POLICY BRIEF

ECONOMIC RECOVERY AND PROGRESS TOWARD THE SDGS:

VIET NAM

IN MULTIPLE TRANSFORMATIONS

Ha Noi, April 2021

Viet Nam has achieved impressive rates of economic growth and steady improvements in human development for three decades. The Government's early and effective response to the coronavirus pandemic helped Viet Nam avoid recession and even manage a modest expansion in 2020. A robust recovery is predicted for 2021, supported by a rebound in global demand and a gradual lifting social distancing measures and travel restrictions.

The Government has set a target of attaining high-income status in time for the nation's centennial in 2045. This is a challenging but obtainable goal. In the second half of the 20th century, East Asian countries emerged from war and extreme poverty to build prosperous economies pursuing a strategy of export-led growth. Some of the lessons from this experience are still relevant: the strategic role of manufactured exports; early and sustained investment in health, education and training; public support for research and development; and agricultural modernization to stabilize food prices and lift rural incomes. Viet Nam will confront new challenges, such as rising protectionist sentiment in the advanced countries and heightened risk of financial instability. Opportunities include a new trade deal with Europe, closer regional integration, and the development of new industries like e-mobility and cybersecurity.

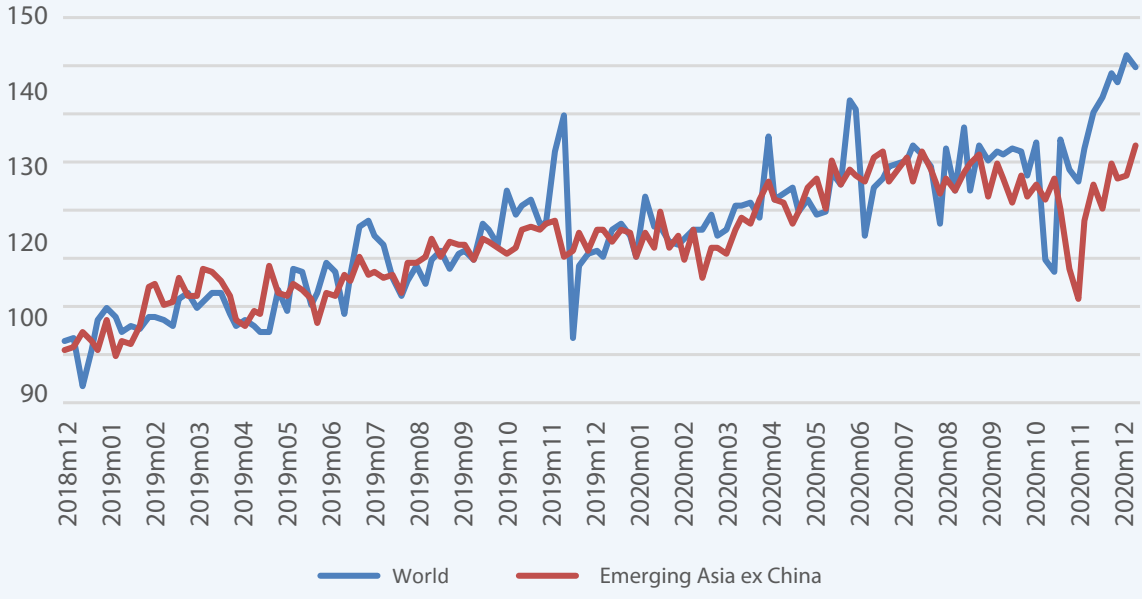
To realize its ambitions, Viet Nam must maintain a high rate of public and private investment, align infrastructure investments more closely to national and regional economic strategy, close the gap between the supply and

demand of long-term domestic financing and promote research and development, especially among exporting firms. Creating a favourable environment for private investment is important but not sufficient to sustain rapid growth. Reform of economic institutions is needed to reduce fragmentation and improve coordination among central government agencies and between central and local government.

THE GLOBAL CONTEXT AND ECONOMIC RECOVERY

The resurgence of Covid-19 infections in Europe, the Americas and South Asia in early 2021, and the appearance of new variants, have complicated efforts to predict the pace and breadth of the economic recovery. The recovery in exports in early 2021 and strength in forward-looking indicators like the purchasing mangers' indices are promising signs. However, risks are magnified by imbalances carried over from the Global Financial Crisis (GFC) in 2008, especially high levels of corporate and household debt, soaring asset prices, trade tensions and rising levels of within-country inequality. In fact, world export volumes were already falling before the pandemic, weighed down by trade disputes and a slowdown in economic growth in the advance countries (Figure 1). Exports from emerging Asia (excluding China) reached their post-crisis peak in May 2018, after which they declined gradually until the full force of the pandemic hit in mid-2020..

