
At 8.4%, Vietnam’s real year-on-year GDP growth rate in 2005 was its highest since the Asian crisis. This growth rate placed Vietnam ahead of all other Asian economies except China. One of the factors contributing to Vietnam’s growth is the expansion of direct investment inflows. This trend reflects increased interest in Vietnam as an alternative location for production facilities at a time when there is a growing concern about the risks associated with concentrated investment in China.

Vietnam’s ruling Communist Party holds its party congress every five years. Activities at the 10th party congress, which opens on April 18, will be monitored closely for signals concerning Vietnam’s political and economic direction over the next five years. In this article we will review past developments and analyze the future outlook.

1. Sustained High Growth

Vietnam began its transition from a planned economic system to a market-based economy in 1986 with the adoption of an economic reform policy known as “doimoi.” While it is a newcomer to the world of market economics, however, it has worked to improve relations with other Asian countries and the West under an omnidirectional foreign policy. This approach has brought increased economic interaction and expanding flows of trade and investment. In the late 1990s, Vietnam’s economic growth rate fell under the impact of the Asian crisis. However, the economy has since followed a recovery trend, and in 2005 the growth rate accelerated to 8.4% (Figure 1). Statistics for individual industrial sectors show that agriculture, forestry and fisheries grew by only 4.0% in 2005, in contrast with a high 10.6% growth rate for manufacturing and construction. The growth rate for the service sector accelerated to 8.5% (Figure 2). Sustained high growth in the manufacturing and construction
sectors has raised the percentage contribution of these sectors to overall GDP, indicating that the Vietnamese economy is becoming more industrialized.

On the spending side, continuing buoyant trends in both domestic and external demand have helped to fuel economic expansion. Private consumption expenditure has expanded in response to improvements in income levels and consumer confidence in an environment of stable economic growth. Vietnam’s per capita GDP in 2005 was around $500. While this is low compared with other key ASEAN economies, consumer spending is being fueled by higher urban incomes. Income levels in major cities, such as Hanoi and Ho Chi Minh, have reached $1,000-2,000. There has also been an upward trend in remittances from expatriate Vietnamese, which are reported to have reached an all-time high of around $4 billion in 2005. This money appears be contributing to the expansion of domestic consumer spending and business sector capital investment.

Another positive factor is growth in the number of foreign visitors, especially tourists, to Vietnam. More recently, there has also been a rise in the number of business visitors. This trend has led to increased sales for hotels, restaurants and other related businesses.

Other factors that have supported economic growth include increased capital investment resulting from the establishment of private businesses, and the expansion of direct investment and exports as more foreign companies move into Vietnam. Infrastructure development by the government has also contributed.

Buoyant domestic demand is reflected in increased imports. Since 2002, Vietnam has recorded deficits in both its trade account and current account. However, buoyant exports of goods and services brought a marginal improvement in the trade account in 2005, while further deterioration in the current account position was halted by increased remittances from overseas.
On the negative side, there is concern about accelerating inflation. The consumer price index has been rising at an increasing pace since 2002 and moved into double figures at one point in 2004 (Figure 3). Though the rate of increase has slowed somewhat, it remains high at around 8%. Food prices have been pushed up by droughts and other weather-related factors, and by the spread of bird flu. Upward pressure on the prices of other goods and services has come from increases in the cost of crude oil and other raw materials, as well as from robust domestic demand.

Figure 3: Consumer Price Index

Source: Compiled by the Research Office, Bank of Tokyo-Mitsubishi UFJ, using CEIC data

2. Scorecard for the Five-Year Plan

Sustained economic expansion has allowed Vietnam to achieve most of its targets for macroeconomic performance under the five-year economic and social development plan launched in 2001. Vietnam sets out its political and economic direction at the five-yearly congress of the Communist Party. Decisions taken at the party congress held in April 2001 included the adoption of a five-year economic and social development plan for the period from 2001 to 2005, and a 10-year economic and social development strategy covering the period to 2010. Among the targets set down were an average economic growth rate of 7.5% in 2001-2005, and the doubling of GDP from its level in 2000 by 2010 with the aim of turning Vietnam into an industrialized economy by 2020. Vietnam has achieved its 7.5% GDP growth target, surpassing the 7.0% average recorded in 1996-2000. Targets relating to the economic structure included GDP contributions of 20-21% from agriculture, forestry and fisheries, 38-39% from manufacturing, and 41-42% from services. These goals were largely achieved by 2005, indicating that the Vietnam is moving increasingly toward an economy centering on manufacturing and services. The export growth rate for the five-year period exceeded the target level of 16% with an average of 17.7%.

