

McKinsey Global Institute



February 2012

Sustaining Vietnam's growth: The productivity challenge



The McKinsey Global Institute

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Preface

Vietnam's economy has grown rapidly since the country opened its economy in the 1980s, and today foreign investors consistently rank it as one of the most attractive investment destinations in Asia. The McKinsey Global Institute therefore decided to provide a perspective on the challenges and opportunities facing the Vietnamese economy over the next decade. In *Sustaining Vietnam's growth: The productivity challenge*, we find that although Vietnam has posted a very strong performance over the last 25 years, today the economy faces complex challenges that require a transition to a productivity-driven growth trajectory.

Marco Breu, a McKinsey principal based in Hanoi; Richard Dobbs, McKinsey and MGI director based in Seoul; Jaana Remes, MGI senior fellow based in San Francisco; and David Skilling, former MGI senior fellow in Singapore, led this project. Jinwook Kim managed the project team, which comprised Pham Quang Anh, Hyungpyo Choi, Sanjeev Kapur, Nguyen Mai Phuong, Sunali Rohra, Vishal Sarin, Ha Thanh Tu, and Le Thi Thanh Van. The team also benefited from the guidance of Jonathan Auerbach, Heang Chhor, Andrew Grant, Tomas Koch, Diaan-Yi Lin, Jens Lottner, Barnik Maitra, Jean-Marc Pouillet, Badrinath Ramanathan, Alfonso Villanueva-Rodriguez, Brian Salsberg, Joydeep Sengupta, Seelan Singham, Shatetha Terdprisant, and Oliver Tonby. The team appreciates the contribution of Janet Bush, MGI senior editor, who provided editorial support; Rebeca Robboy, MGI external communications manager; Julie Philpot, MGI editorial production manager; and Marisa Carder and Therese Khoury, visual graphics specialists.

We are grateful for the invaluable guidance we received from Pham Chi Lan, former vice president of the Vietnam Chamber of Commerce and Industry and former member of the Vietnamese Prime Minister's Research Board; Nguyen Dinh Cung, vice president of the Central Institute for Economic Management; Vu Minh Khuong, assistant professor, and Nguyen Chi Hieu, research associate, at the Lee Kuan Yew School of Public Policy, National University of Singapore; Jonathan Pincus, dean and resident curriculum adviser, Ben Wilkinson, associate director, Vu Thanh Tu Anh, director of research, and Nguyen Xuan Thanh, director of the public policy program, all at the Fulbright Economics Teaching Program of the Vietnam Program at the Ash Center for Democratic Governance and Innovation at the Harvard Kennedy School; and Alex Warren-Rodriguez, economic policy adviser at the United Nations Development Program. We would also like to thank Martin N. Baily, a senior adviser to McKinsey and a senior fellow at the Brookings Institution, and Richard N. Cooper, Maurits C. Boas Professor of International Economics at Harvard University, for their input. We also thank several Vietnam-based Asian Development Bank and the World Bank officials, with whom we conducted interviews, for their time and perspectives. We thank the management of Saigon Securities Incorporation and its research team for support during our field research phase. Finally, we are grateful for the input of executives from 20 companies including other Vietnamese businesses and multinational corporations operating in Vietnam.

This report contributes to MGI's mission to help global leaders understand the forces transforming the global economy, improve company performance, and work for better national and international policies. As with all MGI research, we would like to emphasise that this work is independent and has not been commissioned or sponsored in any way by any business, government, or other institution.

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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.

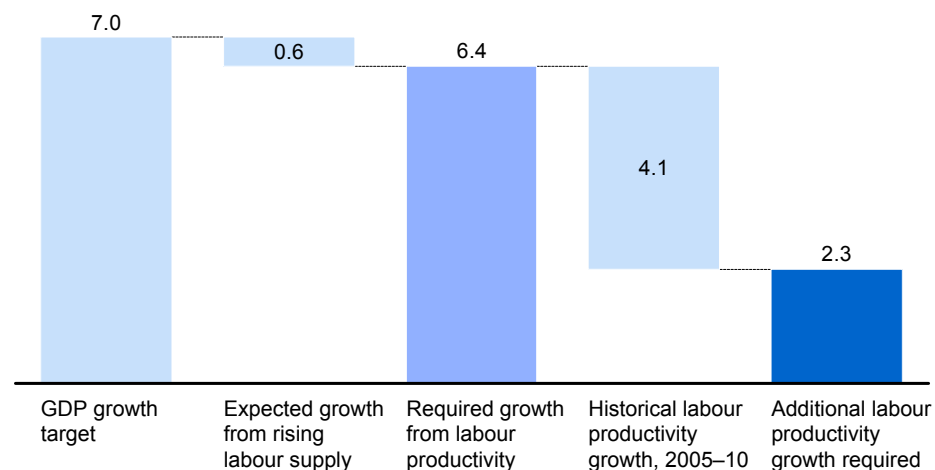
Achieving 6 percent annual growth in economy-wide productivity, while not without precedent, is a challenging goal, and a productivity revolution of this magnitude cannot be achieved solely with incremental change. Deep structural reforms within the Vietnamese economy will be necessary, as well as strong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

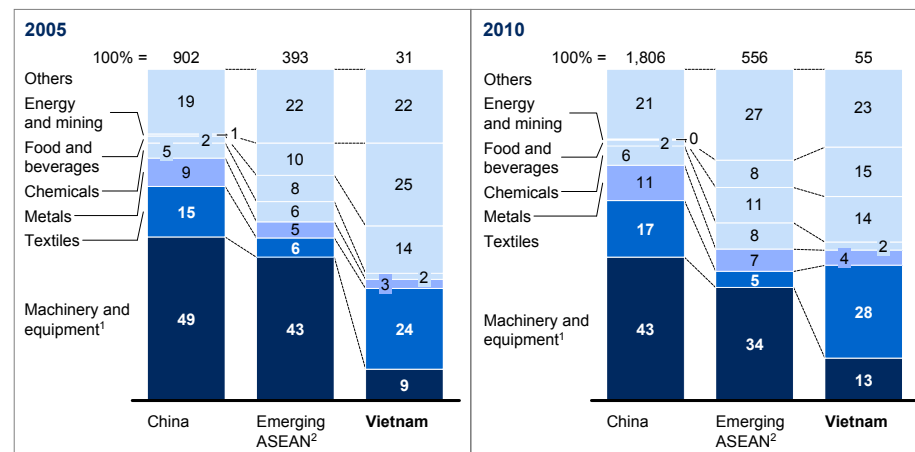
- Help meet rising demand for energy by developing regulations and incentives to boost energy efficiency.** The government could create explicit customer efficiency targets for utilities, establish energy-efficiency standards for consumer goods and industrial equipment, and deepen consumer understanding 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.

1. The keys to Vietnam's recent economic success

Vietnam, a nation once ravaged by war, has been one of Asia's economic success stories over the past quarter century. Since the Communist Party introduced reforms known as Doi Moi or "Renovation" in 1986, the country has progressively reduced barriers to trade and capital flows and opened the economy more widely to private business. Since these reforms began, the economy has posted an annual per capita GDP growth of 5.3 percent, faster than any other Asian economy apart from China (Exhibit 1).

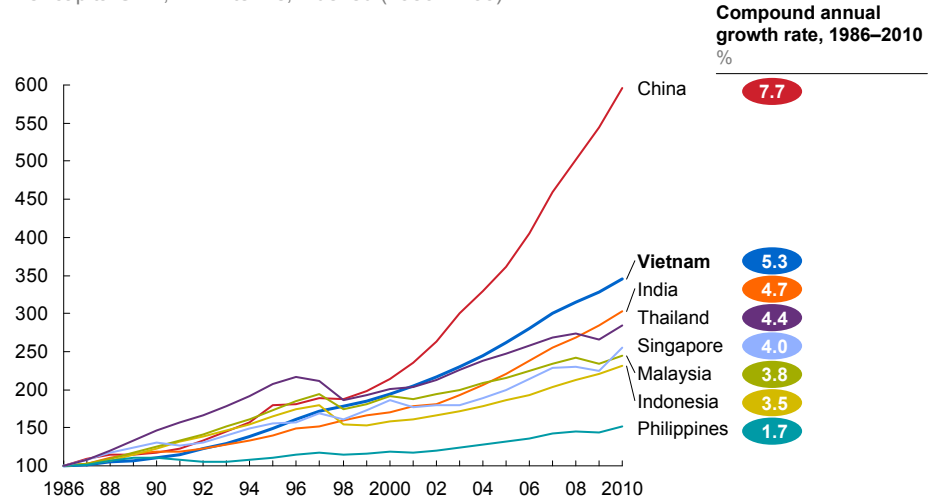
In 2007, Vietnam became a member of the WTO, formalising its full participation in the global economy 12 years after normalising relations with the United States. From 2005 to 2010—a period that included the difficult years of the global economic downturn—Vietnam posted strong annual GDP growth of 7 percent. Vietnam has continued to generate uninterrupted growth in the face of hostile economic conditions both during the Asian financial crisis of the 1990s and in the recent severe global downturn—a more robust record than many other Asian economies (Exhibit 2).

In this chapter, we analyse the main drivers of Vietnam's growth to date in an effort to shed light on the economy's future growth prospects.

Exhibit 1

Since opening up its market, Vietnam has been one of the fastest-growing economies in Asia

Overall economic growth, 1986–2010
Per capita GDP, PPP¹ terms, indexed (1986 = 100)

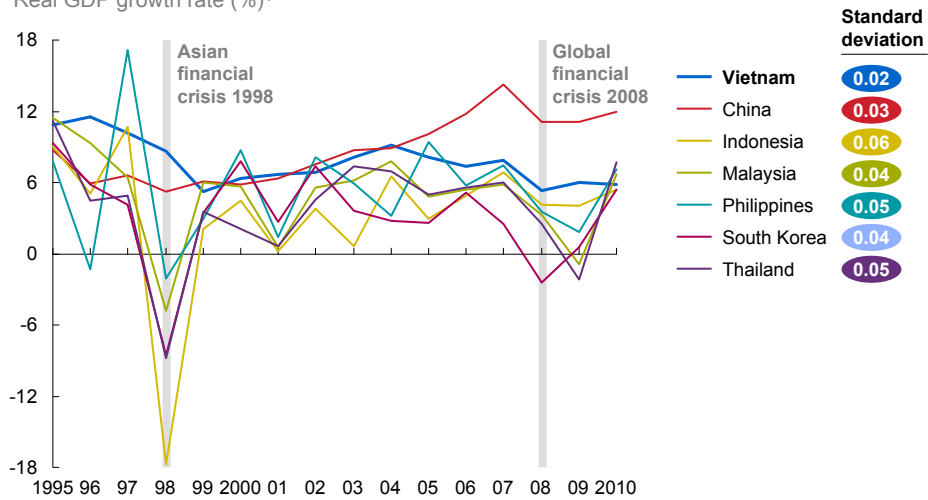


¹ PPP = Purchasing power parity.
SOURCE: The Conference Board Total Economy Database 2011; McKinsey Global Institute analysis

Exhibit 2

Vietnam’s GDP growth has been relatively stable while other ASEAN countries experienced negative growth during the Asian financial crisis

Year-on-year GDP growth rate, 1995–2010
Real GDP growth rate (%)¹



¹ GDP at the constant local currency price in 2005.
SOURCE: Global Insight 2011; McKinsey Global Institute analysis

Vietnam's growth has been driven by a young, expanding workforce, a shift from agriculture, and productivity growth

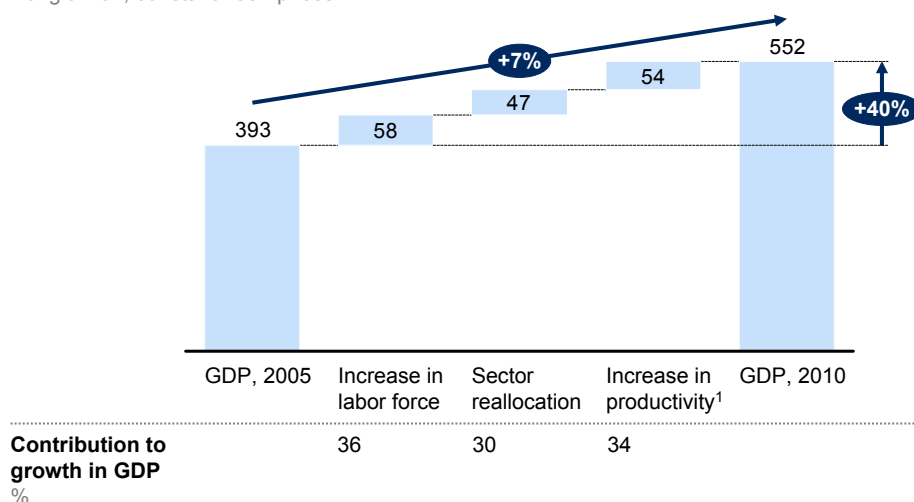
Vietnam's remarkable growth in recent years reflects a migration from agriculture to more productive industries and services, a path typical for a developing economy. At the same time, Vietnam has benefited from a young and growing labour pool and from policy reforms that have opened up the economy after years of isolation. Both rising domestic private investment and new flows of foreign investment sparked significant transformations in the manufacturing and service sectors. Together with relatively low-wage labour, these factors have enabled the muscular and broad-based economic growth of recent years. We estimate that, taken together, an expanding labour pool and the structural shift away from agriculture contributed more than two-thirds of Vietnam's GDP growth from 2005 to 2010—with the last third coming from productivity growth within sectors (Exhibit 3).