Figure 1. Export volumes, global and emerging Asia (except China), 2010=100



Source: Netherlands Bureau for Economic Policy Analysis

Policy makers in the advanced countries relied heavily on monetary policy in the wake of the GFC. Flooding markets with liquidity averted disaster in the financial markets but was less effective at restoring growth. Some advanced country governments even cut spending in a misguided attempt to reduce deficits during the recovery. The result of this combination of expansionary monetary policy and fiscal restraint was an uneven recovery, rising indebtedness, inflated asset prices and slow productivity growth. Fiscal policy will need to play a larger role in the recovery from the pandemic, supporting domestic demand and financing investment in productivity-enhancing infrastructure and technology, especially renewable energy, energy conservation and adaptation to climate change. High levels of indebtedness, including the rapid growth of dollar-denominated corporate borrowing in Asia, have increased the risk of financial turbulence.

The paradox of faltering productivity growth at a time of rapid technological change was a focus of debate in the pre-pandemic period. For some economists, the Third Industrial Revolution of microprocessors and internet communications changed much about the way we consume goods and services but did not transform production in ways that are analogous to electrification and the internal combustion engine of the Second Industrial Revolution. For others, the decisive factor is the decline in the investment rate especially in the high-income countries, which is itself a

product of slow growth of aggregate demand. Either way, the lesson for policy makers is that economic and political factors condition the impact of technological progress on productivity and income growth, and it would be naïve to assume that technological change on its own is enough to restore growth.

VIETNAM IN MULTIPLE TRANSFORMATIONS

In just a few decades Viet Nam has transformed itself from a planned to a diverse, mixed economy; from a producer of agricultural commodities to an exporter of manufactured goods; from a predominantly agrarian to an urban society; from a low-income to middle-income country; from a workforce of self-employed farmers and traders to one comprised mainly of employees and employers; and from a consumer to creator of technological innovation.

Viet Nam is now a wealthier, more mobile, urbanized and educated country than it was just twenty years ago.[1]

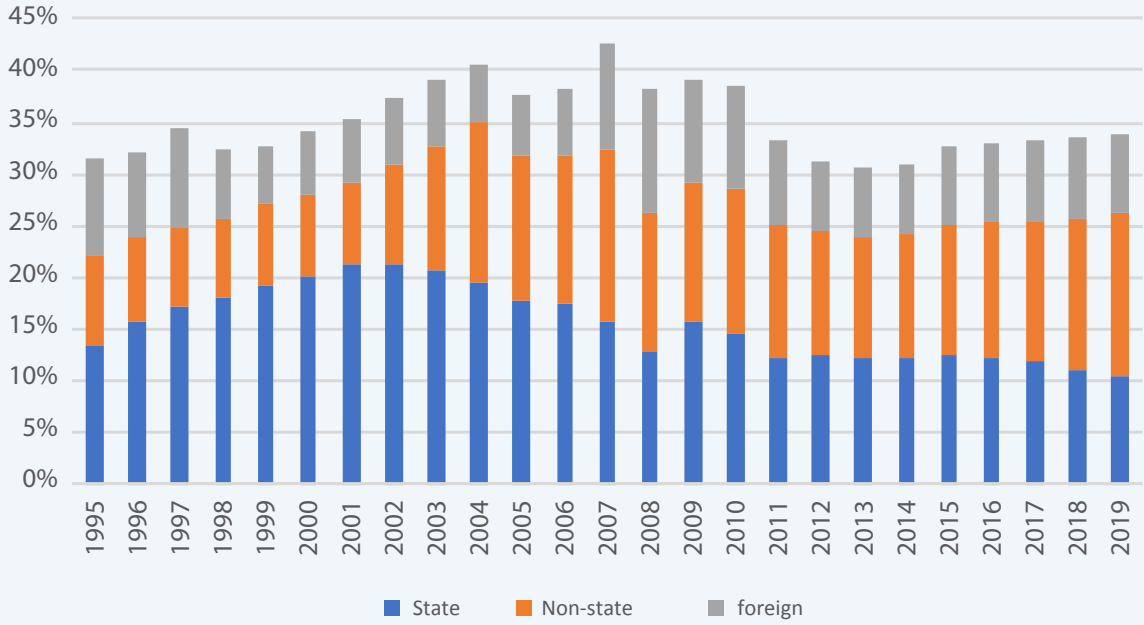
1 *xtreme income poverty, still widespread in 2000, now affects less than two percent of the population. In the same year, four out of every five workers were either self-employed or classified as family laborers, but by 2019 the labor force was equally divided between employees and the self-employed. The share of the labor force in manufacturing has risen nearly three-fold. The state sector now accounts for only one quarter of domestic output and less than one third of investment. Vietnamese are avid consumers of technology, with among the highest rates of internet penetration in the region. All statistics from the General Statistics Office website (www.gso.gov.vn) except for employment figures (ilostat.ilo.org) and internet penetration (World Development Indicators).*

