP growth will continue to be driven by robust domestic demand as a result of strong consumer and business confidence.

Strong consumption growth will be buttressed by continued strong growth in income and private remittances from overseas Vietnamese. Investment growth will be vigorous, boosted by a sharp upturn of 36 percent in FDI commitments in 2005. Such commitments will further accelerate when Viet Nam becomes a WTO member, assuring a consistent and predictable set of rules for investors. The recent US\$605 million commitment by Intel to build a semiconductor assembly and test facility in Ho Chi Minh City marks the largest investment by any U.S. company in Viet Nam to date.²⁸ It is expected to pave the way for other companies to invest in Viet Nam, giving a further boost to FDI inflows in the coming years. Private investment will be further stimulated with improvements in the business environment brought about by two new pieces of legislation, the Law on Investment and the Enterprise Law, which will come into effect in mid-2006. The ratio of investment to GDP is thus expected to increase from the current level of 35.7 percent to 38.6 percent by 2008.

Export revenue growth will remain strong in 2006-2008, though at a slightly lower pace than the very high levels recorded during the last two years. While the recent favorable rises in global prices are expected to eventually come to an end, the price of crude oil has been rising rapidly in the first half of 2006, ensuring continued growth in revenue from Viet Nam's main export commodity this year. Rice prices are still on an upward trend and thus augmenting Viet Nam's receipts from rice exports. Anti-dumping duties imposed by the U.S. on shrimps, and the EU on leather footwear exports²⁹ will lead to lower revenue in these sectors. Garment exports will no longer be subject to the U.S.'s quota when Viet Nam joins the WTO, but this may trigger other countervailing restrictions. Demand for Viet Nam's exports might be somewhat restrained by the forecasted economic slowdown in the U.S., Viet Nam's largest export market.³⁰ The slowdown is, however, not expected to be substantial and will be partly offset by the forecasted strong growth in Asia.³¹ The EU economy, another important export destination for Viet Nam, is also expected to pick up, which should be another favorable factor for Viet Nam's export growth.³²

Inflationary pressures of high commodity prices in the world market are expected to remain, though abating in magnitude, in 2006. The Government had been trying to contain the inflationary impact on domestic fuel prices by

²⁷ The Government's targeted level of GDP per capita in 2010 is US\$1,050-1,100 (Government of Viet Nam, 2006).

²⁸ More information can be found in the EIU Viet Nam Country Report April 2006.

²⁹ The anti-dumping duties were initially levied at 4.0 percent and will reach 16.8 percent after six months (World Bank, 2006c).

³⁰ The U.S. economy is projected to slow down slightly to 3.4 percent in 2006 and 3.3 percent in 2007 (IMF, 2006).

³¹ Developing Asia is expected to sustain strong growth of 8 percent and above during 2006-2007. Japan is expected to accelerate to 2.8 percent in 2006 before slowing down to 2.1 percent in 2007 (IMF, 2006).

³² Economic growth in the Euro area is projected to accelerate from 1.3 percent in 2005 to 2.0 percent in 2006 before declining marginally to 1.9 percent in 2007 (IMF, 2006).

reducing tariffs and providing subsidies to fuel importers. However, similar intervention is not expected to continue as the increasing drain by fuel price subsidies on the budget cannot be sustained. Domestic prices would thus have to be adjusted and inflation would reflect changes in international prices more closely. Nevertheless, oil prices are expected to fall gradually from 2007.³³ In addition, supply side shocks such as the outbreak of avian flu in the last two years are not expected to reoccur or at least to have a milder impact on inflation. Inflation is thus projected to remain high at 7.5 percent in 2006 before gradually declining to 6.5 percent in 2007 and 6 percent in 2008.

Industry is expected to be the main driver of overall economic expansion in the coming years. GDP originating in industrial production is projected to maintain a growth level of around 10 percent (Table 2.2). The strength in industry reflects the resilience of the export manufacturers, such as garment and textile producers, in an increasingly liberalized global trading environment. Viet Nam's accession to the WTO is expected to boost industrial production as exporters will be given quota-free access to the global market, and substantial foreign direct investment will flow in, responding to a more consistent and predictable business environment. Nevertheless, there are concerns over how long it will take Viet Nam to fully reap the potential benefits of WTO membership and whether it will be able to compete with other WTO members such as China.

Table 2.2: Real GDP by Sector of Origin

(percentage change from previous year, constant prices)

	2005e	2006p	2007p	2008p
Real GDP	8.4	8.2	8.0	8.0
Agriculture	4.0	3.2	2.7	2.1
Industry, of which:	10.7	10.2	9.7	9.7
Manufacturing	13.0	12.8	12.4	12.4
Services	8.5	8.6	8.7	8.9

(e = estimate; p = projection)

Source: staff estimates and projections

Growth in the service sector will remain strong and continue to exceed overall GDP growth.³⁴ It is expected to accelerate from 8.6 percent in 2006 to 8.9 percent in 2008, thereby somewhat closing the gap with industrial growth. Continued robust growth will be seen in retail services and tourism with international arrivals set to continue to rise rapidly. WTO membership is also expected to put competitive pressure on and give a boost to important service industries such as banking and insurance. In contrast, growth in agriculture will continue its downward trend to just above 2 percent. Global prices of agricultural commodities are already high and not expected to rise further. Agriculture's share of total GDP is projected to drop to about 18 percent in 2008.

Continued growth will have to be led by a strong private corporate sector. The adaptability and innovation of private enterprises, which are not seen in SOEs, are among the key success factors if Viet Nam is to maintain its growth momentum, especially when Viet Nam fully integrates into the global economy. In addition, the growth of a competitive private corporate sector can stimulate and put pressure on the State sector to improve their performance. As Viet Nam moves forward, promoting and developing a strong private corporate sector becomes indispensable.³⁵

³³ World Bank (2006b).

³⁴ The Government has the stated objective to keep the services sector growing at a higher pace than the overall growth of the economy (Government of Viet Nam, 2006).

³⁵ More elaborated arguments for this can be found in Van Arkardie and Mallon (2003).