Exhibit 3

Three major factors made roughly equal contributions to GDP growth

GDP impact

Dong trillion, constant 1994 prices



¹ Increase in productivity calculated assuming constant sector shares; sector reallocation calculated assuming the observed change in sector allocations and using 2005 productivity levels.

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

Vietnam has been enjoying a demographic dividend

The Vietnamese economy has benefited from its young population. In 1999, 34 percent of the population was between the ages of 5 and 19. As a result, 12 million joined the labour force in the subsequent decade. Between 2000 and 2010, the labour force expanded at a 2.8 percent annual rate, more than twice the rate of population growth, contributing about one-third to Vietnam's overall growth.

The robust rise in the share of working-age population has contributed to Vietnam's ability to double per capita GDP to match India's level today—a particularly impressive performance given that it was achieved despite the

breakup of the Soviet Union, which historically had been Vietnam's major patron and business partner.

Vietnam has shifted away from agriculture at considerable speed

Over the past ten years, agriculture's share of national employment has dropped by 13 percentage points. At the same time, the share of workers employed in industry has risen by 9.6 points and in services by 3.4 points. This shift of workers from agriculture to industry and services has made a powerful contribution to Vietnam's economic expansion because of the large differences in productivity between these sectors. Average labour productivity in industry today is almost six times as high as in agriculture, and services productivity is four times as high. The marginal gains are probably even larger. As a result, agriculture's share of GDP has fallen by 6.7 percentage points while industry's share has risen by 7.2 percentage points. Value-added growth in the services sector has matched the national average, and its GDP share has remained roughly constant. To understand the speed and magnitude of these shifts, consider that agriculture's contribution to Vietnam's GDP fell in half, from 40 to 20 percent, in just 15 years—a pace far more rapid than in comparable Asian economies.

Economic reform has boosted productivity across the sectors of the economy

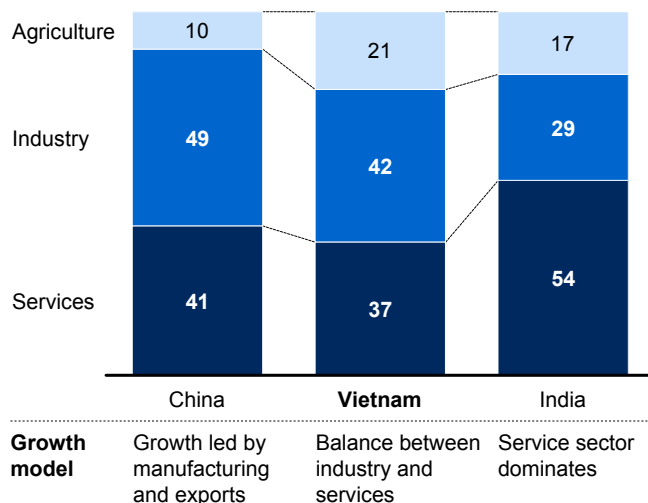
A broad range of reforms has boosted productivity across sectors. In agriculture, reforms have led to higher yields and turned Vietnam into the world's third-largest rice exporter. An expansion in oil exploration and refining helped Vietnam to benefit from strong global demand and rising prices. Manufacturing exports benefited from Vietnam's WTO membership and the government's efforts to create a more attractive business environment. The liberalisation of services has created opportunities for a rapid expansion across a range of services, including retail, transportation, and tourism. Meanwhile, increased investment has helped to boost Vietnam's capital stock, giving business unparalleled access to more, and better, machinery and equipment, and infrastructure that has helped to bolster productivity growth.

Vietnam's growth has been broad-based, with competitive niches across the economy. Industrial and services sectors each account for approximately 40 percent of GDP, with the remaining 20 percent coming from agriculture (Exhibit 4). Over the past five years, output in the industry (including manufacturing, construction, mining, and utilities) and services sectors has grown at comparable annual rates of about 8 percent, while agriculture has expanded at a more modest—but still healthy—rate of 3.3 percent. Three very different sectors have posted strong GDP and productivity growth simultaneously—manufacturing; wholesale and retail trade; and agriculture, forestry, and fishing (Exhibit 5). The fact that Vietnamese growth has come from both globally competitive, tradable industries as well as in industries fuelled by rising domestic demand provides a broader basis for sustained growth.

Exhibit 4

Vietnam's sector distribution suggests that its economy is broadly balanced between industry and services

GDP breakdown 2010, current prices
%



SOURCE: Global Insight 2011; McKinsey Global Institute analysis

Exhibit 5

Some sectors such as manufacturing and retail have achieved substantial GDP and productivity growth

	GDP		Productivity	
	Actual, 2010 ¹ Dong, trillion	Compound annual growth rate, 2005–10 ² %	Actual, 2010 Dong million per person	Compound annual growth rate, 2005–10 %
Agriculture, forestry, and fishing	91	3.3	3.8	3.8
Mining and quarrying	22	-0.9	55.6	-3.5
Manufacturing	139	9.3	19.7	3.1
Electricity, gas, and water supply	18	9.9	68.0	-1.6
Construction	52	8.7	17.2	0.1
Wholesale and retail trade	94	8.0	17.1	3.9
Hotels and restaurants	21	8.9	12.1	-8.8
Transport, storage, and communications	25	10.1	20.1	7.7
Financial intermediation	13	8.8	51.1	-2.2
Real estate and business activities	20	3.6	67.1	-8.8
Public administration and defence	15	7.4	8.0	3.1
Education and training	19	7.7	11.4	-0.4
Health and social work	8	7.5	19.9	3.0
Social and personal services and private household	15	7.0	10.7	-1.6

1 Constant 1994 prices; industry classification based on the Vietnam Standard Industry Classification 2007.

2 Total GDP CAGR growth rate for the same period was 7.0 percent.

3 Two sectors that had the largest labour force increases in the past five years are hotels and restaurants (108 percent) and real estate (433 percent).

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

Vietnam's manufacturing sector grew at a compound annual growth rate of 9.3 percent from 2005 to 2010, and labour productivity in the sector increased at 3.1 percent a year. Because this sector accounts for around 30 percent of overall GDP, this rapid growth made a substantial contribution to Vietnam's expansion during this period. Within manufacturing, some subsectors performed especially well. Motor vehicle production grew at an annual rate of 16 percent during these five years, ready-made clothes by 12.9 percent, and electrical equipment by 12.0 percent.

These broad sources of growth demonstrate that Vietnam offers competitive strength in pockets across agriculture, industry, and services. Both rising exports and expanding inward investment testify to the increasing capacity of Vietnam to compete in the world economy.

FDI has flowed strongly not just into industrial sectors but also into services

Vietnam's strong and stable growth performance over the past decade has certainly struck a chord with international investors. Vietnam is on most lists of attractive emerging markets for foreign investors. In a survey conducted by the Economist Intelligence Unit, Vietnam was rated in 2008, 2009, and 2010 as the most attractive emerging market destination for foreign direct investment (FDI) after the BRICs quartet of Brazil, Russia, India, and China.⁴ Another indicated that 67 percent of private equity investors in Vietnam—or those that have a significant focus there—considered Vietnam to be a more attractive investment destination than other economies including China.⁵ Overall registered FDI flows into Vietnam have grown strongly, increasing from \$3.2 billion in 2003 to \$21.5 billion in 2009—an impressive growth rate even considering that registered FDI is likely to overstate the level of actual investment.⁶

Mining and quarrying sectors that include oil have traditionally been the main beneficiaries of foreign investment. But unlike in the rest of emerging ASEAN (Association of South East Asian Nations), their share has declined and Vietnam's inward investments have become increasingly diversified (Exhibit 6). In contrast to some Asian countries like China, manufacturing has not been the only sector attracting foreign investors to Vietnam—substantial sums have flowed into services and agriculture, too. Real estate accounted for a fifth of FDI in 2009, largely due to the growth in tourism, making this the second-largest recipient of FDI among Vietnam's sectors. Manufacturing is the third-largest recipient of FDI. In 2008, more than half of manufacturing FDI was targeted to the chemicals industry, while only about 10 percent went to textiles and electronics.

4 The Economist Intelligence Unit has carried out annual surveys on emerging market economies in each of these years on behalf of UK Trade & Investment. See *Tomorrow's markets*, 2008; *Survive and prosper: Emerging markets in the global recession*, 2009; *Great expectations: Doing business in emerging markets*, 2010.

5 *Private equity in Vietnam 2009: Investment outlook survey results—Part I*, Grant Thornton, April 2009.

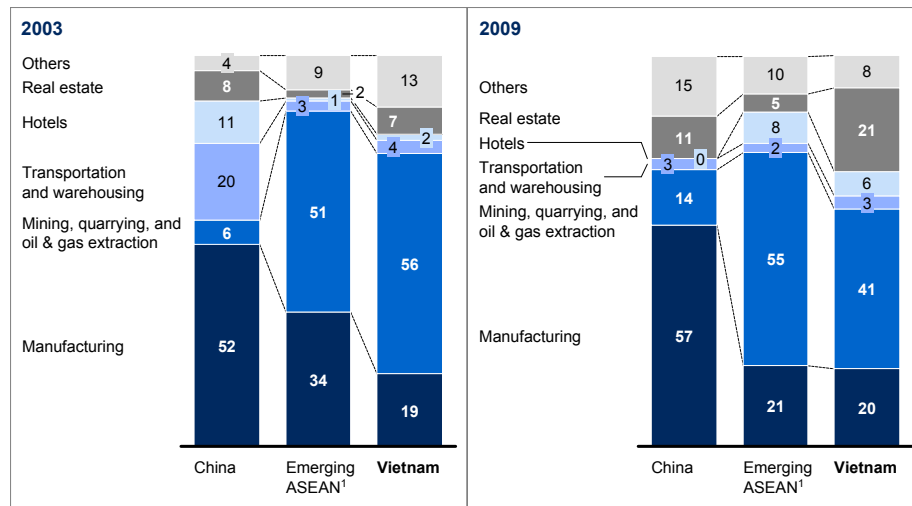
6 Data on implemented FDI by sector in Vietnam are not consistently available for 2008 to 2010. However, data are available for 2009 and show that implemented FDI totalled \$10 billion, compared with the registered total of \$21.5 billion. In some years, the gap between the two measures is even larger. Part of the reason for this is timing, of course—not all registered FDI is implemented in year one in any country.