These multiple transformations are interconnected but not synchronous. Progress inevitably unfolds unevenly across industries, sectors and regions, giving rise to contradictions and tensions between technological vintages, novel and conventional business practices, and modern and traditional attitudes. Yet as Albert Hirschman argued many years ago, unbalanced growth is not necessarily a bad thing (Hirschman 1972). Bottlenecks and the frictions that they cause often inspire the innovations needed to overcome barriers to change—a process popularly known as "fence breaking" in Viet Nam.

FINANCING PUBLIC INVESTMENT

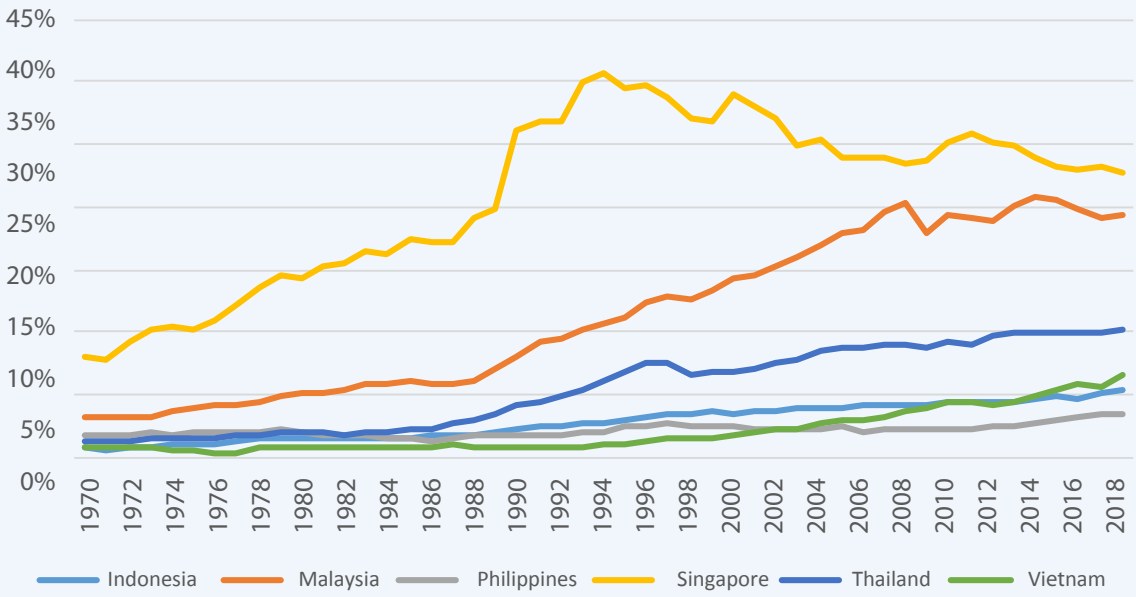
The public investment financing gap is one of Viet Nam's greatest challenges. From 2002 to 2019, public investment fell from 22% to 11% of GDP (Figure 2). Yet demand for infrastructure has never been greater. As a densely populated, coastal country with two low-lying deltas, Viet Nam is vulnerable to the effects of climate change. Public investment is needed for adaptation measures such as flood control, relocation of vulnerable populations, agricultural research, reforestation, and storm-proof housing. To remain competitive internationally, Viet Nam needs to reduce logistics costs and transit times, modernize cities and improve digital connectivity. Although progress has been made, Viet Nam still lags behind Malaysia and Thailand in these areas (Figure 3). Increasing investment in the country's national innovation system is a matter of urgency. Viet Nam currently spends just 0.5% of GDP on research and development, far below the level required to compete with its competitors in the region and beyond (Figure 4).

