

McKinsey Global Institute



February 2012

Sustaining Vietnam's growth: The productivity challenge



The McKinsey Global Institute

The McKinsey Global Institute (MGI), the business and economics research arm of McKinsey & Company, was established in 1990 to develop a deeper understanding of the evolving global economy. Our goal is to provide leaders in the commercial, public, and social sectors with facts and insights on which to base management and policy decisions.

MGI research combines the disciplines of economics and management, employing the analytical tools of economics with the insights of business leaders. Our “micro-to-macro” methodology examines microeconomic industry trends to better understand the broad macroeconomic forces affecting business strategy and public policy. MGI’s in-depth reports have covered more than 20 countries and 30 industries. Current research focuses on six themes: productivity and growth; global financial markets; technology and innovation; urbanization; the future of work; and natural resources. Recent reports have assessed job creation, resource productivity, cities of the future, and the impact of the Internet.

MGI is led by three McKinsey & Company directors: Richard Dobbs, James Manyika, and Charles Roxburgh. Susan Lund serves as director of research. Project teams are led by a group of senior fellows and include consultants from McKinsey’s offices around the world. These teams draw on McKinsey’s global network of partners and industry and management experts. In addition, leading economists, including Nobel laureates, act as research advisers.

The partners of McKinsey & Company fund MGI’s research; it is not commissioned by any business, government, or other institution. For further information about MGI and to download reports, please visit www.mckinsey.com/mgi.

McKinsey & Company in Vietnam

McKinsey & Company is a global management consulting firm that helps many of the world’s leading organisations address their strategic challenges, from reorganising for long-term growth to improving business performance and maximising revenue. With consultants deployed in more than 50 countries across the globe, McKinsey advises on strategic, operational, organisational and technological issues. For more than eight decades, the firm’s primary objective has been to serve as an organisation’s most trusted external adviser on critical issues facing senior management.

McKinsey established an office in Hanoi in 2008 with a team of global and local professionals. Today, the office employs more than 50 Vietnamese staff and serves private local companies, state-owned enterprises, and the public sector in Vietnam, as well as multinational corporations and international financial institutions interested in building their presence in the country.

McKinsey Global Institute

February 2012

Sustaining Vietnam's growth: The productivity challenge

Marco Breu
Richard Dobbs
Jaana Remes
David Skilling
Jinwook Kim

Executive summary

During the past quarter century, Vietnam has emerged as one of Asia's great success stories. It has transformed itself from a nation ravaged by war in the 1970s to an economy that, since 1986, has posted annual per capita growth of 5.3 percent. Vietnam has benefited from a programme of internal modernisation, a transition from its agricultural base toward manufacturing and services, and a demographic dividend powered by its youthful population. Vietnam has also prospered by choosing to open itself more broadly to the outside world, joining the World Trade Organization (WTO) in 2007 and normalising trade relations with the United States. These steps have helped to ensure that the economy is consistently ranked as one of the region's most attractive destinations for foreign investors. Despite the recent volatility in global markets, China is the only Asian economy to have grown faster than Vietnam since 2000.

Overall, Vietnam's growth has been relatively balanced, with the industrial and services sectors each accounting for about 40 percent of annual output. Thanks to an abundance of low-wage labour, Vietnam's manufacturing sector grew at a compound annual growth rate of more than 9 percent from 2005 to 2010. Not content with simply serving a growing domestic market, Vietnam has also expanded its exports of manufactured goods, especially products such as textiles and footwear. The liberalisation of services created opportunities for rapid expansion across a range of sectors including retail and transportation. The nation also boosted its tourism infrastructure and experienced a surge of interest in residential and commercial real estate. Vietnam's exports of commodities such as rice and coffee have also grown briskly.

The McKinsey Global Institute (MGI) estimates that, taken together, an expanding labour pool and the structural shift away from agriculture contributed two-thirds of Vietnam's GDP growth from 2005 to 2010. The other third came from improving productivity within sectors. But the first two drivers are now waning in their power to drive further growth. According to official statistics, growth in Vietnam's labour force is likely to decline to around 0.6 percent a year over the next decade, a reduction of three-quarters from the annual growth of 2.8 percent generated from 2000 to 2010. Given the extraordinarily rapid pace of economic development already achieved, it seems unlikely that Vietnam can further increase the contribution of productivity growth that has resulted from migration from farm to factory to make up for the weakening of growth in the labour force.