Exhibit 6

FDI to Vietnam has become less dependent on mining investment

FDI breakdown by sector

%



¹ Average for Indonesia, Malaysia, the Philippines, and Thailand.

NOTE: Numbers may not sum due to rounding.

SOURCE: FDI Markets 2011; McKinsey Global Institute analysis

Exports have expanded strongly, holding up well during the global economic downturn

Vietnam's overall exports of goods grew by more than 8 percent a year from 2004 to 2009, an impressive performance given the global economic downturn toward the end of this period. Exports weakened sharply in 2009 amid global turmoil but rebounded strongly in 2010, a trend that has continued into 2011. Exports are relatively diversified and categories of exports that account for just over 80 percent of the value of Vietnam's exports have been increasing their global market share since 2005. As one would expect given the stage of Vietnam's economic development, the largest and fastest growing export segments have been relatively labour-intensive, low-value-added manufactured products such as textiles and footwear and to a lesser extent furniture. Collectively, they represent almost one-third of Vietnamese exports. Indeed, Vietnam's exports are more concentrated at the lower end of the value-added spectrum than in other ASEAN economies (Exhibits 7 and 8). Yet agricultural exports such as coffee, rice, and aquaculture have also expanded rapidly, and oil exports continue to be an important source of foreign income.⁷ Both categories have benefited from rising global resource prices. Vietnam has also started to gain global export share in machinery and equipment, even though their share of exports at 13 percent in 2010 is small compared with China's 43 percent and 34 percent on average in fellow ASEAN economies Indonesia, Malaysia, the Philippines, and Thailand.

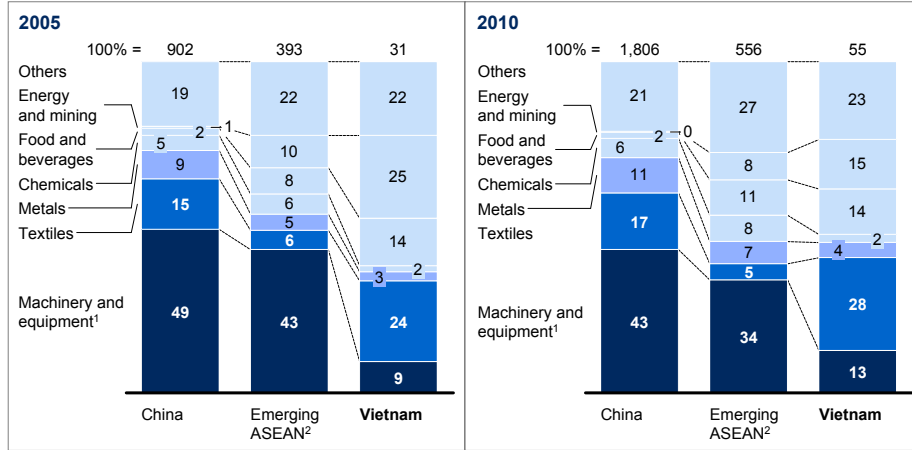
Vietnam's service exports including tourism have posted robust growth. Export receipts from transportation have grown at an annual rate of 15 percent since 2005 and in travel by 7.5 percent, a reflection of the fact that the number of foreign tourists coming to Vietnam has risen by one-third since 2005.

⁷ Aquaculture, also known as aquafarming, is the farming of aquatic organisms such as fish, crustaceans, molluscs, and aquatic plants.

Exhibit 7

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

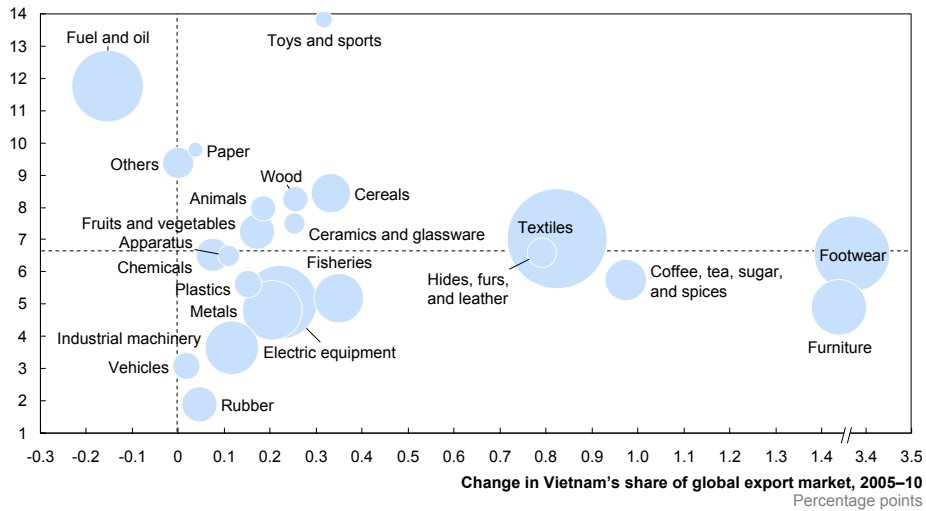
Exhibit 8

Vietnam has been gaining relevance in exports of consumer goods, food, and beverages

● Size of bubble represents 2010 export value

Goods export performance by product type, 2005–10

Total global value in export markets
Compound annual growth rate (%)



SOURCE: Comtrade 2011; McKinsey Global Institute analysis



A broad range of sectors has contributed to the strong growth of the Vietnam economy over the past five years—agriculture, industry, and services all have high-performing sectors. But can this promising combination of factors persist? In the next chapter, we look at worrying signs that the factors that have driven Vietnam's growth appear to be weakening and explore what could take their place and drive the economy forward over the next decade and more.

2. The challenges now facing Vietnam

Looking ahead, the future path of the Vietnamese economy does not look as smooth as a view of the past, seen through the rear-view mirror.

In the near term, Vietnam faces a highly uncertain global environment and heightened risk due to macroeconomic pressures, such as inflation, that have built up as a by-product of the government's efforts to maintain robust growth in the face of the global economic crisis. The recent global economic downturn led to a dramatic decline in global trade and FDI in early 2009 and added significant uncertainty as to whether, when, and how strongly these two sources of economic activity might recover. The slow recovery of the United States and Europe, together with the nuclear disaster in Japan, has created additional near-term uncertainty. In response to the global economic downturn, the Vietnamese government relied on expansive macroeconomic policies that have led to budget and trade deficits, inflationary pressures, and exchange rate instability. There are signs that the financial sector is under stress, and international credit ratings agencies have lowered their ratings on Vietnam's debt.⁸

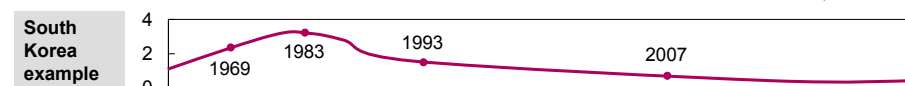
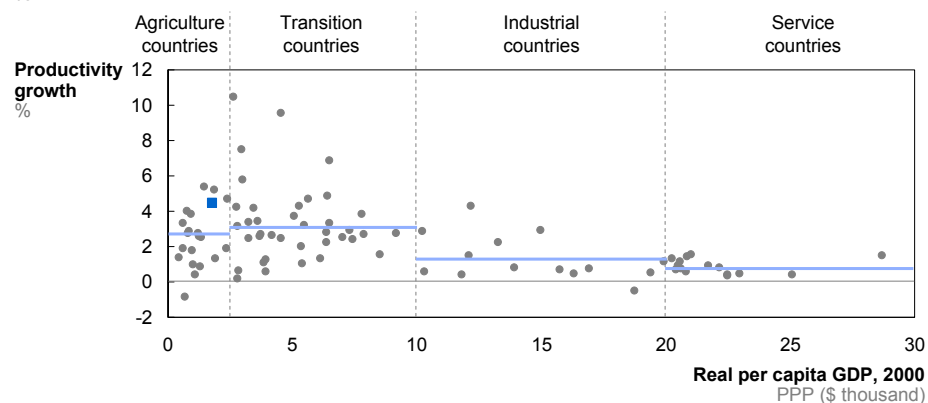
In the longer term, what matters more are trends suggesting that the key drivers that powered past growth are beginning to run out of steam. Vietnam needs to develop new sources of growth to replace those that drove its earlier transformation. Productivity gains must begin to make up for the weaker growth that will come from a dwindling demographic dividend. And because the transition out of agriculture will no longer be the driving force for productivity gains that it once was, manufacturing and services industries need to step up their productivity growth performance. To continue expanding at around 7 percent per year, Vietnam needs to boost productivity growth by 50 percent, from 4.1 percent annually to 6.4 percent. Without this boost, we estimate that the glide path for Vietnam's growth would decline to between 4.5 and 5 percent annually, significantly below the 7 percent more typical in recent years and the government's own target, set at the 11th National Party Congress in January 2011, of 7 to 8 percent annual GDP growth by 2020. Reaching 6 percent plus annual growth in economy-wide productivity is a challenging goal, but achieving it is not without precedent. The successes and failures other economies have experienced when faced with a productivity imperative now offer Vietnam a road map for broadening the bases of productive growth within its own economy (Exhibit 9).

⁸ For an extensive account of recent macroeconomic stresses in Vietnam, see the World Bank's recent report *Taking stock: An update on Vietnam's recent economic developments*, annual consultative group meeting for Vietnam, Ha Tinh, June 8–9, 2011.

Exhibit 9

A 50 percent acceleration in labour productivity growth is demanding, but achievable

GDP compound annual growth rate, 2000–10¹
%



¹ Based on data of 89 countries between 2000 and 2010.

SOURCE: The Conference Board Total Economy Database 2011; United Nations 2011; McKinsey Global Institute analysis

Under a business-as-usual scenario that assumes no change in underlying trends, our analysis suggests that Vietnam's economy is likely to expand by an average of between 4.5 and 5 percent over the coming decade. This would be in line with the perfectly respectable average growth of Southeast Asian nations over the past three decades, but this rate would still be markedly below the government's own growth target and the expectations of many forecasters and global investors. Although companies, investors, and policy makers in Vietnam are aware of current macroeconomic risks and recognise that the economy may face some short-term turbulence, there is still a general sense that Vietnam's solid fundamentals ensure strong growth over the longer term. Our research suggests, however, that these expectations implicitly take an optimistic view of the capacity of the Vietnamese economy to continue its transformation and to find new sources of growth to replace the adverse demographic trends and a weakening of some of the previous structural drivers of growth.

If growth indeed slows to 4.5 to 5 percent a year, the implications would be significant. By 2020, Vietnam's annual GDP would be 30 percent—or some \$46 billion—lower than it could be if a 7 percent annual growth rate were sustained. Assuming no shift in the structure of the economy as a whole, we estimate that private consumption would be \$31 billion lower. It would take Vietnam's economy 14 years—rather than ten—to double in size.

Labour inputs are weakening as a driver of growth

The demographic tailwind responsible for driving a third of Vietnam's past growth is now slackening. Some companies already report labour shortages in major cities. By 2020, the share of the population aged 5 to 19 is projected to drop to 22 percent from 27 percent in 2010 and from 34 percent in 1999. Although Vietnam's median age of 27.4 years is still relatively young compared with such countries as China (with a median age of 35.2), Vietnam's population is also

aging. According to government projections, growth in Vietnam's labour force is likely to be around 0.6 percent a year over the next decade, a decline of three-quarters from the annual growth of 2.8 percent generated from 2000 to 2010 (Exhibit 10). Labour force growth will still make a positive contribution to GDP growth, but notably less than had been the case over the past decade.