Figure 2. Investment as a share of GDP, 1995-2019



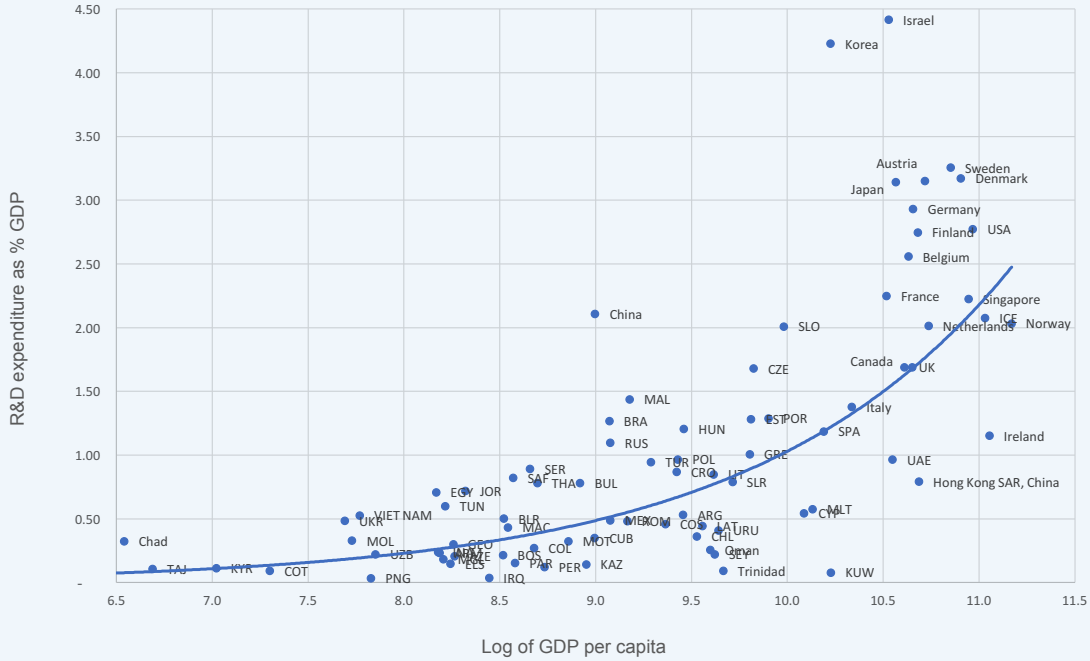
Source: General Statistics Office

Figure 3. Public capital stock as a percent of GDP



Source: IMF Investment and Capital Stock Database

Figure 4. R&D spending as % GDP and GDP per capita, 2016



Source: Authors' calculations from UNESCO and World Development Indicators

Foreign investment and Overseas Development Assistance (ODA) can help, but the reality is that most of the capital needed will come from domestic sources. As a foreign-exchange constrained economy, Viet Nam should restrict foreign financing to projects that are self-liquidating in the sense that they generate foreign exchange earnings or savings to repay the loans. Viet Nam needs new economic institutions to mobilize long-term, domestic capital and to allocate public investment more efficiently.

Multilateral institutions like the World Bank and the Asian Development Bank leverage their capacity to borrow at low rates on international bond markets to offer long-term loans (in US dollars) to developing countries. National development banks (NDB) fulfil the same function in domestic currency. A recent survey estimates that total assets controlled by NDBs was US$5 trillion in 2015, larger than the assets of all the multilateral development banks combined (Gallagher 2016). They are funded by government and national and international capital markets, and offer long-term loans and loan guarantees, usually co-financed by private lenders. Examples of institutions that have played a central role in national development include China Development Bank, Germany's KfW, and Brazil's BNDES. NDBs have the scale and sophistication to finance large, complex and technically advanced infrastructure projects involving multiple contractors and end users. Because projects are subject to a variety of technical, financial, ecological and social risks, NDBs build capabilities and experience in handling complexity and mediating among the various interests involved (Studart 2018).