Instead, a surge in productivity within manufacturing and services will need to compensate. Vietnam will need to boost its overall labour productivity growth by more than 50 percent, from 4.1 percent annually to 6.4 percent, if the economy is to meet the government's own target of 7 to 8 percent annual growth by 2020 (Exhibit E1). Without such a boost, we estimate that Vietnam's growth is likely to decline to between 4.5 and 5 percent annually. The difference sounds small, but it isn't. By 2020, Vietnam's annual GDP would be 30 percent lower than it would be if the economy continued to grow at a 7 percent pace.

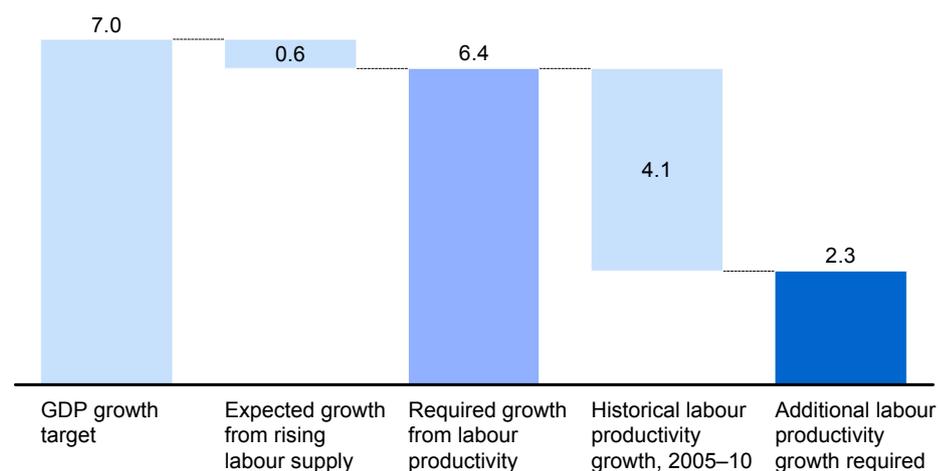
Achieving 6 percent annual growth in economy-wide productivity, while not without precedent, is a challenging goal, and a productivity revolution of this magnitude cannot be achieved solely with incremental change. Deep structural reforms within the Vietnamese economy will be necessary, as well as strong and sustained commitment from policy makers and firms.

Vietnam needs to further develop its capabilities across all sectors of the economy, become increasingly versatile, and build on recent successes. The economy needs to be an environment that encourages companies to continuously innovate. And Vietnam needs to identify new sources of growth to replace those that are becoming exhausted. Because state-owned enterprises (SOE) still hold enormous weight, accounting for about 40 percent of the nation's output, we find that reform of the ownership and management incentives for these enterprises is likely to be crucial, as will the need to improve the overall capital efficiency of SOE operations.¹

Exhibit E1

Sustaining Vietnam's recent growth performance will require a 50 percent increase in its labour productivity growth rate

Annual real growth rates, 2010–20
%



SOURCE: Vietnam General Statistics Office 2011; McKinsey Global Institute analysis

In this report, we analyse the roots of Vietnam's recent economic achievements and, based on this diagnostic, shed light on the challenges the nation faces as it attempts to sustain growth in a volatile period of global economic turmoil. We also highlight the experience of other countries, and the policies and practices they have used to address similar challenges in their economies. So, while our purpose is not to offer specific policy recommendations to these challenges, nor assess the broader social implications, we hope that our perspective offers potential options that Vietnam can explore as it seeks to become a more important player in a rapidly globalising and evolving economic system and pursues additional sources of sustainable growth.

As Vietnam embraces this agenda, it can learn from the experience of other nations that have faced a similar challenge. We have identified four key areas where significant policy changes can boost the nation's economic performance.

¹ Vietnam Ministry of Finance, *Vietnam SOEs equitisation slows down in 2010*, January 2011.

Stabilise the macroeconomic environment

The first priority for officials is to restore calm in the macro economy and ensure that Vietnam retains the trust and enthusiasm of national and international investors. Surging inflation, repeated devaluations of the currency, a deteriorating trade balance, and rising interest rates have undermined investor confidence in recent times. Although banks have thus far proved resilient, we see three long-term systemic risks facing the financial sector.