The draft plan for the five-year period starting in 2006 calls for the maintenance of
the present growth track. Targets include an average growth rate of 7.5-8.0% in the five years from 2006 to 2010, which would bring GDP to 2.1 times the 2000 level by 2010. A new senior leadership team will be announced at the party congress. This new administration is expected to follow the current reform policy, including the maintenance of high growth and the strengthening of competitiveness.

3. Foreign Investment — “China + 1” Profile Attracting Sustained Influx of Direct Investment

At the 2001 party congress, Vietnam’s leaders signaled their commitment to economic transition by using the phrase “market economy” for the first time, when describing their economic policy as being based on a “socialist-oriented market economy.” The government also acknowledged that the development of a more competitive economic structure would be a vital priority as Vietnam moved toward an open market system, and it identified the aggressive introduction of foreign investment as one of the measures that would be used to strengthen the economy.

Direct investment in Vietnam has continued to increase in recent years, aided by the positive stance adopted by the government, and by buoyant trends in overseas economies (Figure 4). Vietnam’s first investment boom occurred in the mid-1990s. However, the boom faltered after investor confidence plummeted under the impact of the Asian crisis. There were also problems with Vietnam’s capacity to accept investment, including an underdeveloped investment environment.

Investment has since returned to an expansionary trend, thanks to a turnaround in the external environment, combined with improvements in Vietnam’s investment environment, including changes to the foreign investment law in 2000, and the development of industrial estates and infrastructure. The number of new approvals is at an all-time high, and the value of investments implemented has climbed to $3.3 billion, which is higher than the level in Vietnam’s previous investment boom. In recent years, a deteriorating business environment has raised risk levels in China, and investment in Vietnam has been seen a useful way to spread this risk. Factors attracting increased investment to Vietnam, especially in the manufacturing sector, include low labor costs, a stable political situation, and good law and order.

Particularly significant is the recent rise in Vietnam’s reputation among Japanese companies. According to the results of a survey by the Japan Bank for International Cooperation (JBIC), Vietnam’s ranking as a favored target for business investment in medium-term plans has remained unchanged in the past three years. However, the percentage of companies indicating that they have a favorable view of Vietnam has risen over the years, as have the amount of actual investment and the number of investment projects (Table 1,
Japanese companies with business operations in Vietnam are mainly in manufacturing industries, such as electrical machinery and transportation equipment (Figure 6). Major companies that obtained investment approvals in 2005 include Canon, Honda and Mabuchi Motor. While some companies are moving into Vietnam for the first time, others are expanding their existing operations there, such as by establishing second or third production facilities. Features of this trend include large-scale investment in northern Vietnam. Vietnam’s recent investment boom is symbolized by an increase in the number of people viewing industrial estates, and a decline in the availability of space in a Japanese industrial estate in the north.

Figure 5: Japanese companies with business operations in Vietnam are mainly in manufacturing industries, such as electrical machinery and transportation equipment (Figure 6). Major companies that obtained investment approvals in 2005 include Canon, Honda and Mabuchi Motor. While some companies are moving into Vietnam for the first time, others are expanding their existing operations there, such as by establishing second or third production facilities. Features of this trend include large-scale investment in northern Vietnam. Vietnam’s recent investment boom is symbolized by an increase in the number of people viewing industrial estates, and a decline in the availability of space in a Japanese industrial estate in the north.