Vietnam has two policy banks: the Viet Nam Development Bank (VDB) and the Viet Nam Bank for Social Policies (VBSP), the latter specializing in microfinance and loans to small and medium-sized enterprises. VDB mobilizes funds from government-backed bonds and official donors to finance infrastructure, exports and strategic industries. It offers long-term loans and guarantees commercial bank lending. From 2006-2016, VDB mobilized US$22.5 billion, including $9 billion for electricity generation and distribution (UNESCAP 2017). With assets on this scale, VDB is small relative to the size of the economy. Moreover, 75% to 80% of lending was directed to state owned enterprises in 2011 (Binh 2015).

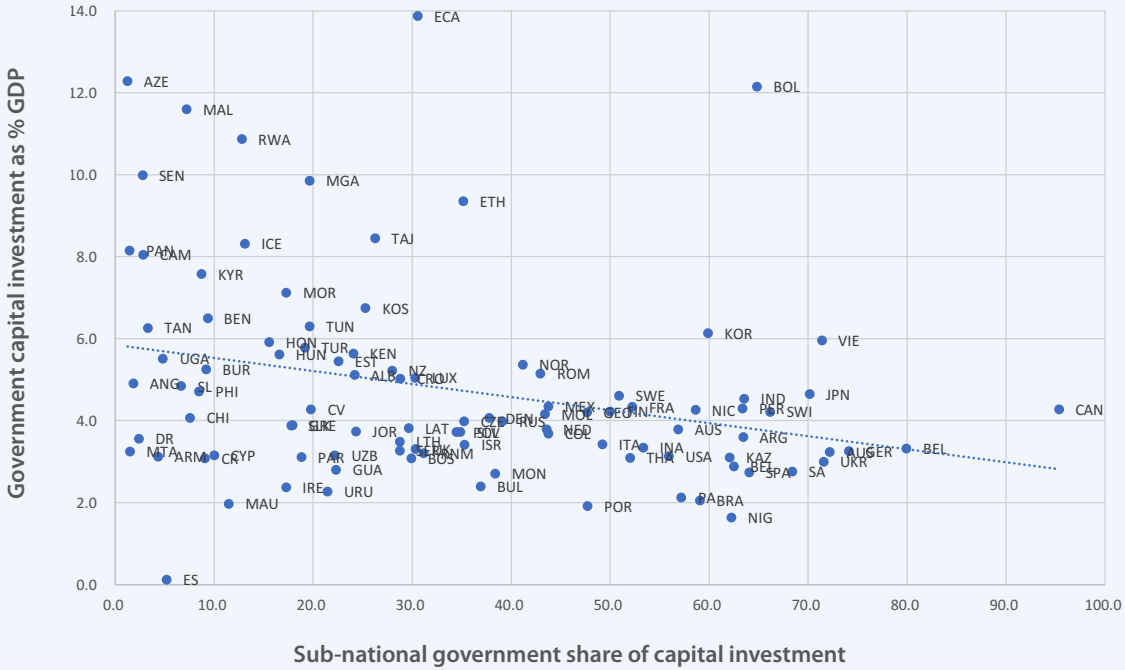
The domestic corporate bond market is another potentially important source of long-term financing. From a standing start in 2005, the market is now equivalent to ten percent of GDP. The main obstacle is the absence of reliable information in the market and credible ratings agency, which impeded the development of the secondary market. Accurate and timely reporting of bond trading data is also needed to increase transparency and liquidity.

MANAGING PUBLIC INVESTMENT

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

With more than 70% of disbursement under local control, Viet Nam is one of the most decentralized countries in the world with respect to public investment (Figure 5). Local control is associated lower levels of public investment because local government units are too small to realize economies of scale and also favour smaller projects. Local government is also constrained by the amount of funding it can raise and the cost of financing. Local revenue sources also are more pro-cyclical because of borrowing limitations (UNDP 2018).

Figure 5. Public Investment as % GDP and Sub-national government as share of total public investment, 2016



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

Over the past two decades Viet Nam has decentralized the planning, allocation and implementation of public investment. Plans are compiled from lists of projects submitted by ministries and provinces and approval is also in the hands of project owners for most classifications. The separation of approval from financing reduces the completion rate because of funding shortfalls and delays in implementation. National priority projects are approved by the National Assembly with support from MPI but local leaders also exert influence over these decisions because they make up a majority of members of the legislative body. Monitoring and evaluation are carried out by ministries and provinces with limited reporting responsibilities to MPI and MOF.