The first of these systemic risks is that bank lending has been expanding rapidly by 33 percent a year over the past decade, the strongest growth rate recorded by any Association of South East Asian Nations (ASEAN) country, India, and China. Such a robust expansion is often accompanied by a parallel rise in non-performing loans. While the reported level of Vietnam's non-performing loans appears to be under control, their true volume is likely to be much higher than reported figures. This year the Vietnamese Government introduced various measures such as a 20 percent cap on credit growth and limits on loans to non-productive activities. Yet these measures are unlikely to suffice, notably because new caps on interest rates, which are significantly below underlying inflation, are likely to counteract the intention of policy and spur more demand for loans. It is a source of risk that a large share of Vietnam's financial system is run by state banks, some of which may, at times, lend based on political or policy grounds rather than on strict financial merit. Additionally, the prevalence of cross-holdings can weaken corporate governance, while the sector has a large number of sub-scale banks. Vietnam needs to enforce stricter standards for recognising bad loans, further equitise state banks, and enforce rules on cross-holding and related regulations on party transaction. Strengthening independent auditing and potentially setting up a "bad" bank to manage and work out the troubled assets are other steps to consider.²

The second systemic risk is that of a liquidity crisis. Vietnam's funding market is heavily skewed toward the short term, driven by customers who see bank savings tools mainly as a way to hold and invest their funds for the short term. Recent regulation capping interest rates may exacerbate the situation.

The third systemic risk is Vietnam's foreign-exchange position, measured by the stability of its foreign reserves. Vietnam's trade deficit has widened despite multiple dong devaluations that, together with a flight to dollars and gold, have contributed to a drying up of foreign reserves. Vietnam needs to strike the right balance in its exchange-rate policy to both maintain cost competitiveness in the face of inflation and ensure that hidden foreign reserves come back into the official economy to be invested productively.

At root, Vietnam needs to tackle today's limited governance and transparency. Today, the financial reporting standards and risk management techniques practised by Vietnamese banks are still a long way from Basel II or Basel III standards. Laying out a clear roadmap for the adoption of international standards such as Basel is necessary. Vietnam could also usefully run a series of bank stress tests to identify banks that are struggling and separate them from those that are performing well.

2 A bad bank is set up to buy the bad loans of banks with significant non-performing assets at market prices.

Strengthen productivity and growth enablers

To facilitate a transition to higher productivity activities, low-wage labour needs to be replaced with new sources of comparative advantage. Vietnam has already established itself as an attractive investment location for foreign investors, yet it lags behind many of its Asian peers in overall international competitiveness rankings. Government efforts to simplify business start-up processes, improve permitting processes, and reduce tax rates have already helped to improve Vietnam's ranking in the World Bank's "Doing Business index" by ten places. Vietnam now needs to institutionalise processes to ensure continued progress. Even in the more challenging aspects of the business environment, actionable lessons can be drawn from other countries that have made progress in their competitiveness. Two specific categories where Vietnam scores poorly on the World Economic Forum's competitiveness index are infrastructure and education.

Vietnam has already made significant new investment to improve its infrastructure. The country's road density surpasses those of the Philippines and Thailand, and investment in new ports and airports such as in Da Nang and Can Tho have improved the nation's connections to the rest of the world. Yet both interviews with executives and international assessments of infrastructure strongly suggest that more infrastructure investment will be necessary to support the economy's transition to more productive activities.

To increase the economic benefits of infrastructure investment, Vietnam will need to set overall priorities based on a clear assessment of which projects offer the greatest economic benefit, tying investment decisions more closely to the country's broader development strategies and improving coordination among government agencies. Tourism offers a good example. Central government can play a key role in ensuring that public-sector investment in infrastructure, transportation, and real estate is closely tied to, and consistent with, private-sector spending in such areas as hotels and resort developments and transit services in order to promote synergy. Exploring how to collaborate with the private sector may also be warranted.

With many employers now reporting a shortage of properly trained workers and managers, another key opportunity for Vietnam is to facilitate transparency and quality control within the nascent private education industry. Simply by gathering and publishing the performance statistics of such schools, running online assessment polls in which students can evaluate their school programmes, and requiring trainers to certify their own educational attainment would boost the quality of these institutions. These changes also would also make the schools more attractive to potential students. The state can also ensure that common standards are applied to all public and private institutions providing education and training programmes in order to boost transparency, and to issue certificates to graduates of certified training programs showing they mastered a specified set of skills. These certificates would make it easier for employers to identify qualified workers.