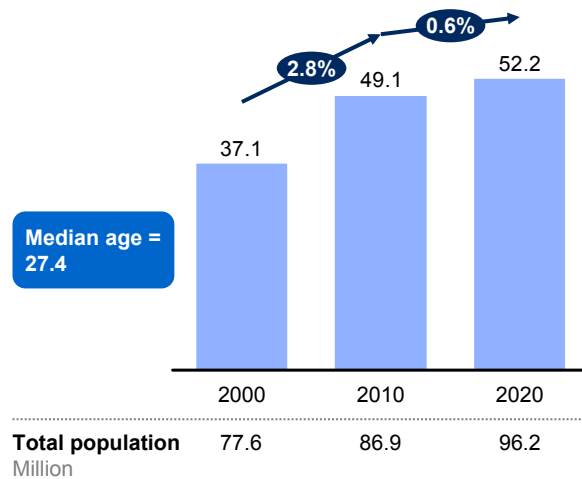
The labour market is already tightening, and survey evidence consistently indicates that Vietnam's cost advantage is eroding. Wages in most of Vietnam's regions rose more than 15 percent per year from 2003 to 2008. After adjusting for exchange rates, Bangladesh and Cambodia now offer lower-cost labour than does Vietnam. Naturally, as relative wages and prices rise, the attractiveness of locating purely cost-driven low-skill manufacturing in Vietnam (e.g., apparel and shoe assembly) starts to decline.

There are no easy ways for Vietnam to achieve a significant increase in the growth of its labour force. Options are limited to further expanding the participation of women, young people, and seniors in the labour force, given that Vietnam's participation rate is already quite high relative to other nations at similar levels of development. Although it is possible that older members of the workforce could be encouraged to work longer, it is also likely that younger people will spend more years in school, thus reducing the size of the available workforce.

Exhibit 10

Vietnam's labour force growth is expected to decelerate over the next decade

Labour force¹
Million people



¹ Working age ranges from 15 to 60 for men and to 55 for women; a labour participation rate of 86.9 percent remains constant to 2020.

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

The productivity of labor and capital will need to become the key driver of Vietnam's future growth

Given this waning demographic dividend, Vietnam needs to compensate with higher productivity gains in the economy in order to sustain past growth rates. To achieve a 7 percent annual average growth rate, Vietnam's labour productivity will need to improve at a rate of about 6.4 percent a year, compared with its historical average of 4.1 percent—a boost of 50 percent. This is particularly challenging

because the productivity boost that results from the reallocation of labour away from agriculture will also diminish. Vietnam will need an even stronger contribution from productivity growth within sectors to meet that target.

Given the extraordinarily rapid pace of economic modernisation that has taken place so far, the continued migration of workers from rural areas to towns and cities is likely to contribute less to future productivity gains. According to our estimates, even aggressive assumptions on the pace of the transition away from agriculture would not be sufficient to compensate for the effects of the decline in overall labour force growth. Without a change in within-sector productivity growth patterns, agriculture's share of the labour force would need to decline at twice the rate of the past decade —a decline that is unlikely given the already fast pace of recent redeployment of workers and the aging of the rural population.

Ensuring that capital resources remain available for investment is critical to continuing rapid labour productivity growth. In the recent past, extensive national savings and foreign capital inflows have funded new plants and equipment that have dramatically improved the capacity of each worker to produce more and better outputs.⁹ Investment in increasingly capital-intensive production methods and new technologies will continue to be important for sustaining productivity growth. It is notable that both South Korea and China, two countries that have maintained labour productivity growth of more than 6 percent a year for some years, have also invested at least 35 percent of their GDP over sustained periods.

Since 2000, Vietnam's investment rate has exceeded 30 percent of GDP, and it reached 40 percent in 2007.¹⁰ This suggests that access to capital investment is unlikely to be a constraint to growth in the near future. Instead, Vietnam's challenge will be to ensure that capital is allocated across the economy in the most productive investment. What this means, in short, is that Vietnam needs less financing of unprofitable businesses, including state-owned enterprises, and improved supervision of the financial sector to ensure that investment is properly channelled to its most productive and profitable uses.

Today, SOEs, which are less capital-efficient than companies in the private sector, enjoy disproportionate access to capital. Raising the productivity of Vietnam's SOEs will be a particularly vital effort, given their continued prominence in the economy. Labour productivity needs to rise but so, too, does the productivity of invested capital (see Box 1, "Raising the capital efficiency of Vietnam's SOEs").

9 In our analysis of Vietnam's growth, we include capital as a key factor enabling labour productivity growth. This means that instead of decomposing GDP growth into the contributions of labour and capital inputs and total factor productivity, we decompose GDP into increases in labour inputs and labour productivity, and account for the impact of capital through the impact that capital intensity (or available machinery, equipment, and buildings per labour input) has on growth in labour productivity.

10 Investment rate refers to gross fixed-capital formation as a percentage of GDP, a standard measure of aggregate investment rate, as reported in the World Bank's World Development Indicators.

In its efforts to ensure efficient use of capital, Vietnam might take a lesson from South Korea, whose impressive growth during the quarter century before 1997 can be explained largely by the fact that its people worked long hours and saved a great deal, which led to rapid accumulation of capital.¹¹ South Korea was able to invest huge amounts in the best technology available in fields such as steel-making and the manufacture of semiconductors. Nevertheless, the low efficiency of much investment was exposed during the Asian financial crisis of the late 1990s. This forced the nation to address its capital allocation and management practices, reform its corporate governance, and increase its exposure to foreign competition in order to achieve a shift to more productivity-led growth. The challenge for Vietnam is to make the transition to productivity-led growth without going through a severe financial crisis.

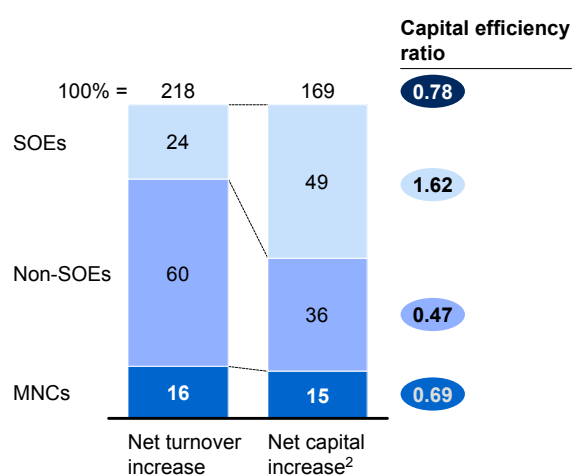
Box 1. Raising the capital efficiency of Vietnam's SOEs

One measure of how productively a company invests is the capital efficiency ratio, the amount of investment needed to generate an additional unit of revenue; the higher the ratio, the poorer is the efficiency of the capital invested. The average capital efficiency ratio for Vietnamese SOEs is 1.62—they need \$1.62 in capital to generate one additional dollar of revenue. That compares with the average ratio we calculate in Vietnam for multinational corporations of 69 cents and for private companies as a whole of just 47 cents—a gap that differences in the underlying sector cannot explain. Boosting the productivity of SOEs is particularly important in the transportation, storage, and telecom industries, all of which MGI has identified as having significant growth potential but where SOEs control 60 percent of the domestic market. Raising the capital efficiency of Vietnam's SOEs would contribute a great deal to boosting economy-wide capital efficiency (Exhibit 11).

Exhibit 11

Increasing the capital efficiency of state-owned enterprises could contribute significantly to Vietnam's overall capital efficiency

Net increase 2005–09
%; \$ billion¹



¹ \$1 = 17,065 Vietnamese dong.

² Increase in fixed-asset and long-term investment.

SOURCE: Vietnam Enterprise Survey 2009; Vietnam General Statistics Office 2011; McKinsey Global Institute analysis

¹¹ For more detail on South Korea's economic performance, see *Productivity-led growth for Korea*, McKinsey Global Institute, March 1998 (www.mckinsey.com/mgi).



The acceleration in productivity that is required to sustain a 7 percent growth rate will not come about if only incremental changes are made. Instead, deep, structural reforms of the Vietnamese economy are necessary, and this will require a strong and sustained commitment from policy makers and a much-improved contribution from companies operating in Vietnam. We now turn to a discussion of an agenda for spurring future productivity and sustained growth

3. A four-point agenda for sustaining growth

Vietnam's government today is naturally focused on fire fighting in the midst of a bout of macroeconomic instability. It is important that officials restore calm and regain the trust and enthusiasm of both national and international investors by addressing the risks from current macroeconomic imbalances. Over the longer term, Vietnam needs to find new fuel for growth, given the weakening of past growth drivers. Increasing productivity across sectors in the economy will be the key to vaulting Vietnam into an invigorated phase of new growth.

The many strengths that Vietnam's economy already boasts offer a solid platform from which to plan the next phase of productivity-led growth. Now the government needs to improve its capabilities across the sectors of the economy, become increasingly versatile, and build on recent success stories. It needs to encourage companies to continuously innovate while identifying new growth opportunities to replace those that are becoming worn out. In this effort, Vietnam can learn from the experiences of other nations that have faced similar transitions.

First, Vietnam has to get the basics right: maintain macroeconomic stability, continue to reduce red tape, expand the talent pool, and resolve infrastructure bottlenecks. The need for these improvements is widely recognised within Vietnam; the country needs to move from a discussion of "what" to tangible proposals that deal with "how." Action on these fronts is necessary but not sufficient. The Vietnamese government needs to refine its role and capabilities to help boost industry-level productivity and build a strong foundation for sectors that offer the best potential for sustained growth.

MGI's 20 years of research on productivity and competitiveness across more than 20 countries and 30 sectors has shown that governments play a vital role in creating an environment that leads to higher productivity and growth—yet that role varies by sector. The spectrum of public policy interventions ranges from a "hands-off" approach limited to creating the necessary market institutions to becoming a central operator in a sector. The right policy mix varies, depending on the economic and competitive dynamics of each industry. To get the incentives right, any government needs to understand the economics of different industries and the global competitive environment in which each sector operates, and to ensure that it has the skills and capacity to execute policy effectively.¹²

In this chapter, we provide policy recommendations in four priority policy areas: maintaining macroeconomic stability; strengthening productivity enablers such as education and infrastructure; shaping a coordinated, industry-specific government growth agenda; and continuing to reform the role and capabilities of the government itself so that it can deliver on an increasingly nuanced pro-growth policy. We now discuss each of these in turn.

¹² *How to compete and grow: A sector guide to policy*, McKinsey Global Institute, March 2010 (www.mckinsey.com/mgi).

Ensure macroeconomic and financial sector stability

Most of the macroeconomic indicators for the Vietnamese economy have started to look problematic in recent years, prompting international credit rating agencies to downgrade the nation's credit rating. Inflation has been rising and topped 20 percent in June 2011. The authorities had devalued the dong four times in 20 months at the time of this writing and had ramped up interest rates to 20 percent in an effort to curb rising prices, yet consumer inflation still rages. There also has been a marked deterioration on the trade front with the current account deficit reaching \$6 billion in 2010—or 6 percent of GDP—and a drop in foreign reserves to \$12.4 billion in 2010, a total that is equal to 39 percent of Vietnam's total foreign debt, down from over 100 percent of the same in 2007.

Many emerging economies experience similar periods of turbulence as they develop, so comparing Vietnam's macroeconomic pressures with experiences elsewhere is a useful exercise. The financial sector offers an example, because the stability of the financial system is critical not only to reduce macroeconomic risks but also to encourage robust savings growth and to guide investment toward areas that boost productivity.

If we look at two metrics that have often triggered crises in other countries, Vietnam's financial sector appears vulnerable. The first of these signals is the rapid expansion in bank lending that is often accompanied by a parallel rise in the share of non-performing loans. Total outstanding bank loans have increased sharply, at a rate of 33 percent a year over the past decade, the strongest growth rate recorded in any ASEAN country, China, or India (Exhibit 12). By the end of 2010, the value of loans outstanding had reached an estimated 120 percent of GDP compared with only 22 percent in 2000. While comparable international statistics on non-performing loans are currently not available, there is a widely shared concern that the associated rise in non-performing loans may trigger significant economic distress (as it has elsewhere) and could force the Vietnamese government to intervene to protect depositors, the banking system, and ultimately taxpayers.¹³ China took this path in mid-2000, South Korea during the Asian financial crisis in the late 1990s, and the United States and the United Kingdom took it during the most recent global financial crisis.