Fragmentation of the planning system has reduced the impact of public investment in every sector. Rather than develop integrated logistics systems that channel trade to two or three large ports serviced by long-distance freight services, Viet Nam has built hundreds of small ports connected to industrial areas by local roads. Every province has plans for an airport, a port and several industrial estates. Industrial activity is geographically dispersed, reducing the scope for agglomeration effects in export industries.

Fragmentation also causes delays in implementation as provincial government lacks capacity to manage large-scale public investment projects. Disbursement of public investment has declined as the system has become more decentralized (Figure 6). Although there are many reasons for the slowdown in project realization, weak planning and insufficient vertical coordination with line ministries and financing agencies are frequently to blame (UNDP, 2019). Even national priority

projects like the North-South Expressway and the Long Thanh Airport have been held up by capacity constraints at the local level. Land compensation procedures and negotiations are a common cause of delays.

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

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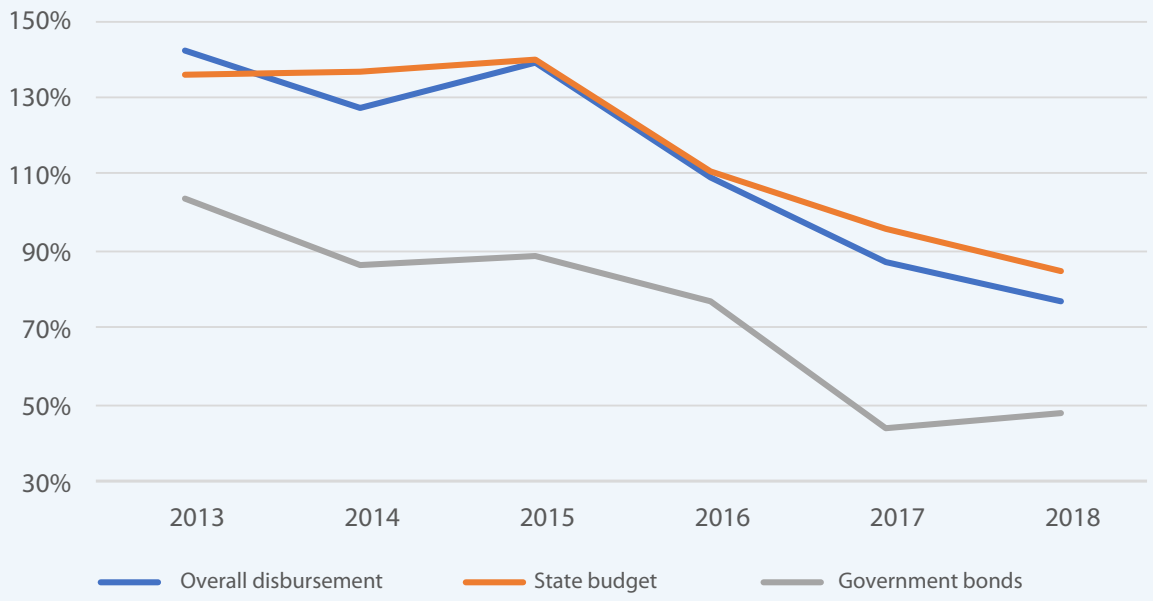
Figure 6. Public investment realization against capital allocation plan



Source: Ministry of Finance

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

The central government has lost control of approvals and financing under the decentralized system. With too many projects in the pipeline, resources are rationed based on requests from project owners. Underfunding results in project delays and hoarding of capital by projects that cannot disburse but that want to retain access to funds. Caps imposed by the medium-term budget framework are honored, but the allocation of capital between projects is unrelated to need and performance. Requiring adjustments to the medium-term investment program to obtain National Assembly approval introduces additional rigidities that reduce efficiency and impact.