Create tailored, industry-specific policies that encourage productivity and growth

Getting economy-wide regulation right is a necessary condition for productivity and growth, but that will not be sufficient to sustain the broad-based growth from which Vietnam has benefited in recent years. Experience shows that variations in industry-specific government action go a long way toward explaining divergences in how sectors perform across economies—but that those approaches differ, depending on the sector. Vietnam's next challenge is to establish an enabling environment at the level of individual industries and sectors by enhancing domestic competition and helping industries such as software development and IT services gain firm ground and move up the value chain. Steps that Vietnam could take to enhance productivity include:

- **Make targeted investment to boost quality and productivity of agriculture and aquaculture.** Vietnam has made notable strides in boosting the production and export of its agricultural products. Now Vietnam needs to help rural sectors develop greater expertise so that they can move toward higher-quality products that can command higher prices. Government regulation and standards can play a role. However, Vietnam can also help to improve the quality of its fish farming—and the quality of its seafood exports—by more actively promoting internal control systems in which international organisations train local farming cooperatives to inspect for quality among their own members. Investing in cooperatives that monitor and police feeding practices, sanitary conditions, and sustainability can help. The government can also ensure that its food testing system is rigorous enough to sustain international scrutiny by upgrading to the latest testing equipment.
- **Play an enabling role in developing Vietnam as a global hub for outsourced and offshore services.** Offshore services such as data, business process outsourcing, and IT appear to be promising areas. Building on its expanded pool of university graduates, Vietnam has the potential to become one of the top ten locations in the world for offshore services. To succeed, Vietnam needs to overcome infrastructural weaknesses related to high bandwidth connectivity and power supply, continue to raise technical and language skills of its workforce, and improve Vietnam's visibility within the industry in order to attract global players that could anchor further growth. Vietnam should also consider strategies to take advantage of domestic demand to incubate and grow domestic IT capabilities and enable a transition toward higher-skill IT services and software-development services. Vietnam needs to create a concerted action plan focused on stimulating demand and enabling supply to meet it, integrated into an ambitious vision and agenda to catalyse growth.
- **Focus on boosting productivity-led growth in manufacturing.** Vietnam would benefit from encouraging growth in sectors that are already expanding quickly because of domestic demand and can move into exports, such as electrical equipment. To facilitate this transition, the government can play an important role, particularly in segments where local players are fragmented and lack the scale to take on the export challenge. It can also put in place a quality-assurance programme to improve the quality of products being exported. Another priority is to help companies develop longer-term strategies to facilitate the stage-by-stage transition to higher-value-added activities

across global business value chains in segments including electronics. Today, Vietnam's exports are relatively low-value-added in comparison with those of other ASEAN economies and China (Exhibit E2).

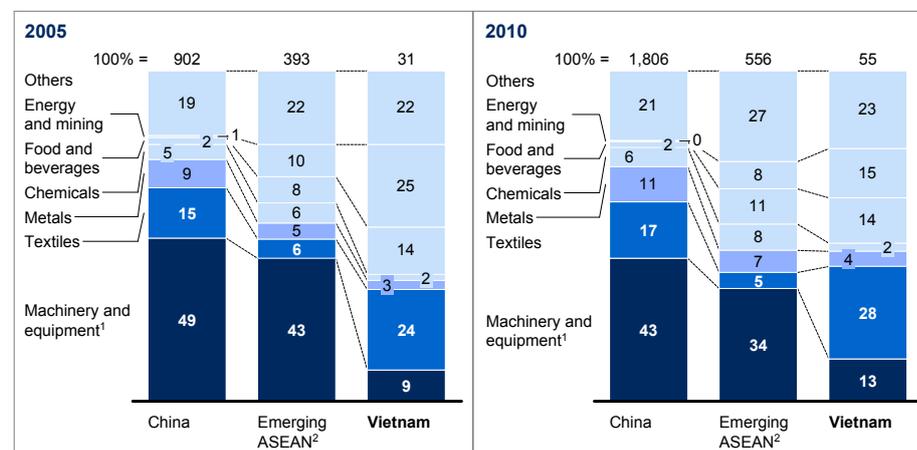
- Help meet rising demand for energy by developing regulations and incentives to boost energy efficiency.** The government could create explicit customer efficiency targets for utilities, establish energy-efficiency standards for consumer goods and industrial equipment, and deepen consumer understanding of energy efficiency by creating energy service corporations and utility-executed demand-side management programs. Retrofits of existing industrial plants could also generate significant returns.³

Exhibit E2

Vietnam's exports are concentrated in low-value-added products compared with ASEAN countries

Export breakdown by subsector

%; \$ billion



¹ Includes electric equipment, electronic products, and general machinery and equipment.