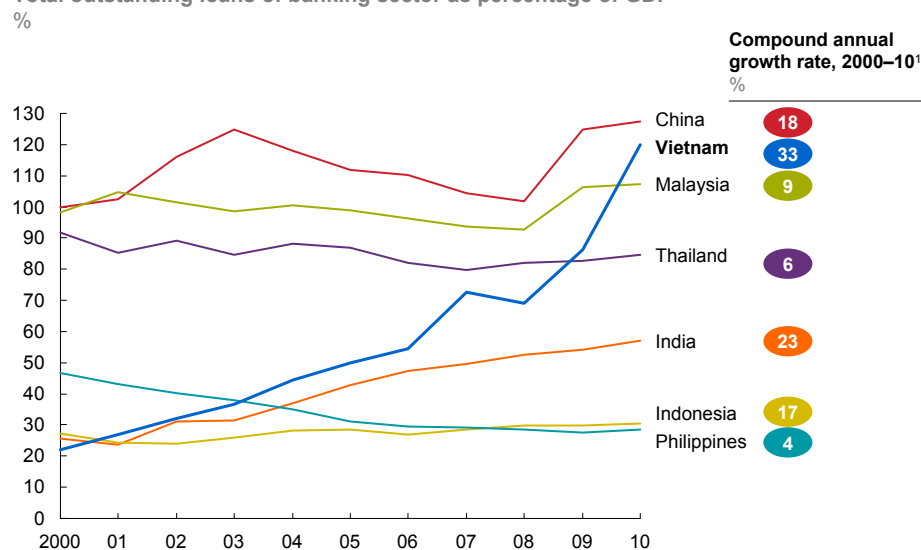
This year the Vietnamese government introduced several banking regulations including a 20 percent cap on annual credit growth and limits on non-productive bank activities such as real estate and securities markets investment. In addition, Vietnam capped deposit rates at 6 and 14 percent—firmly in negative real interest territory. Yet these measures are challenging to enforce and unlikely to suffice. For example, the actual credit growth exceeded the annual target rates in both 2009 and 2010. And these aggregate limits on credit growth do not address the accumulated risk in existing bank portfolios or the broader liquidity risk arising from a mismatch between short-term deposits and medium-term lending.

¹³ The official share of non-performing loans is 2 percent in the overall banking system. However, the World Bank among others has stated that if the regulation were upgraded to international standards and enforced effectively, the share would be significantly higher. See *Taking stock: An update on Vietnam's recent economic developments*, World Bank, prepared for the annual consultative group meeting for Vietnam, Hanoi, December 7–8, 2010.

Exhibit 12

Loans from the banking sector have grown rapidly in Vietnam

Total outstanding loans of banking sector as percentage of GDP



¹ Local currency, nominal.

SOURCE: McKinsey Global Banking Pools; McKinsey Global Institute analysis

We see three long-term systemic risks facing the sector today, especially given the uncertain macroeconomic environment. To reduce these risks, the government will need to take major steps to change the rules of the game and encourage structural change in the industry. The first of these is that, while the reported level of non-performing loans appears to be under control, their true volume is likely to be much higher than the reported figures. The key sources of risk here are Vietnam's large share of state banks, some of which may lend on political direction rather than financial grounds; the fact that cross-holdings are prevalent and these weaken corporate governance; and that the sector has a large number of sub-scale banks. In response, Vietnam needs to enforce stricter standards for recognising bad loans, and further equitising state banks and enforcing rules on cross-holding and related regulations on party transactions. The government needs to pay special attention to the health of Vietnam's largest state-owned banks that pose a systemic risk due to the sheer size of their balance sheets. Strengthening independent auditing and potentially setting up a central bank to manage and work out the troubled assets are other steps to consider. Finally, Vietnam should enforce minimum capital requirements to drive the consolidation of sub-critical players.

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 invest money in the short term. Term deposits with durations of a month or less are Vietnam's most popular product. 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 has seen its trade deficit widen despite multiple devaluations of its currency, the dong, and—together with a flight to dollars and gold—these have contributed to a drying up of foreign reserves. In addition to boosting the confidence of investors in broad terms, Vietnam will need to strike the right balance in its exchange-rate policy to maintain cost

competitiveness in the face of inflation and help ensure that hidden foreign reserves are brought back into the official economy so these funds can be invested productively.

All of these factors in combination have led to a series of episodes in which funding becomes scarce and very expensive. The next “mini crunch” may be underway given that small banks are struggling to raise customer deposits because, with the interest rate cap, they no longer can offer more attractive returns. On a positive note, the banking sector thus far has proved resilient despite hostile global conditions and it appears to have contained any problems. It would be beneficial if the current squeeze could kick-start the consolidation of smaller banks and catalyse the introduction of true investment products such as open-ended mutual funds.

Many of the issues that Vietnam faces today come down to limited governance and transparency. Laying out a clear roadmap for the adoption of international standards such as Basel would be helpful for improving the long-term stability and viability of the sector and bolstering confidence among investors. 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. Vietnam could usefully run a series of bank stress tests to identify banks that are struggling and separate them from those that are performing well and can be deemed to be “safe”.

Strengthen productivity and growth enablers

To facilitate a transition toward higher productivity operations, Vietnam needs to replace low wage costs with new sources of comparative advantage. Though Vietnam has clearly established itself as an attractive investment location for foreign investors, it lags behind many of its Asian peers in overall international competitiveness rankings (Exhibit 13).

Many of the areas showing the largest gaps when compared with other Asian economies are well recognised, and Vietnam has already started to address many of these shortcomings.¹⁴ The government’s efforts to simplify business start-up regulations, improve permitting processes, and reduce tax rates enabled Vietnam to improve by its ranking by ten places in the World Bank’s Doing Business index. What Vietnam now needs is to institutionalise processes to ensure continuous progress. Singapore is among global benchmarks for making continuous improvements to its government’s capabilities, and other nations have followed similar approaches. Saudi Arabia, for example, established a high-profile 10x10 initiative in 2006 that aimed to make the economy one of the ten most competitive in the world by 2010. As a result, it initially improved in the World Bank’s business environment rankings by 15 places in just two years and its ranking has continued to improve, reaching 11th place globally this year.

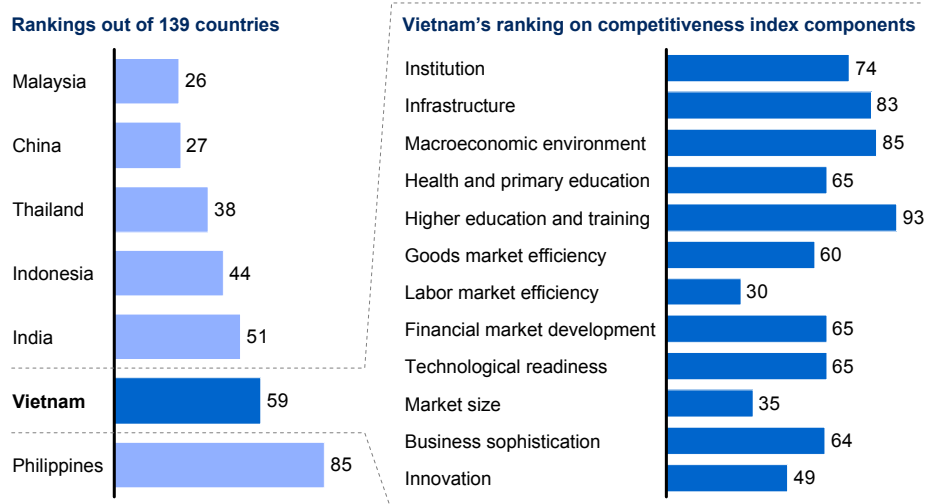
14 The World Bank judges Vietnam to be one of the ten most improved economies on competitiveness. See *Taking stock: An update on Vietnam’s recent economic developments*, prepared by the World Bank for the annual consultative group meeting for Vietnam, Ha Tinh, June 8–9, 2011. Also see Christian Ketels, Nguyen Dinh Cung, Nguyen Thi Tue Anh, and Do Hong Hanh, *Vietnam competitiveness report*, Vietnam’s Central Institute for Economic Management and Asia Competitiveness Institute, 2010.

Even in areas where the business environment is more challenging, actionable lessons can be drawn from countries that have succeeded in making progress. Let us illustrate with two of the categories in which Vietnam gets a low score on the World Economic Forum's competitiveness index: infrastructure and education.

Exhibit 13

Vietnam lags behind other Asian economies on international competitiveness rankings

World Economic Forum global competitiveness rankings, 2010–11



SOURCE: World Economic Forum Global Competitiveness Report 2010–11; McKinsey Global Institute analysis

VIETNAM NEEDS TO FOCUS INFRASTRUCTURE INVESTMENT ON STRATEGIC PRIORITIES AND EXECUTE WITH THE PRIVATE SECTOR

Vietnam has already made significant investment in its infrastructure. The country's road density reached 0.78 kilometres per square kilometre in 2009, higher than the density of the Philippines or Thailand.¹⁵ Electricity networks covered more than 96 percent of the nation in 2009.¹⁶ New ports such as those in Dung Quat and Cai Mep and airports such as those in Da Nang and Can Tho have improved connections with 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 increasingly productive activities. This need has been recognised by Prime Minister Nguyen Tan Dung, who said, "In 2009, the country's infrastructure did not improve. This will continue to hurt Vietnam's economic growth."¹⁷ Yet given the fact that funding for infrastructure is limited, the government will need to prioritise projects and boost the return on investment in all infrastructure spending. In order to prioritise infrastructure projects that offer the greatest economic benefits, investment decisions will need to be tied closely to Vietnam's broader economic development strategy and be closely coordinated with a

15 *The study on national road traffic safety master plan in the Socialist Republic of Vietnam until 2020*, Japan International Cooperation Agency, 2009.

16 *Vietnam's success in increasing access to energy through rural electrification*, Asian Development Bank, 2011.

17 *Vietnam Investment Review*, November 2009.

range of government agencies that have roles to play in creating an effective “ecosystem” for success.

Tourism offers a good example of how government can play a key role not only in managing the infrastructure, transportation, and other relevant government agencies but also in coordinating different private-sector industries (such as hotels, real estate, and transport services) to work synergistically. After successfully positioning the country as a long-distance destination, Vietnam has established a master plan for continuing to develop tourism between 2011 and 2020. The plan sets strategic priorities to target key market segments and develop regional clusters, as well as established a desired approach to marketing.¹⁸ As the government develops this strategy, it would be useful to look at international experiences that strongly suggest that success in meeting such goals depends critically on placing the right enabling investment in infrastructure within a broader strategic plan (see Box 2, “Government’s coordinating role in tourism”).¹⁹ For example, to sustain and expand high-end, long-distance tourism at relatively high prices, Vietnam could benefit from more coordination among individual development projects and from focusing on destinations that are close to important heritage sites, where restaurants and tours could gain sufficient scale to differentiate themselves from other regional destinations. Vietnam’s location and its long coastline give the country a strong starting position from which to become an early mover in the growing Chinese middle-class market. The elimination of visa requirements for tourists intending to visit the southern island of Phu Quoc, Vietnam’s largest, where plans for major resorts and casinos are being actively discussed, is one such opportunity to attract a new segment of tourists.

Vietnam’s infrastructure plan suggests that the private sector will need to contribute a substantial share toward overall infrastructure investment. For instance, more than 40 percent of investment in transportation is expected to be privately funded. This appears to be an effective strategy. MGI finds that as long as infrastructure projects are executed effectively, private-sector participation can deliver a 30 percent increase in productivity in five to ten years. Vietnam is already exploring ways of collaborating with the private sector. The Long Thanh-Dau Giay Expressway in Ho Chi Minh City is currently largely financed by overseas development assistance but there are plans to get the private sector involved. Vietnam’s state-owned enterprise Vinaconex has two partnerships with South Korea’s Posco Engineering and Construction: the expansion of the Lang-Hoa Lac expressway and on the building of a new city called North An Khanh. Again, as it develops these collaborations, Vietnam has many successful examples from around the world from which to learn lessons on execution, as we discuss in the following section.