Figure 4: Direct Investment in Vietnam

Source: Compiled by the Research Office, Bank of Tokyo-Mitsubishi UFJ, using Ministry of Planning and Investment data

Table 1: Countries/Regions Favored in Medium-Term Overseas Expansion Plans of Japanese Businesses

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There have also been conspicuous increases in investment from neighboring Asian economies, notably Taiwan and South Korea. Taiwanese companies, especially in labor-intensive export industries, have continued to invest in Vietnam, in reaction to a deteriorating business environment in China. In real terms, including investment through third countries, Taiwan was the biggest investor based on the value of new approvals in 2005.

In addition to labor-intensive industries, South Korean companies have also moved into construction and real estate and have made notable investments in housing construction and infrastructure development.

Since the start of this year, Vietnam has also approved major investments by American companies. Intel, a leading U.S. semiconductor manufacturer, has announced that it will build a semiconductor plant in Ho Chi Minh City. At $600 million, it is the largest investment ever undertaken by an American company in Vietnam. Vietnam’s economic relationship with the United States since the signing of the Bilateral Trade Agreement at the end of 2001 has been characterized by a dramatic increase in exports to the United States. In addition, American companies are at last starting to invest directly in Vietnam on a significant scale.

This increase in direct investment inflows is making a significant contribution to economic growth. The foreign-owned sector’s share of GDP has more than doubled, from 7% 10 years ago to 15% in 2004. Foreign companies make particularly large contributions to production and exports, accounting for 30% of industrial production and 60% of exports in 2005 (Figure 7). Their share of exports of goods other than crude oil now stands at 35%, up from 23% in 2000. Vietnam’s main export items are primary products, such as crude oil and agricultural products, and light industrial goods, such as apparel and footwear. However, exports of electronic equipment and other products are also increasing, apparently because of
the start of full-scale production in plants established by foreign manufacturers that have moved into Vietnam.

Figure 7: Economic Contribution from Foreign-Owned Enterprises

There is much room for improvement in the investment environment for companies moving into Vietnam. Problems include inadequate infrastructure, weak supporting industries, and inconsistencies in the administration of laws, systems and regulations. However, there has been progress toward the improvement of the environment for investment between Japan and Vietnam, including the signing of the Vietnam-Japan investment agreement, and dialog on the Vietnam-Japan joint initiatives.

Vietnam is also making gradual improvements to its legal infrastructure. For example, a joint investment law and an integrated company law were established in November 2005 and will take effect from July 2006. Under these new laws, domestic and foreign-owned enterprises will be subject to the same legal framework.

On the negative side, a dispute over an increase in minimum wages paid by foreign-owned companies triggered widespread strikes in Ho Chi Minh city. The strikes, which occurred at the start of this year, mainly targeted South Korean and Taiwanese companies. Another cause of concern is the supply of labor. There are new concerns as some companies report that recruitment is not as easy as in the past. To achieve its goal of using foreign investment to drive economic growth, Vietnam will need to make continuing efforts to provide a good business environment for foreign-owned companies.

4. Globalization — Adaptation and Challenges

(1) WTO Membership and SOE Reform

Vietnam’s transition to a market economy will also be a process of economic
globalization. WTO membership is an important priority in Vietnam’s economic foreign policy, and the negotiations have reached a crucial stage. Initially Vietnam hoped to achieve membership by 2005, but this was not possible. It has already reached agreement in bilateral negotiations with most of the advanced industrialized economies, including Japan and the EU. One of the four remaining is the United States, and the timing of Vietnam’s achievement of WTO membership will depend on progress in its negotiations with Washington. However, senior Vietnamese officials have commented that the negotiations are now in the final stage, and WTO membership could be achieved as early as 2006.

Because WTO membership will result in a gradual opening of Vietnam’s domestic markets, the reform of uncompetitive SOEs has become an important priority. SOEs still account for 40% of Vietnam’s GDP, and the improvement of their operating efficiency will be crucial to the improvement of productivity across the whole economy. SOE reforms in progress are based on restructuring measures, including mergers, liquidations and equitization. In 2005, 724 enterprises were equitized, and the number of SOEs was reduced to 3,200, compared with 5,600 in 2001. Initially most of the SOEs targeted for restructuring were relatively small enterprises, but recently the focus has gradually shifted to major companies.

