

# **Building and Strengthening Supporting Industries in Vietnam**

## **A Survey Report**

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This report summarizes the findings of the survey conducted by the author as a senior investment advisor of the Japan External Trade Organization (JETRO) from February 16 to March 24, 2004 (38 days) in Vietnam. The purpose of the survey was to facilitate matching between local companies and Japanese companies operating in Vietnam in a variety of industries in order to build and strengthen supporting industries.

More specifically, this survey had the following five tasks.

- (1) Clarification of the policy orientation of the Vietnamese government and related organizations regarding the promotion of supporting industries.
- (2) Survey of the situation of Vietnamese companies that may contribute to the creation of supporting industries.
- (3) Study of the part procurement pattern of foreign assembly companies and the part supply pattern of foreign parts companies operating in Vietnam with special attention on Japanese, Taiwanese and Korean companies.
- (4) Producing a draft guideline for Japanese part manufacturers considering investment in Vietnam.
- (5) Producing a draft guideline for Vietnamese companies wishing to trade with Japanese companies, including those willing to supply parts to Japanese firms operating in Vietnam.

In the course of this survey, 19 ministries and agencies of the Vietnamese government were interviewed. In addition, 26 Vietnamese companies were visited, among which 18 were state-owned and 8 were private. As to foreign companies, 33 establishments were interviewed, among which 17 were joint ventures and 16 were 100% foreign owned. The number of total visits was 78.

## **I. Signs of the Birth of Supporting Industries in Vietnam**

It has long been said that supporting industries were nonexistent or extremely primitive in Vietnam. However, this survey has found that this view is not entirely correct, that it will be more appropriate to say that Vietnamese supporting industries are finally burgeoning and beginning to develop at present. This evaluation is based on three key observations, namely, (i) an increase in FDI inflow; (ii) the accelerating reform of state-owned enterprises; and (iii) the emergence of private enterprises.

However, a continued robust growth of supporting industries requires a proper policy package of the Vietnamese government and proper Japanese assistance to supplement this effort. For this purpose, the Vietnam-Japan Joint Initiative<sup>1</sup> has a key role. Through the current survey, the critical importance of following up and implementing the action plan of this Initiative was reconfirmed.

What is even more important than government policy and Japanese assistance is the willingness of enterprises, both state-owned and private, to recognize the importance of supporting industries in bolstering their competitiveness, and to create and develop such industries by their own effort. Continued policy measures and active campaigns to raise the recognition and willingness of Vietnamese companies toward this goal are needed.

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<sup>1</sup> *The Vietnam-Japan Joint Initiative to Improve Business Environment with a View to Strengthen Vietnam's Competitiveness*, concluded by the Minister of Planning and Investment Vo Hong Phuc and the Japanese Ambassador to Vietnam Norio Hattori in Hanoi on December 4, 2003. Specifically, its Part I, Item 1 calls for the development, introduction and utilization of supporting industry in Vietnam.

Our survey has identified the motorbike industry and the electric home appliance (“white goods”) industry, which have relatively large output volume, as the initial core industries for fostering supporting industries in Vietnam. The part localization ratios of these industries have already reached 70-80 percent. For this reason, it is realistic to begin with the evaluation of concrete weaknesses of the supporting industries of these two industries (including even the weaknesses of individual part manufacturers) to remedy the problems in quality, technology and supply volume.

Based on the results of such problem-solving processes for the motorbike industry and the home appliance industry, the supporting industries of other industries, such as audio-visual consumer electronics, can also be developed. Ultimately, the supporting industries of the automobile industry, which currently faces a small domestic demand and requires a relatively high level of technology, can also be promoted along this line.

## **II. Current Situation in Vietnam**

### 1. Perception of supporting industries among government bodies

Among the ministries and other agencies of the Vietnamese government, most officials are unfamiliar with the concept of supporting industries although some have begun to recognize its importance. This is partly because state-owned enterprises (SOEs) that constituted the pillar of the national economy in the past had a vertically integrated production structure where every part was internally produced and processed. Another problem arises from the lack of legal definition of supporting industries, which prevents an effective execution of promotion measures. The Vietnamese government remains unclear as to how this situation should be corrected.

### 2. Polarization and specialization of SOEs

There are roughly 6,000 SOEs in Vietnam. Depending on the qualification, ability and determination of the top management, SOEs are beginning to diverge into high

performers and hopeless losers. Some high-performing SOEs are already equitized and enjoy management autonomy. Even those general directors who have stayed for a long time at the same SOEs are beginning to realize the excitement of new business opportunity. We had the chance to interview some of them during this survey. We were also pleasantly surprised to see a fairly large number of high-performing SOEs in the North. It is important for the government to identify and strongly support such high-performing SOEs as the one of the core groups for generating supporting industries.

Moreover, some large-scale SOEs are beginning to shift away from vertically integrated production structure of the past and specialize in the products or processes in which they have competitiveness. In a few cases, there is even an attempt to establish a production network of SOEs based on such specialization.