18 *Master plan for tourism 2010–2020*, Vietnam Ministry of Culture, Sports and Tourism, 2010.

19 The World Economic Forum’s travel and tourism competitiveness report of 2009 ranks Vietnam 89th out of 133 nations and highlighted transportation, hotels, and services as challenges. See World Economic Forum, *Travel and tourism competitiveness report 2009: Managing in a time of turbulence*, 2009.

Box 2. Government's coordinating role in tourism

Many governments have been proactive in their efforts to boost the growth of tourism. Becoming an attractive location for tourists requires a wide range of services, from the construction of large-scale airport and road infrastructures to the provision of hotel and restaurant services.

Experience shows that government efforts to orchestrate these disparate parts of the tourism jigsaw can make the difference between success and failure. In the development of Mexico's upmarket Riviera Maya beach resort area, the government used zoning to ensure the development of exclusive hotels, upscale restaurants, and boutiques that enabled average hotel rates double those of Cancún, a more tightly built beach resort with a deteriorating image 65 kilometres to the north. The government also cultivated anchor destinations including the Xcaret Eco Theme Park and the Xel-Ha aquatic nature park. The strategy of separating mass-market Cancun and the more upmarket Riviera Maya resorts, providing supporting services for each, was enabled by increasing the capacity of Cancún airport.

In Morocco, the highest level of government (including the king) committed to developing the country as a tourism destination. The government designed the strategy; set up an agency to manage the project, fund marketing, and monitor progress; and collaborated closely with the private sector. Major infrastructure improvements were a key part of the plan. These included the liberalisation of airline routes with an emphasis on encouraging low-cost carriers (including a low-cost subsidiary of the national airline) and improving road access to heritage locations. Together with tax exemptions in favour of the industry, this coordinated and well-executed approach has helped to almost double international arrivals in six years.

In contrast, insufficient coordination can hold back tourism. Egypt's Sharm El-Sheikh is an example where ad hoc tourism development led by the private sector rather than a coordinated approach has failed to make the most of the area's strong intrinsic assets—beach resorts and coral reefs for divers close to historical heritage sites. Absent alignment between public and private investors or indeed between the region and central government, the public transport infrastructure has lagged behind the development of tourism, and services such as trash collection have not been on par with expectations of international travellers. Connections between beaches and cultural sites are not easy. The overall result is that tourism is not making as large a contribution to Egypt's economy as it could.

VIETNAM NEEDS TO BROADEN EDUCATION AND TRAINING AND IMPROVE THEIR TRANSPARENCY AND EFFICIENCY

Among the most critical drivers for achieving a transition to more productive, higher-value-added activities is expanding Vietnam's talent pool. Two major problems on the talent front emerged from interviews that MGI conducted with executives from local companies and multinational corporations (MNCs). The first was a lack of basic work-readiness among new recruits in both the manufacturing and service sectors. Many companies in other countries have responded effectively to this problem by providing in-house training both before an employee starts working and while on the job. In Vietnam, businesses such as FPT Software, a leading Vietnam-based software development company, have already demonstrated that company-run training schemes can be successful, too.

The second challenge cited was a shortage of qualified engineers and middle managers—a shortcoming that is common in rapidly developing economies.²⁰ The situation in Vietnam, however, appears to be more challenging than in other Asian economies, according to survey evidence (Exhibit 14).²¹ In parallel with a broad effort to enhance the quantity and quality of public postsecondary education, Vietnam can continue to refine its collaboration with companies and external educational institutions to address these particular skill challenges.

Exhibit 14

Vietnam has a relatively high skills gap

Human capital in Vietnam

%



NOTE: Based on the results of a survey of 808 firms operating in Asia.

SOURCE: Japan External Trade Organization; McKinsey Global Institute analysis

Another role for the Vietnamese government is to facilitate transparency and quality control within the nascent private education industry. One clear opportunity is for the government to make the performance of private schools transparent through simple means such as gathering and publishing their performance statistics, running online assessment polls in which students can

²⁰ *The emerging global labor market*, McKinsey Global Institute, June 2005 (www.mckinsey.com/mgi).

²¹ *2010 JETRO global trade and investment report: A global strategy for Japanese companies to open new frontiers in overseas markets*, Overseas Research Department, Japan External Trade Organization, August 2010.

evaluate private educational programmes, and requiring trainers to hold certain certificates that attest to their own levels of educational attainment.²² Such methods would encourage companies and educational institutions to focus on increasing the quality and not just the quantity of their education and training programmes. These changes would also increase the attractiveness of such programmes to potential students thinking about enrolling in such privately managed educational courses. Because various bodies in local, state, and central government share authority over both public and private provision of education and training, there is clearly scope to apply standards common to each in a transparent way.

Another potential avenue is for the government to issue certificates for qualified training programmes that demonstrate that an employee who has completed instruction has mastered certain skills. Such certificates would make participation in company-provided programs more attractive to potential trainees and would encourage companies to provide more generalist training—perhaps as part of earlier-stage recruiting efforts. And while the government already offers financial incentives to companies that participate in educational programmes, it could tier the subsidies to favour programmes that offer training in skills that are most broadly applicable within the economy.

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

Getting economy-wide regulation right is a necessary condition for productivity and growth. But even smart regulation alone is not sufficient to sustain the broad-based growth Vietnam has enjoyed in recent years. Differences in industry-specific government action go a long way toward explaining variations in the performance of sectors between economies—but in very different ways depending on the sector.

Vietnam's next challenge is to establish an enabling environment at the level of individual industries and sectors. This can mean pushing for more competition in domestic markets or strengthening enablers in sectors that are well positioned for growth and for competing globally. Drawing on MGI's extensive research on industry productivity across the globe, we highlight four examples of industries where examples from other countries suggest opportunities to shift the role of government.

TARGETED INVESTMENT CAN HELP BOOST QUALITY AND PRODUCTIVITY IN AQUACULTURE

In the past decade, Vietnam has made notable strides in improving the production and exports of its valuable agricultural products. Privatisation in the paddies has helped Vietnam emerge as the world's third-largest exporter of rice, while the nation's entrepreneurs helped turned Vietnamese tra and basa catfish products into exports consumed across Europe and North America. These are significant achievements that we should not overlook.

²² The International Finance Corporation and the Islamic Development Bank have produced a number of interesting ideas applicable to the Middle East that Vietnam could explore. See *Education for employment: Realizing Arab youth potential*, International Finance Corporation and Islamic Development Bank, April 2011.

But in the course of Vietnam's drive to become a more important player on the global agricultural stage, the country has learned that its rural sectors need to develop greater expertise and more technical training in order to produce higher-quality products that can command higher prices. Both nongovernmental organisations such as the Food and Agriculture Organization of the United Nations and Vietnamese government agencies are beginning to teach Vietnam's producers the intricacies of good agricultural practices so they can compete more effectively in world markets now that Vietnam has joined the WTO. Some within the country are discussing the potential for creating identifiable brands for Vietnamese seafood products, but this aspiration would require Vietnam to create a more comprehensive and modern infrastructure to certify the sustainability and safety of its aquaculture products. The importance of such an effort was underlined in July 2011 when the Canadian government threatened a ban on Vietnamese catfish products after finding samples with excess levels of the antibiotic enrofloxacin, according to the Vietnam Association of Seafood Exporters and Processors.²³

Government regulation and standards can play a role, but Vietnam also can help to improve the quality of its fish farming by more actively promoting internal control systems by which international organisations train local farming cooperatives to inspect for quality among their own members. Self-policing by such cooperatives often has proved effective because the reputation of all depends on the reliability of each member. Investing in cooperatives that monitor and police feeding practices, sanitary conditions, and sustainability can help raise the quality profile of Vietnam's seafood exports as it competes for share in the seafood-loving markets of Europe and the United States. The government also can purchase advance testing equipment to ensure that its food-testing system is rigorous enough to sustain international scrutiny.

Chile provides an interesting example of how to use public funds to foster innovation and competitiveness of agricultural products. A driving force behind the growth of the Chilean salmon industry, among others, has been Fundación Chile, a venture-capital investment fund established with an original endowment from the government. The fund has a mandate to invest in business development in areas such as agriculture where the fragmented supplier base limits the capacity for R&D; to develop promising ideas into viable businesses; and to spin off into the private sector those companies that prove most successful. Perhaps the most effective instance of the fund's approach was its support for the growth of the Chilean salmon industry through a broad, coordinated effort on research on viable breeds, investment in plants producing feed for the salmon, streamlining the export processes, and technical assistance to individual farmers (e.g., ongoing support for developing vaccines against diseases). As a result, Chile has become the world's second-largest salmon exporter.

GOVERNMENT CAN ENABLE THE DEVELOPMENT OF VIETNAM AS A GLOBAL HUB FOR OUTSOURCED AND OFFSHORE SERVICES

Outsourced and offshore services are a rapidly growing global industry that offers a broad range of opportunities for creating productive jobs. The global industry generated between \$110 billion and \$115 billion in revenues in 2011 and revenues are expected to increase to at least \$400 billion in 2020. Vietnam already has

²³ "Canada warns Vietnam about antibiotic in catfish," info.vn, July 26, 2011.

created an initial base for a successful outsourcing and offshore service sector. Total annual revenues today exceed \$1.5 billion and more than 100,000 people are directly or indirectly employed in the sector. Several prominent MNCs already have established operations in Vietnam, including Hewlett Packard, IBM, and Panasonic. The question is how might Vietnam sustain growth in this globally competitive market, and fulfill its potential to become one of the top ten locations in the world for outsourced and offshore services.

Vietnam starts with two significant advantages: a relatively large pool of young graduates and relatively low wages. Vietnam produces 257,000 college and university graduates a year. A software programmer in Vietnam can be hired for less than 60 percent of what it costs to hire one in China, while data processing and voice processing agents both cost 50 percent less to employ than their counterparts in China. To capitalise fully on its talent advantage, however, Vietnam needs to make significant improvements in the quality of that talent and also to overcome infrastructural and regulatory bottlenecks (Exhibit 15).

Exhibit 15

Vietnam can significantly improve its attractiveness by working on actionable opportunity areas

Existing strength
Opportunity area

Location Readiness Index (LRI), FY 2010
1 = most attractive, 5 = least attractive



1 Location Readiness Index uses the following weights: cost 35 percent, talent (35), risk (10), infrastructure (10), and vendor maturity (10).

SOURCE: McKinsey Outsourcing and Offshoring Practice Location Readiness Index, FY 2010; McKinsey Global Institute analysis

Limits to Vietnam's talent pool—both in terms of command of English and technical talent—will continue to constrain the growth of segments where these skills are critical. Deputy Prime Minister Nguyen Thien Nhan emphasised in early 2011 that Vietnam can realise its dream of becoming an IT power, but acknowledged that Vietnam still has problems with the quality of its labour force, particularly in the IT sector and, more broadly, in areas where foreign language skills are necessary. Moreover, reliable, high bandwidth connectivity to international business locations is a necessary condition for the sector's growth. In India, poor infrastructure delayed the growth in offshore services until local and private initiatives around Bangalore provided sufficiently reliable power and telephony services.²⁴ In Vietnam, beyond continuing to help expand the talent pool and improving reliability of infrastructure, the government can do more to

24 *New horizons: Multinational company investment in developing economies*, case study on software and IT services, McKinsey Global Institute, October 2003.

facilitate the growth of the industry. Vietnam is competitive in the data, business process, and IT outsourcing segments where low costs and the capacity necessary to establish large-scale service centres are critical. In addition, Vietnam offers niche segments such as the French language outsourcing services provided by Officience, a company that focuses on telecommunications and the Web-Internet operations industry. Vietnam already offers favourable incentives to companies in this sector, including a waiver on taxes in the first four years and a 50 percent tax reduction in the next five years. However, these incentives need to be backed by a comprehensive programme that addresses local infrastructure and real estate gaps and increases Vietnam's visibility within the global industry. While a number of special economic zones are already in progress, a dedicated government body could be assigned to spearhead global marketing efforts and attract global anchor companies to boost awareness and momentum for expansion.