² Including Indonesia, Malaysia, the Philippines, and Thailand.

NOTE: Numbers may not sum due to rounding.

SOURCE: Global Insight 2011; McKinsey Global Institute analysis

Develop government execution capabilities to deliver a growth agenda

Moving the economy toward more productive growth opportunities will be complex and demanding. To meet the challenge, the government needs to continue to reform, adjust its role in the economy, and strengthen its organisational effectiveness and the delivery skills it needs to execute a policy agenda.

Reform in the ownership and management incentives of SOEs can be an effective institutional vehicle for improving economy-wide productivity and growth, given the considerable weight state-owned businesses still have in the Vietnamese economy. Vietnam has already established a State Capital Investment Corporation (SCIC) to energise the reform of SOEs and improve the

³ The World Bank has estimated that savings of 25 to 30 percent are likely. See *Vietnam: Expanding opportunities for energy efficiency*, Asian Sustainable and Alternative Energy Program, The World Bank, 2010.

efficiency of the economy's capital utilisation. The experience of Singapore's Temasek, Malaysia's Khazanah Nasional Berhad, and Kazakhstan's Samruk-Kazyna suggest that developing a sufficiently autonomous organisation with the right leadership and talent can improve the effectiveness of efforts to push performance standards across their portfolio of SOEs.

Leading a proactive productivity and growth agenda requires strong political leadership that can coordinate action across multiple agencies behind a single vision and shape the management models and skills to fit the requirements in different organisations. Achieving both requires a significant upgrade in the talent pool of the public sector. The experience of other nations in addressing these challenges could be a useful road map for Vietnam:

- **Agencies to attract foreign direct investment (FDI).** Singapore and Ireland have set the bar for the capacity of government organisations to operate highly effective agencies with a mission to attract investors. Both have built capable organisations that have many of the hallmarks of high-performing private-sector sales forces. While Vietnam has established organisations at both the national and the local levels to attract FDI, it can continue to increase the effectiveness of these institutions by more closely integrating their operations with national industry priorities and by building a customer-focused, high-performance culture. To succeed in the increasingly competitive global arena, agencies need to have a good understanding of the specific priorities among cutting-edge firms in their target sectors, and the capacity to design and deliver a tailored value proposition for each.
- **Public-private partnership management units.** Public-private partnerships are an increasingly attractive way to achieve investment in an era of constrained public finances, but they do not always deliver on all of their anticipated benefits. McKinsey finds that focusing on building the capabilities of a dedicated public-private partnership unit and shaping the processes carried out by it can enhance the value of the partnership by 10 to 20 percent. Vietnam has already engaged private firms to help build and operate the Phu My 2-2 and Phu My 3 power-generating stations and can broaden its use of such collaborations to improve their effectiveness. Experience from around the world suggests that capacity to define an appropriate structure for public-private collaboration is critical to ensure its success.
- **Government delivery units.** Many governments are under pressure to deliver improved results and have set ambitious reform goals and developed strategic plans to achieve them. Most plans require alignment and coordination among all interested parties, and some countries, including Malaysia, have made effective use of government delivery units to speed up the delivery of priority initiatives. Former British Prime Minister Tony Blair set up the Prime Minister's Delivery Unit (PMDU). This unit appointed a full-time delivery leader who reported directly to the leader of the public-sector organisation. The PMDU was small enough to preserve flexibility, allow selectivity in hiring, promote a cohesive culture, and develop and coach a talented group of staff. Blair concluded in his memoir that the PMDU "was an innovation that was much resisted, but utterly invaluable and proved its worth time and time again."

There are implications for foreign and domestic businesses

The challenges Vietnam confronts today contain significant implications for international as well as domestic business. The low-wage, labour-abundant model on which many firms have tended to rely on in recent years may no longer be quite as successful. SOEs will be forced to raise their game to more international standards as their access to capital becomes constrained and the competitive landscape shifts. Multinational firms will need to ensure that they don't lock in excess capacity and that their business models can be both flexible and sustainable even if wages rise and growth turns out to be slower than they had anticipated. Vietnamese domestic firms, in turn, will need to focus more on long-term value creation, including boosting branding and increasing quality, improving management, and focusing on bottom-line rather than simple revenue growth.

McKinsey Global Institute
February 2012
Copyright © McKinsey & Company
www.mckinsey.com/mgi

 @McKinsey_MGI

 McKinseyGlobalInstitute