FEBRUARY 2012

McKinsey Quarterly

MCKINSEY GLOBAL INSTITUTE

Taking Vietnam's economy to the next level

To continue on a strong GDP growth trajectory, the country should work to raise its labor productivity.

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During the past quarter century, Vietnam has emerged as one of Asia's great success stories. In a nation once ravaged by war, the economy has posted annual per capita growth of 5.3 percent since 1986—faster than any other Asian economy apart from China. Vietnam has benefited from a program of internal restructuring, a transition from the agricultural base toward manufacturing and services, and a demographic dividend powered by a youthful population. The country has also prospered since joining the World Trade Organization, in 2007, normalizing trade relations with the United States and ensuring that the economy is consistently ranked as one of Asia's most attractive destinations for foreign investors.

The McKinsey Global Institute (MGI) estimates that an expanding labor pool and the structural shift away from agriculture contributed two-thirds of Vietnam's 7 percent annual GDP growth from 2005 to 2010.[1] The other third came from improving productivity within sectors. But the first two forces have less and less power to drive further expansion. According to official Vietnam statistics, growth in the country's labor force will probably decline to about 0.6 percent a year over the next decade, down from 2.8 percent between 2000 and 2010. Given the past decade's rapid rate of migration from farm to factory, it seems unlikely that the pace can accelerate further to raise productivity enough to offset the slowing growth of the labor force.

Instead, Vietnam should increase its labor productivity growth within sectors to achieve an economy-wide boost of some 50 percent—to 6.4 percent annually—if the economy is to meet the government's target of a 7 to 8 percent annual GDP expansion by 2020. Without such an increase, we estimate, Vietnam's growth will probably decline to about 5 percent annually. The difference sounds small, but it isn't: by 2020, Vietnam's annual GDP will be 30 percent lower than it would be if the economy continued to grow by 7 percent.

Achieving 6 percent–plus annual growth in economy-wide productivity is a challenging but not unprecedented goal. Nevertheless, incremental change will not achieve a revolution of this magnitude. Deep structural reforms within the Vietnamese economy and a strong and sustained commitment from policy makers and companies will be necessary (see sidebar, "An agenda for sustaining growth"). Also, many companies have prospered in Vietnam because of the country's strong and stable growth and inexpensive, abundant labor. In the future, they may no longer be able to rely on either, so they will need to ensure that their business and financing models are sufficiently robust to withstand a period of lower growth and, perhaps, economic volatility.

The challenges facing Vietnam

In the near term, Vietnam must cope with a highly uncertain global environment. The economy faces a state of heightened risk because of macroeconomic pressures, including

[1] The full report, *Sustaining Vietnam's growth: The productivity challenge* (February 2012), is available online at mckinsey.com/mgi.

inflation that has built up as a by-product of the government's efforts to maintain robust growth despite the global economic crisis. In early 2009, Vietnam's global trade and foreign direct investment declined dramatically, and while exports have recovered, the future of these two sources of economic activity is quite uncertain. 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 not only to inflationary pressures but also to budget and trade deficits and unstable exchange rates. Some signs suggest that the financial sector is under stress, and international credit-ratings agencies have lowered their ratings on Vietnam's debt.

In the longer term, Vietnam has a larger challenge. Since the key drivers that powered its robust growth in the past—a young, growing labor force and the transition from agriculture to manufacturing and services—are beginning to run out of steam, Vietnam now needs new sources of growth to replace them. The demographic tailwind responsible for driving a third of Vietnam's past growth is slackening. Some companies already report labor shortages in major cities. By 2020, the share of the population aged 5 to 19 is

An agenda for sustaining growth

Six percent–plus annual growth in economy-wide productivity is a challenging but not unprecedented goal. The successes and failures of other countries that had to raise their productivity offer a road map for broadening the bases of its growth.

The priority for officials is to restore calm in the economy and ensure that Vietnam retains the trust and enthusiasm of national and international investors. Surging inflation, repeated currency devaluations, a deteriorating trade balance, and rising interest rates have undermined investor confidence. And Vietnam's financial sector does appear to have a degree of fragility. Three long-term systemic risks loom—a rising volume of nonperforming loans, squeezed liquidity, and a drying up of foreign-exchange reserves. Many of the issues Vietnam faces come down to limited governance and transparency. Today, for example, the financial-reporting standards and risk-management techniques of Vietnamese banks are a long way from Basel II or Basel III standards. Laying out a clear road map for their adoption would help improve the sector's long-term stability and viability and bolster confidence among investors.