Over time, outsourced and offshore services may have the potential to evolve into higher-skill segments and contribute to Vietnam's goal of become a leading nation in information and communications technology by 2020. Both the software and IT services segments are areas where the availability of skilled workers at a globally competitive cost drives growth. In Vietnam, local companies including FPT Software are providing outsourced services to many multinational corporations, particularly in North America and Japan; FPT Software is actively looking for business opportunities from Japanese companies such as Nippon Oil and Hitachi. To support these individual efforts, industry associations in India (Nasscom) and the Philippines (BPAP) have coordinated efforts to resolve industry bottlenecks at home and become active spokesmen for the local industries in global industry meetings.

In addition, Vietnam should consider strategies to take advantage of domestic demand to incubate and grow IT and business process services offerings. Because local demand is the main driver of growth in IT services within nations, government software purchasing can be a stimulus to boost domestic companies. In the United States and Israel, public defence spending has been a major source for expanding software capabilities. Both Norway and Singapore have relied on local suppliers for e-government solutions, while Brazil has used a local provider to deliver an electronic voting system. In China, national and local governments use Chinese vendors for both operating systems and applications. With the right competitive environment, public-sector demand can be an important contributor to the growth of local industry.

Like India, China, and the Philippines, Vietnam could aspire to play a leadership role in the global outsourced and offshored services industry. With the right action to stimulate demand and enable supply, this industry in Vietnam could produce annual revenues of between \$6 billion and \$8 billion a year, much of it export-oriented. This sector could become an engine of job creation in urban areas, employing an additional 600,000 to 700,000 people by 2020 and contributing 3 to 5 percent to Vietnam's GDP growth. The government needs to craft a concerted plan of action, backed by an overarching vision for the industry, that focuses on five imperatives: (1) attracting service providers and MNCs that can stimulate demand; (2) building a sustainable talent pool, focusing on quality and availability; (3) creating a world-class infrastructure in terms of real estate and connectivity; (4) putting in place an enabling regulatory environment; and (5) aggressively promoting "Brand Vietnam" in international forums.

VIETNAM NEEDS TO SHIFT INTO HIGHER-PRODUCTIVITY SEGMENTS AND ACTIVITIES IN MANUFACTURING

Vietnam has successfully developed and expanded textile, shoes, and other relatively low-skill manufacturing industries, as we have discussed. Now Vietnam should consider focusing more energy on efforts to boost productivity-led growth in manufacturing. This needs to come from both raising productivity in existing operations and expanding the share of higher-value-added, higher-productivity activities. To achieve the latter, Vietnam needs to enable segments that already have achieved relatively high productivity to thrive and grow, and encourage companies—both MNCs and Vietnamese—to expand into higher-value-added, higher-productivity activities. The path to achieving productivity-led growth varies among individual manufacturing industries. But experience in Vietnam as well as in other countries suggests potentially productive areas to explore. Below, we highlight two such areas.

First, industries that are growing rapidly because of rising domestic demand can use this as a springboard to boost their sales beyond the local market and expand exports to neighbouring economies such as Laos and Cambodia. Sectors performing well on the back of local demand range from electrical equipment including wire, cable, and batteries where local companies have performed strongly, to beauty and sanitary products including soap and cosmetics where multinational companies including Unilever and Procter & Gamble have established a strong presence. Exports of electrical equipment products reached \$500 million during the first five months of 2010, 100 percent higher than in the same period of 2009. Encouraged by this success, the government plans to invest about \$7 billion from 2011 to 2015 to help develop these industries. The government aims for annual export growth of 18 percent during this period (and 35.5 percent in the case of high-quality electrical wire and cable exports)—even while meeting domestic demand. However, to facilitate this transition from largely serving the domestic market to also serving those overseas, the Vietnamese government has a role to play, particularly in segments with fragmented local players that may lack the scale to meet export hurdles. The government also needs to tightly run a quality-assurance program, because product quality has emerged as an issue as exports have grown.

Second, the Vietnamese government might give some thought to developing a longer-term strategy to facilitate the stage-by-stage transition to higher-value-added activities across global business value chains. MNCs in the electronic products segments, including Canon, Intel, Samsung, Fujitsu, Tokyo Micro, and Brother, have broadened their footprint in Vietnam as part of their efforts to build a global manufacturing base and to serve growing local demand. Vietnam is attractive because of its access to promising ASEAN markets with their expanding middle classes, and as a hedge against any risk that might emerge in China. However, most of the activities such MNCs carry out in Vietnam are simple assembly or basic R&D that deals with embedded software. Vietnam could aspire to follow the evolutionary path observed in other countries. East Asian giants including Samsung, LG, Huawei, and Haier all started as local suppliers to or assembly manufacturers for global players of that time and gradually climbed up the value chain. Huawei illustrates how a Chinese company developed into a firm with global clout. Between 1987 and 1992, Huawei became a regional leader in the manufacture of private branch exchanges and the assembly of fire alarm systems. A Hong Kong-based private branch exchange manufacturer was the company's main buyer. At that time, the company was in competition with

around 20 similar players in Shenzhen and in Guangdong Provinces. From 1993 to 2000, Huawei successfully launched into producing digital circuit and optical transmission switches, targeting both the middle and high ends of the market. During this phase, Huawei became a leading player along with three competitors in China. Since 2001, the company has expanded into a number of developing economies as well as into Western Europe and has grown to handle all activities along the value chain from R&D to final assembly. As it went global, the company received significant support from the Chinese government. For example, then-Prime Minister Zhu Rongji asked banks to give Huawei vendor-financing credits.²⁵ Chief executive officer Ren Zhengfei was able to accompany Hu Jintao, the future president of China, on official visits to potential markets.²⁶

In past decades, the speed of how industry has evolved has accelerated. For instance, it took Japanese companies 40 years on average to climb up the global value chain from basic assembly to core skilled operations, but only 30 years for South Korean companies to complete this transition and 20 years for Chinese businesses. It is therefore possible that Vietnamese firms could make this transition within a shorter time frame. But, to ensure speedy progress and be most effective, Vietnam needs to tailor its policies to the stage of a particular industry's development in order to be most effective. For instance, the domestic electronics industry is in its early stages of development, so the most effective policy is likely to be encouraging competition among local assembly outfits and suppliers so that competitive champions can emerge. Once these businesses become capable of using the domestic market as a launch pad into international markets, the Vietnamese government might consider giving these companies targeted help.

Targeted and carefully calibrated support from government has proved effective in many cases, but it is important to judge where such help can make a difference. In fast-moving, innovative, and globally competing sectors such as software and semiconductors, global industry dynamics and competition among companies are the key factors driving overall performance, and it is harder for governments to have as direct an influence. What matters more is creating a strong enabling environment for private-sector success. Yet, even in this rather more limited role for government, success is far from guaranteed. Malaysia and Singapore both provided heavy subsidies to develop semiconductor clusters to imitate Taiwan's successes in the sector, but in neither case did the industry achieve scale. Such failed initiatives can cost governments billions. To improve their odds of sustaining growth, governments need to focus their aid on activities that are based on solid business logic and offer a realistic potential for competitive advantage.

REGULATION CAN HELP IMPROVE ENERGY EFFICIENCY AND HELP VIETNAM MEET RISING DEMAND FOR ELECTRICITY

Vietnam has already electrified most of the nation, but today's electricity infrastructure—and particularly transmission and distribution networks—is unable to meet rising demand from rapidly expanding businesses and increasingly wealthy consumers. According to the World Bank, energy demand in Vietnam

25 Cheng Dongsheng and Liu Lili, *The truth of Huawei*, Contemporary China Publishing House (Shanghai: 2004).

26 Xiaoyan Sheng, *Chuan Qi (legend): Ren Zhengfei*, Modern Publishing House, 2010.

may triple in the next decade if current trends hold.²⁷ Expanding investment in the power-supply infrastructure is among the priorities laid out by the government, and regulatory reform of the sector is under way. Yet to meet the needs of an increasingly higher-productivity economy, the regulatory environment needs to address three challenges: (1) encourage continuing investment to expand generating capacity; (2) establish incentives for utilities to adopt economically attractive technologies and solutions for generation, transmission, and distribution; and (3) develop strong incentives for more efficient electricity use by consumers.

All three are important. But MGI finds that the most cost-effective way to address these energy supply concerns is on the demand side: through improving energy productivity—raising the level of output an economy achieves from the energy it consumes.²⁸ By adopting existing energy-efficient technologies that pay for themselves in future energy savings, developing countries on average can reduce their energy demand growth by more than half, significantly reducing the need to expand overall electricity supply capacity to keep up with demand. Time is of the essence for Vietnam, as with other developing economies that are amassing capital stock—buildings, machinery, and equipment—on a large scale and at a rapid pace. Vietnam needs to seize a precious opportunity to ensure that this stock is built with an economically optimal level of energy efficiency, thereby locking in lower energy consumption for a generation. The World Bank has estimated that boosting energy efficiency in Vietnam's industrial facilities can reduce energy demand by 25 to 30 percent.²⁹

Continue to reform government's role in the economy and strengthen delivery capabilities

The task of steering the Vietnamese economy in the direction of productivity-led growth is complex and demanding. At the same time, expectations of what governments can deliver have increased across the globe. Citizens and companies demand better results—and faster than in the past. In an increasingly competitive global economy, governments, as in Lewis Carroll's Alice in Wonderland, must learn to run just to maintain position. To meet the challenge, the government needs to continue to reform and adjust its role in the working of the economy, and also to strengthen its organisational effectiveness and delivery skills to execute a policy agenda. To illustrate some successful models that Vietnam can draw upon, we discuss here the experiences of other countries facing similar challenges.

27 *Vietnam: Expanding opportunities for energy efficiency*, Asian Sustainable and Alternative Energy Program, The World Bank, 2010.

28 MGI reports on energy productivity include *Curbing global energy demand growth: The energy productivity opportunity*, May 2007; *Wasted energy: How the US can reach its energy productivity potential*, June 2007; *The case for investing in energy productivity*, February 2008; and *Fueling sustainable development: The energy productivity solution*, October 2008. All are available to download at www.mckinsey.com/mgi.

29 *Vietnam: Expanding opportunities for energy efficiency*, Asian Sustainable and Alternative Energy Program, The World Bank, 2010.

CONTINUE GOVERNMENT REFORM TO BECOME AN EFFECTIVE INVESTOR IN STATE-OWNED COMPANIES

Given the economic weight the SOEs bear in the Vietnamese economy, reform of the ownership and management incentives for public enterprises can be an important institutional vehicle for improving productivity and growth. One option that has been used effectively elsewhere is the creation of powerful government holding companies (GHCs)—such as Singapore's Temasek, Malaysia's Khazanah Nasional Berhad, and Kazakhstan's Samruk-Kazyna—to oversee the state's portfolio in ways that insulate corporate managers from political influence or control and thereby pushes performance standards. Vietnam has already established the State Capital Investment Corporation (SCIC) in 2005 with a mandate to facilitate the reform of SOEs and to improve the efficiency of the economy's capital utilisation. SCIC could look at how other GHCs have organised and equipped themselves internally and what levers they have used to improve the performance of their SOEs (see Box 3, "Governance in Kazakhstan's government holding company").

Successful GHCs have an effective governance structure, people with the right skills, and, critically, a clear mandate and the political support they need to implement and enforce change in SOEs. GHCs typically require three components to be in place. First, they need a powerful board that reports directly to the highest level of government—president or prime minister—and consists of key government officials such as ministers of finance, economy, and industry, as well as respected leaders from the private sector. Second, the CEO or leader of the GHC needs to have a clear mandate and the personal skills to drive change. Third, the organisation must have sufficient autonomy to hire, fire, and incentivise its employees and be shielded from any backlash against politically unpopular decisions. Without these sources of internal and external strength, most GHCs are unable to execute the difficult but unavoidable choices necessary to position the government's portfolio for growth.