INSTITUTIONAL TRANSFORMATION AND THE NATIONAL INNOVATION SYSTEM

The fate of manufacturing firms is increasingly tied to technological capabilities. Failure to innovate at the required rate can mean not just lower profits but the failure of the company and the destruction of its capital. Firms are locked in a "technological arms race" in which they must at least match the R&D spending of their competitors. R&D spending doubled in the first two decades of the millennium and now exceeds US$2 trillion per year. In the advanced countries, the public sector has stepped up R&D spending through various channels, including higher spending on the military technology and other forms of public procurement, support for public and private research institutions and universities, energy policy and support for SMEs. The idea of the "entrepreneurial state" has moved into the mainstream as the pace of technological innovation has accelerated and the social and political costs of falling behind have become more apparent (Mazzucato 2015).

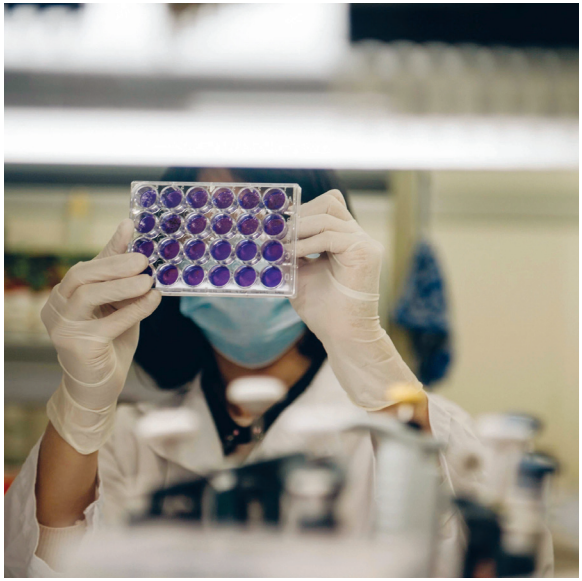
The central role of technological change in the development of firms has rekindled interest in National Innovation Systems (NIS), a broad category consisting of an array of institutions including enterprises (especially in high-tech fields), public and private research institutions, government agencies, universities and other training institutions, banks, investment funds and other private investment vehicles. The roles that these institutions play vary from place to place depending on structural and historical factors. Developing countries have borrowed institutional

forms from successful countries, but these models need to be adapted to local conditions and evolve as the economy develops and technologies change (Lundvall 2010).

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

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

Viet Nam's national innovation system consists of public research institutes, universities, high-tech parks, venture capital funds and tax incentives. Science and technology have been identified as priorities in successive five-year Socio-Economic Development Plans and ten-year Socio-Economic Development Strategies. Under the Science and Technology Law enacted in 2013, the national



government is required to allocate two percent of its budget to R&D. However, in every year since 2008 the government has fallen short of half this amount. The ambition of achieving a productivity breakthrough through science and technology has not been realized in practice.

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

Viet Nam has also had success in attracting foreign direct investment in the technology sector, including world-leading companies like Samsung, Intel, Microsoft, Apple, Nintendo, Canon and many others. The supplier firms of these apex companies soon followed, creating opportunities for domestic firms to participate in their supply chains. The main obstacle is scale: global companies need suppliers large enough to deliver massive quantities of standardized parts at the requisite quality and a competitive price. Vietnamese technology companies are still too small to produce at this scale, leaving global firms to turn to their regular suppliers (Pham 2019).

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

CONCLUSION

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

Infrastructure development is held back by poor regional and sectoral coordination. Decentralization of decision-making to the provincial level and separation of project selection from financing decisions has led to

a proliferation of small projects, duplication and missed opportunities to realize economies of scale. Weak local government capacity has contributed to cost overruns and delays. The costs of fragmentation are recognized in the Law on Planning enacted in 2017, but there has been no progress in implementation. Public investment decisions should be closely integrated into national and regional development plans and strategies, promoting industrial clustering wherever possible to enhance export competitiveness.

Viet Nam's national innovation system is underfunded and lacks a clear sense of mission and coherence. The aim of creating a supportive ecosystem for innovation is worthwhile but falls far short of what is needed to build the technological capabilities of national firms. A stronger focus on export growth, particularly in manufacturing, and instruments to increase demand for, as well as supply of innovation are urgently needed.

This policy brief was written by Nguyen Thang, Director, Center for Analysis and Forecasting Viet Nam Academy of Social Sciences, and Jonathan Pincus, Senior International Economist, UNDP Viet Nam. All of the views expressed in the paper are the authors, and do not necessarily reflect those of the Center for Analysis and Forecasting, The Viet Nam Academy of Social Sciences and UNDP.

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