First, Vietnam could usefully run a series of stress tests to identify struggling banks and separate them from well-performing, "safe" ones. In addition, the country could ensure that sufficient supervision is in place to intervene in projected to drop to 22 percent, from 27 percent in 2010 and 34 percent in 1999. Although Vietnam's median age, 27.4 years, is still relatively young compared with that of countries such as China (35.2), its population is also aging.

According to government projections, Vietnam's labor force is likely to grow by about 0.6 percent a year over the next decade, a decline of more than three-quarters from the annual growth of 2.8 percent from 2000 to 2010. Growth in the labor force will still make a positive contribution to GDP, but notably less than it did in the past decade. Vietnam's growth has also been propelled by extraordinarily rapid migration from rural areas to towns—from relatively low-productivity agriculture to the relatively higher-productivity services and manufacturing sectors. Economic restructuring is unlikely to continue so quickly. Indeed, even aggressive assumptions on the pace of the transition away from agriculture would not compensate for the effects of the decline in overall labor force growth. Without an improvement in productivity growth patterns within sectors, agriculture's share of the labor force would need to decline at twice the rate of the past decade—unlikely given the aging of rural areas and the decline of agriculture's share of the total population, by 13 percentage points, over the past ten years.

banks whose portfolios are excessively risky and to consolidate weaker banks when necessary. The dual challenge of inflation and exchange rate policy must be addressed in a way that raises the confidence of investors and encourages hidden foreign reserves to come back to the official economy so they can be invested productively.

Second, to facilitate a transition to more productive activities, new sources of comparative advantage must be found, beyond low-wage labor. Vietnam has already invested significantly in infrastructure, for example, yet interviews with executives and international assessments strongly suggest that more will be necessary to support the transition to increasingly productive activities. Funding for infrastructure projects will probably be limited, so Vietnam should assess which of them offer the greatest economic benefit, linking investment decisions more closely to broader development strategies and emphasizing stronger coordination among government agencies. Tourism offers a good example. The central government can play a key role in ensuring that public-sector investment in infrastructure, transportation, and real estate is closely tied to private-sector spending in areas such as hotels, resorts, and transit services.

Third, getting economy-wide regulation right is necessary for productivity and growth but not sufficient to sustain the broad-based expansion of recent years. Vietnam's next challenge will be

Vietnam should identify sources of growth to replace those now becoming exhausted. Manufacturing and service industries ought to step up their productivity growth performance. Vietnam could also further develop the capabilities across all sectors, become increasingly versatile as an environment in which companies can constantly innovate and build on recent successes. Offshore services such as data, business-process outsourcing, and IT appear to be promising areas. Vietnam can establish an enabling environment at the level of individual industries and sectors by enhancing domestic competition and helping industries move up the value chain. 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. Because state-owned enterprises still have enormous importance, accounting for about 40 percent of the nation's output, reform of their ownership and management incentives is likely to be crucial, as will the need to improve their overall capital efficiency.

As we have seen, to achieve GDP growth of about 7 percent a year, Vietnam needs to raise annual productivity growth to 6.4 percent. Without such an increase, we estimate, the glide path for Vietnam's growth would decline to between 4.5 and 5 percent annually,

to establish an enabling environment at the level of individual industries and sectors by enhancing domestic competition and helping industries to move up the value chain in, for example, software development and IT services. Areas Vietnam could target include investments to raise agricultural quality and productivity, productivity-led growth in manufacturing, and energy efficiency.

Fourth, reform in the ownership and management incentives of state-owned enterprises can be an important institutional vehicle for improving their productivity and growth. Vietnam has already established a State Capital Investment Corporation (SCIC) to energize the reform of these companies and to help the economy use capital more efficiently. SCIC could consider the governance and operational approaches other countries have used to improve the performance of their public enterprises. The experiences of Malaysia's Khazanah Nasional and Kazakhstan's Samruk-Kazyna suggest that a sufficiently autonomous organization with the right leadership and talent can push performance standards across a portfolio of state-owned companies. Suitable moves include the creation of agencies to raise the government's effectiveness, set ambitious reform goals, and develop strategic plans to achieve them; to attract foreign direct investment; and to manage public–private partnerships.