To revamp its portfolio, Khazanah Nasional Berhad in Malaysia undertook a sequenced transformation in which it first strengthened the composition of its board, its governance structure, and the leaders of its largest portfolio companies. The organisation then developed a comprehensive transformation programme to improve performance across its portfolio of investments. The programme consisted of ten initiatives: enhancing the effectiveness of boards, strengthening the capabilities of directors, enhancing the holding company's monitoring and management functions, improving the regulatory environment, clarifying social obligations, revamping procurement practices, optimising capital management, managing and developing human capital, intensifying performance management, and enhancing operational improvements. To ensure the successful execution of these initiatives, Khazanah set up a transformation-management office to launch and implement them across its portfolio of companies.

Box 3. Governance in Kazakhstan's government holding company

Kazakhstan set up Samruk, a government holding company, and later merged this GHC with Kazyna, the country's sovereign wealth fund. The combined organisation manages the nation's SOEs. Samruk conducted a diagnosis of the performance of Kazakhstan's SOEs and identified the levers most likely to improve that performance. It then laid out organisational requirements for these enterprises, including a clear separation of roles and responsibilities by government ministries, the GHC, and SOEs to ensure streamlined and rapid decision-making and processes. Samruk also developed a best-practice governance approach that includes setting objectives for SOEs such as the recruitment of managers and how to incentivise them, planning and budgeting processes, and monitoring mechanisms. Samruk was chaired by Sir Richard Evans, the former chairman of BAE Systems, who brought his experience of governance in Europe to the organisation.

CONTINUE TO STRENGTHEN GOVERNMENT EXECUTION AND DELIVERY CAPABILITIES

Leading a proactive productivity and growth agenda requires strong political leadership that can align and coordinate actions across multiple agencies behind a single vision and shape the management models and skills to fit the requirements in different organisations. At the same time, it requires strong execution and delivery skills within specific agencies that can vary depending on the nature of each. Achieving both requires a significant upgrade in the talent pool of the public sector through dedicated training (in civil service colleges, for example) and even developing a planned career path for elite civil servants that may include a period of foreign education. A number of other nations have addressed these challenges:

- **Effectiveness of FDI agencies.** While Vietnam has established organisations at both the national and the local levels to attract FDI, they can continue to increase their effectiveness by more closely integrating their operations with national industry priorities and through building a customer-focused, high-performance culture. On both accounts, Singapore and Ireland have set the global bar for operating highly effective agencies to attract foreign investors. Both have built capable organisations that have many of the hallmarks of a sales force. Singapore's Economic Development Board (EDB), established in 1961, set out by rigorously identifying areas of strength and weakness and used this assessment to establish national industrial policy priorities—including removing barriers against company expansion and investment aimed at cultivating new businesses. Early on, the EDB focused its efforts on attracting relatively low-skill, labour-intensive operations of multinational companies. It used a systematic approach of identifying potential investor companies, cultivating relationships with those companies, seeking to understand their decision processes, and then developing tailored packages to attract businesses to Singapore. Over time, the focus has shifted to more skilled manufacturing and services, and the efforts to promote Singapore have become increasingly sophisticated. Today, the leaders of Singapore's EDB are paid CEO-level salaries. Entry-level EDB salaries that are 5 percent

higher than in the private sector ensure that they attract people with high skill levels and experience in the industry that allow them to deal with complex interaction with the private sector. Ireland has long focused on attracting FDI, pursuing key investors over a prolonged period—a decade or more in some cases. Intel and Microsoft were early anchor investors. IDA Ireland, founded in 1949 as Industrial Development Authority, is the key agency leading this effort—to seal the deal with Intel, within five weeks the agency interviewed 300 Irish engineers who were living abroad and presented the US company with a list of 85 qualified candidates. IDA Ireland has 16 international offices on four continents. Although the IDA is a government agency, it has developed its own customer-focused and performance-based culture. The agency assesses its staff on the basis of outcomes, not targets.

- **Public-private partnership capabilities and processes.** Public-private partnerships are an increasingly attractive way to acquire investment in an era of constrained public finances, borrowing from private-sector expertise to help ensure effectiveness and value. Nevertheless, such partnerships do not always deliver on all their anticipated benefits. McKinsey finds that focusing on the capabilities of the public-private partnership unit and the processes carried out by it can enhance the value of the partnership by 10 to 20 percent. It is important to make sure that the respective roles of those involved in a deal—and the risks and responsibilities that each takes on—are apportioned effectively. Standardising the way that the partnerships are designed and implemented can save 50 percent on the time it takes to get them up and running. McKinsey has found that if the right institutional capacity is in place—including sufficient investment officers and managers—and performance indicators are developed to track the progress of implementation of each deal, a government can attract approximately 70 percent more private investment annually. Vietnam has already engaged private firms to help build and operate the Phu My 2-2 and Phu My 3 power-generating stations, but this is an isolated example. Successful examples from elsewhere include line 1 of the subway in São Paulo, Brazil. In this case, the partnership was set up with a contract in which the risks involved were clear for all participants. Because this was a green-field development, it was difficult for the private partner to project revenue flows, but the government took a flexible approach, using staged subsidies for passengers at different times during the project. In the United Kingdom, the M6 toll road is the country's first privately funded motorway—an alternative to an existing heavily congested highway. The toll road was built by a public-private partnership, completed on schedule and on budget. It has garnered high customer ratings. Among the key factors behind the road's success were a transparent competitive bidding process and a sensible structure for the partnership, including the operator's ability to set toll prices throughout the concession.
- **Government delivery unit.** Experiences in other countries suggest that setting up a government delivery unit can be an effective approach to ensure the success of key change programs. Many governments are under pressure to deliver improved results and have set ambitious reform goals and developed strategic plans to achieve them. However, most plans require alignment and coordination among all interested parties (e.g., different government departments and their partners in the private sector) rather than fragmentation, which so often compromises the effective execution of policy. Some countries, including Malaysia and the United Kingdom, have set up government delivery

units to execute clear, narrowly defined mandates. 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."

However, delivery unit should not be seen as a complete solution to achieving a broad improvement in performance across government. Based on experience elsewhere, delivery units are most effective when senior government leaders set clearly defined, targeted goals for the unit and specific performance targets tied to those goals; hold ministers and their deputies responsible for meeting these goals with robust and differentiated performance reviews; motivate and closely manage project leaders; instil a comprehensive problem-solving discipline into project teams; and create some form of information "hub" that ensures the integrity, completeness, and timeliness of performance data to ensure accountability. As is the case of reform efforts across the board, building a high-performance unit that is motivated and focused on delivering on its goals often requires developing a team with the right talent and skill mix (e.g., private sector experience).

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If Vietnam acts decisively to head off short-term risks and embrace a productivity-led growth agenda, there is every chance that the nation's many intrinsic strengths will help the economy to continue to grow and develop. Businesses need to adjust their focus on the economy, looking at promising growth areas and ensuring that they stress-test their strategy for the possibility of lower growth and rising labour costs. In the next chapter, we discuss the implications for multinational corporations, and private-sector firms and SOEs in Vietnam.

4. Implications for companies

Companies active in the Vietnamese market or aspiring to enter it need to ensure that their business and financing models remain successful during a sustained period of lower growth rates as well as amid potential increases in short-term volatility. The exposure of companies and investors to different economic growth outcomes clearly depends on whether they are primarily engaged in the domestic or export market. Domestically oriented companies, such as those in the financial services or retail sectors, are much more exposed to slower growth in Vietnam than are companies that use Vietnam as an export base for manufactures. Given that prospects for growth vary substantially from sector to sector, companies need to understand and manage their specific exposures. The expected slowing in the expansion of Vietnam's labour force has significant implications for companies. In the future, Vietnam will need to be approached as more than just a low-cost, labour-abundant country. Companies need to understand that labour will be less easy to secure in the future. Anecdotal and survey evidence consistently indicate that Vietnam's wage cost advantage is eroding, and low wages are unlikely to remain a source of competitive advantage for Vietnam in the way they were a decade ago.

- **SOEs need to anticipate more constrained access to capital and increasing competition—and raise their game.** State-owned companies will need to become more efficient before circumstances force them to become so. Improved management and better governance can improve the competitiveness of these firms and boost their overall growth potential. In China, for instance, the significant gains in productivity that resulted from reform within the state-owned sector led to increased profitability as well. Vietnam's state-owned firms will also need to recognise the gaps in their pool of talent and recruit top-drawer, internationally trained experts to help transform themselves into more globally competitive enterprises. Indeed, to prosper in the years to come, SOEs will increasingly need to benchmark themselves against the best international firms, not only to measure their internal operations against competitors, but also to help firms develop realistic plans for expansion and product development. In this context, the adoption of international accounting standards will be a key to developing properly detailed analysis. As they mature, many SOEs are likely to be forced to make a series of hard decisions as to which businesses will remain core to their operations and which should be exited because they can no longer be profitable. In addition, while equitisation of SOEs remains a focus of many policy conversations within Vietnam, most of those carried out to date have not fundamentally tackled the efficiency problems associated with SOEs because the state typically has remained the controlling shareholder. More aggressive steps toward fuller privatisation might well help firms adjust more rapidly to an era of increasingly vigorous international competition.
- **Vietnamese corporations need to continue to strive for improvements in their management and operations.** These companies need to focus on fundamentals; build their capacity, including that required for innovation; and

leverage the latest international best practice. They need to emphasise the creation of long-term value and bottom-line profits rather than merely seeking to boost top-line revenue. Many domestic Vietnamese companies spend too much time competing primarily on price and spend insufficient energy on the importance of product quality, features, and branding and on developing unique product offerings that can command price premiums. To build a wider global market, Vietnam's companies need to bring more distinctiveness to the market. They also need systematically to develop programs to recruit and train employees to boost their skill base and productivity, and to become more professional in retaining and promoting their best employees through incentive packages, greater management autonomy, and other approaches. The notion of increasing the value of each employee's performance is not yet widely understood among major firms, and family-owned businesses, which remain a major part of the Vietnamese economy, have thus far tended to resist efforts to improve their governance. Agility, adaptability, and continuous innovation have been the watchwords of successful private-sector firms around the world. With potential turbulence ahead in the global economy, these are the qualities that Vietnamese businesses need to embrace if they are to have a competitive edge.

- **MNCs need to ensure that their Vietnam strategy is robust to a broader set of potential economic outcomes.** Multinational corporations in the Vietnamese market or aspiring to enter that market need to take into account significant upside and downside risks. Many such corporations have opened facilities in Vietnam—or plan to do so—with the primary aim of hedging their exposure to China without adequately assessing the prospects, both positive and negative, for expanding their business within Vietnam itself. These firms need to avoid locking in excess capacity on the assumption that the favourable growth trends of Vietnam's recent past will continue unabated. And they should consider a variety of options that offer them a high degree of flexibility—notably to ensure that their Vietnamese business model is sustainable even if relative wages rise. It would be useful for these companies to engage proactively with the Vietnamese government to remove barriers to initiatives that have clear mutual benefits, including training and increasing capital intensity. And, just as domestic and export-oriented firms need to boost their productivity to be competitive, so do multinationals.

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After 25 years of strong and stable growth, the Vietnam economy is moving into a more challenging period. Although many of its economic fundamentals remain strong, a shift in thinking and approach will be needed by companies and policy makers alike. Many companies have prospered in Vietnam because of its strong and stable growth as well as an ability to access cheap and abundant labour. They may no longer be able to rely on either. Policy makers have been buffeted recently by increased volatility and the emergence of significant macroeconomic imbalances—short-term difficulties that they need to tackle. But beyond the economy's immediate difficulties, policy makers need to develop a much more acute emphasis on retooling the economy's structure to achieve the productivity growth that will sustain strong long-term growth.

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February 2012
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