For example, Song Cong Diesel Company (DISOCO) in the North produces diesel engines for ships and agricultural machines. It once was a vertically integrated giant factory with all processes performed in its extensive premise including forging, casting, machining, surface treatment, heat treatment and assembly. However, it is now moving to strengthen forging while the adjacent Machinery Spare Parts Company No.1 (FUTU1) is upgrading its machining functions. As a result, these two SOEs are cooperating based on each other's specialization. Furthermore, DISOCO is hoping not only to perform forging for itself but also to receive orders from a Japanese motorbike assembler. For this, the company plans to invest in new equipment and improve technology. Such a move was totally unthinkable in large-scale SOEs in the past. On the other hand, FUTU1 also performs high-precision machining to supply parts for a Japanese motorbike company. Unlike the traditional SOEs, its factory floor was clean and well arranged and its operation was high and brisk.

By contrast, losing SOEs often fail to grow out of the outdated management style and ask official assistance whenever they face difficulties. The managers of such SOEs also lack entrepreneurial spirits and regard their jobs only as temporary positions before they move to other jobs or retire.

### 3. The rise of private small and medium enterprises (especially in the South)

Partly due to the new enterprise law of 2000 which liberalized and simplified the procedure for establishing companies, a large number of private companies have sprung up in Vietnam. In the South of the country, the history of private companies is even longer and some are increasingly successful in the areas of bakery, footwear and cookware.

For instance, one manufacturer of aluminum and stainless steel pots have introduced technology from a foreign firm and drastically improved quality even to the extent of establishing its own brand name. It is now building a new large factory in the suburbs of Ho Chi Minh City to expand its business vigorously. Applying its in-house technology to produce pots, this company now additionally supplies the inner case of rice cookers to a Japanese home electronics company.

In the area of plastic injection, some local companies have mastered the quality control method by becoming suppliers to foreign-invested companies. The quality of their products is now regarded highly. Similarly in molding, the managing director of a certain company keenly recognized the importance of high-quality molds. Consequently, this company absorbed technology from Japanese and German firms and has grown to produce molds for both plastic injection and die casting. It is now recognized as an excellent company by the Plastic Association.

### 4. Active foreign investment especially by Taiwanese

Recently, FDI from Taiwan and Korea is increasing rapidly. Taiwanese firms in particular are very active in not only investment but other forms of business partnership including financing Vietnamese local companies. As noted by the president of the China External Trade Development Council (CETRA), the scope of activities by Taiwanese

firms is much larger than the official statistics of MPI reports (an accumulated total of 1,100 projects).

In the South, Taiwanese motorbike assemblers brought their part manufacturers in droves to Vietnam. They are concentrated in industrial parks developed by Taiwanese companies creating an agglomeration of supporting industries for the motorbike industry. Some have even Japanese staff to market their parts and components to the Japanese assemblers operating in Vietnam. As a result of this effort, some Japanese motorbike producers have begun to rely on Taiwanese part suppliers. However, it is reported that Taiwanese part suppliers sometimes fail to satisfy the quality requirements of Japanese motorbike assemblers.

As to Korean companies operating in Vietnam, most of them engage in labor-intensive production processes in the garment and footwear industries without investing much in the supporting industries. This statement was made by the president of the Korean Trade and Investment Promotion Agency (KOTRA).

### **III. Some Considerations for Future**

#### **1. Establishment of promotion policy**

For the purpose of establishing a proper policy framework, the first task should be the legal clarification of the definition of supporting industries. After that, policy for promoting supporting industries including preferential tax treatment and business supporting measures must be formulated without discrimination between domestic and foreign companies.

In order to maximize the use of limited human and financial resources, the Vietnamese government should clearly state a relatively small number of priority areas in developing

supporting industries. One option is to concentrate efforts in creating the forging, casting, heat treatment and molding industries which are currently lacking in Vietnam.

The robust growth of assembly industries, especially in consumer electronics and automobiles, also has an enormous impact on the development of supporting industries. In this sense, the drafting of overall industrial development policy, including assembly, is crucial. This must be done in a way that takes advantage of the full implementation of the Common Effective Preferential Tariffs (CEPT) of AFTA in 2006.

The Vietnamese government has raised tariffs on automobile parts to promote part localization. However, in the case of an industry that requires huge investment to produce parts such as the automobile industry, compelling assembly companies to use domestic parts unilaterally will have the opposite effect of discouraging the growth of such an industry. By contrast, if the domestic market grows and the scale of production surpasses a certain critical level, assembly companies will naturally desire local part procurement in order to reduce costs. This prompts them to voluntarily invite part manufacturers and related industries from abroad. If this favorable situation is combined with an effective promotion policy of the government, the inflow of part manufacturers will be further accelerated and supporting industries will be established sooner. If this is achieved in the automobile industry which has high technology and extensive upstream and downstream industrial linkage, Vietnam's overall industrial strength will be raised significantly. This point must be conveyed persistently and on every occasion to relevant officials in the Vietnamese government so that they will fully understand the importance of market size for the promotion of supporting industries.