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 to 2020. 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 (some $46 billion) lower than it could be with 7 percent annual growth. Assuming no shift in the structure of the economy as a whole, we estimate that private consumption would be $31 billion lower. Vietnam's economy would take 14—rather than 10—years to double in size.

Implications for companies

The exposure of companies and investors to different economic growth outcomes clearly depends on whether they are active primarily in the domestic or export market. Domestically oriented companies, such as those in the financial-services or retail sectors, are much more threatened by slower growth in Vietnam than are companies that use the country as an export base for manufactured goods. Since prospects for growth vary substantially from sector to sector, each company must understand and manage its own specific problems. The expected slowing in the expansion of the labor force also has significant implications for companies. Those that view Vietnam primarily as a low-cost economy with an abundance of workers need to adjust their thinking.

Multinationals

Primarily to hedge their exposure to China, many multinational corporations have opened facilities in Vietnam (or plan to do so), without adequately assessing the prospects, both positive and negative, for expanding business in Vietnam itself. These companies should avoid locking in excess capacity—the country's economy may not match the strong growth trends of the past—and ensure that their Vietnamese business models are sustainable even if wages rise substantially. Anecdotal and survey evidence consistently indicates that the wage cost advantage is eroding. Much as domestic and export-oriented companies must boost their productivity to be competitive, so too must multinationals, which could also engage with the government to remove barriers to initiatives that clearly benefit both sides, such as programs to increase capital intensity and improve training.

Training is especially important. Multinationals complain about 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 on the job. Surveys suggest that Vietnam has an even bigger shortage of qualified engineers and middle managers than other rapidly developing economies do. Multinational companies can work with the government and educational institutions to address this skill gap. If the Vietnamese government were to issue certificates for qualified training programs, companies might feel more confident in providing such training.

Private-sector Vietnamese corporations

Improving competitiveness and using the latest global best practices should be priorities for Vietnamese companies in the private sector. They should emphasize long-term value and bottom-line profits rather than merely seeking to increase top-line revenue. Too many domestic Vietnamese companies spend too much energy competing on price and too little on product quality, features, and branding and on developing unique offerings that can command premiums.

These companies must develop programs to recruit employees and train them so that their skills and productivity improve. They should also take a more professional approach to retaining and promoting their best workers, through incentive packages and greater management autonomy. The notion of increasing the value of each employee's performance is not yet widely understood among major Vietnamese companies. Family-owned businesses, which remain a major part of the economy, have thus far tended to resist efforts to improve their governance.

State-owned enterprises

More limited access to capital and increasing competition mean that state-owned enterprises must lift their productivity before circumstances force their hand. Improved management and better governance could raise their competitiveness and 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 companies will also need to recognize the gaps in their pool of talent and to recruit top-drawer, internationally trained executives to help them become more globally competitive. They will increasingly have to benchmark themselves against the best international competitors not only to measure internal operations but also to create realistic plans for expansion and product development.

In this context, the adoption of international accounting standards will support the creation of the detailed performance benchmarks required to identify areas for improvement. Many maturing state-owned enterprises will have to make hard decisions about which businesses should remain core and which should be exited because they can no longer be profitable.

Selling shares in these companies remains a focus of many policy conversations in Vietnam. But most of the sales carried out to date haven't fundamentally tackled the efficiency problems, because the state typically remains the controlling shareholder. More aggressive steps toward fuller privatization and improvements in the governance of state-owned businesses might help them adjust more rapidly to an era of increasingly vigorous international competition.

We think Vietnam can act decisively to head off short-term risks and embrace a productivity-led agenda. If the country does so, it can build on its many intrinsic strengths—a young labor force, abundant natural resources, and political stability, to name a few—to create a second wave of growth and prosperity. There are challenges, to be sure, but we believe that they can be overcome.

The authors wish to acknowledge the contributions of Tu Ha, Jinwook Kim, and Diaan-Yi Lin to the development of this article.

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