(2) Financial and Capital Market Reform

At the same time as its SOE reforms, Vietnam is also reforming its financial sector. The mainstays of the domestic banking sector are state-owned commercial banks, which lend mainly to SOEs. These banks are plagued by inefficient management and deteriorating assets. Since 2002 efforts to alleviate these problems have centered on the disposal of non-performing assets and the use of capital injections to strengthen financial structures. The government is currently preparing for the equitization of state-owned commercial banks, and it is likely that there will be a phased reduction in the government’s ownership of these institutions. There are reports that the Vietcom Bank, a state-owned commercial bank, issued convertible bonds to domestic investors in preparation for equitization, and that it is making plans for an overseas listing as a means of strengthening its capital. Other local banks are also preparing for future market liberalization. Since last year, a succession of capital partnerships have been formed between Vietnamese banks and Western financial institutions, such as Standard Chartered Bank, the Australia and New Zealand Banking Group and Hong Kong and Shanghai Banking Corporation, and also the Singapore-based OCBC. By forming partnerships with Western banks, Vietnamese banks hope to improve their competitiveness by absorbing knowledge about financial services.

With the progress of SOE equitization, Vietnam has also started to develop its stock market. A stock exchange was established in Ho Chi Minh City in July 2000, and in March 2005 another exchange was opened in Hanoi. In September 2005, the government decided to
lift the ceiling for ownership of listed companies by foreign investors from 30% to 49%. There has been a surge of market activity this year, following the listing of a Taiwanese-owned company as the first foreign-owned company on the Ho Chi Minh Stock Exchange, as well as the listing of a major state-owned food company. The Ho Chi Minh Stock Exchange is still small with only 35 companies listed. However, there are indications that the market is about to expand, including plans for the listing of major SOEs.

In November 2005, Vietnam issued its first sovereign bonds overseas. Initially a $500 million issue was planned, but the amount was increased to $750 million in response to increased demand from investors. Following the success of this issue, it is likely that Vietnam will gradually increase its overseas financing activities.

(3) Future Issues

While Vietnam has made progress with structural reforms in these areas, much still needs to be done. Admission to WTO membership will bring opportunities for the expansion of trade and investment. However, exports of cheap goods from Vietnam have already triggered trade friction with the United States over seafood, and with the EU over footwear and other items. The outlook for export expansion is not entirely optimistic. Furthermore, WTO membership will bring with it an obligation to comply with rules, including rules concerning the protection of intellectual property rights. An anticorruption law will come into force in June 2006, but it remains to be seen how effective this legislation will be in practice.

Vietnam appears to be achieving reasonable benefits from equitization. In a survey of equitized companies, the majority indicated that their business performance had improved. Unfortunately, the restructuring process has tended to fall behind schedule because of factors that include delays in government procedures, and opposition from employees. Vietnam must continue to restructure its remaining SOEs, including major corporations, and it must also deal with each of the many challenges to its transition to a market economy, including the development of the private business sector and the reinforcement of the financial sector.

Conclusions

In 2006 Vietnam will launch a new five-year plan. Its macro-performance over the past five years has been generally good, and it has gradually implemented the institutional reforms needed for its transition to a market-based economic system. In terms of Vietnam’s environment in Asia, expectations toward China’s growth potential and growing awareness of risks in China have created new growth opportunities for Vietnam as the “China + 1” investment target. Moreover, infrastructure construction linked to development of the Mekong Basin, including the East-West Corridor scheme, is expected to result bring increased economic vitality to the region. Vietnam’s gradual inclusion in regional economic integration
and globalization should bring increased trade and investment opportunities. However, Vietnam is still in its initial phase of development, and reforms associated with market liberalization are likely to generate intense domestic pressures. Vietnam has made steady progress in its transition into a market-based economy. Its commitment and its ability to implement reforms are about to be put to the test as it works to adapt to a continually changing international economic environment while transforming its domestic economic structure.

Kayo Yamamoto, March 30, 2006