## 2. Progress in SOE reform

The Vietnamese government is currently restructuring SOEs according to the law on SOE reform, but its progress is fairly slow. Since some equitized SOEs are beginning to perform well as explained earlier, there should be a concentrated support toward these enterprises to develop them even further. This will contribute to the efficient use of

limited capital as well as the leveling up of the SOE sector in general. These high-performing SOEs should be encouraged to shift from vertically integrated production structure to specialization with a network of cooperation with other companies. This will require a higher capability of the Ministry of Industry and other ministries to encourage and coordinate such intra-firm cooperation. On the other hand, what to do with hopeless SOEs is a big problem for the government. Eventually, however, there is no other way but to boldly consolidate and eliminate them.

### 3. Promotion and support of private firms

It is evident from the experiences of other countries that private firms play the principal role in the development of supporting industries. In Vietnam, the burgeoning private sector, especially small and medium enterprises, should also be strongly supported by the government. Previously, private firms encountered a large number of regulations which impeded their healthy development. The large part of supporting measures should therefore be the removal of such regulations on private firms so that they can operate more freely.

In Vietnam, enterprises are classified and often treated differently according to whether they are SOEs (under the law of SOEs), foreign firms (under the law of FDI) or private firms (under the law of enterprises). While officials state that all enterprises are already treated equally, there are many claims that private firms are frequently discriminated against. It is reported by the president of the Hanoi Union of Associations of Industry and Commerce (HUAIC) that the government is currently considering re-classification of enterprises according to its legal status as joint stock, limited liability or collective companies.

There are many successful small and medium firms in the private sector that warrant further encouragement. It is essential that these firms are given special tax privileges in re-investment to allow them to expand their business with retained profit and contribute further to the development of the Vietnamese industries. The lack of financial access is



the perennial problem for private firms. Financial institutions to support small and medium enterprises effectively must be created with the support of JBIC (with two-step loans) and IFS (with the Mekong Private Sector Development Facility), if necessary.

#### 4. Human resource development

##### (1) Supply of engineers

It is needless to say that human resource is vital to the development of supporting industries. With the working population of 46 million, Vietnam can supply a large number of workers without difficulty. However, there is a shortage in middle to upper level engineers. Newly recruited university graduate engineers on a management track with sufficient capability are hard to come by especially in the North. This is partly due to the lack of practical training in science and engineering (mechanical engineering, electrical engineering, applied chemistry, etc) in university education which in turn comes partly from the shortage of physical equipment. The lack of enthusiasm in absorbing practical knowledge is another problem on the students' side.

This points to the need to radically reform university education in both hardware (physical equipment) and software (curriculum and instruction method) for producing a large number of engineers to work in supporting industries. Joint programs between industries and academic institutions, such as internship, should be effective for students to acquire practical skills and required attitude for working in a manufacturing company.

To generate a large number of middle level engineers, the expansion of technical colleges and vocational training centers are necessary. A good example is the revamping of the Hanoi Industrial College with the support of JICA since 2002 in providing machinery and equipment, training Vietnamese instructors, and finding customers for its part production. It is recommended that similar assistance programs be implemented at technical colleges in the South as well to boost the technical level of the entire country.

## (2) Fostering middle management

Partly due to the effect of war, there is a shortage of age cohorts that can serve as a middle management in Vietnam. Foreign firms frequently face difficulty in securing a sufficient number of capable middle-level managers. For this reason, career-track managers had to be chosen among newly recruited university graduates and trained through a long-term OJT program. One Japanese electronics manufacturer even voluntarily sponsors an annual management training course for Vietnamese small and medium enterprises. It would however be far more effective if the government organized such courses for strengthening middle management. Official training services of Japan's Association for Overseas Technical Scholarship (AOTS), for example, should be actively used among Vietnamese enterprises.

## (3) Training and leveling up of Japanese-Vietnamese interpreters

Vietnamese is one of the most difficult languages for Japanese to learn. Overcoming this language barrier is very important for Japan and Vietnam to jointly develop the supporting industries of Vietnam. Good interpreters will play an increasingly important role in precise communication and deeper bilateral understanding. To improve the level of interpretation, the publication of a Japanese-Vietnamese dictionary in technical terms, especially in economic and engineering terms, is highly desirable.

## 5. Dissemination of company information

Under the planned economy of the past, enterprises merely received production orders from above without expanding markets with their own effort. Even today, many small and medium enterprises only passively respond to orders without struggling to find new customers for their products. To discover potentially high performers among local firms, an official system of disseminating enterprise information and building inter-firm networks should be installed. For this purpose, the information and matching services of the Vietnam Chamber of Commerce and Industry (VCCI), the Union of Associations of

Industry and Commerce (UAIC) and the Investment and Trade Promotion Center (ITPC) should be enhanced. In addition, the frequency of trade fairs and reverse trade fairs for finding business partners between locals and FDI companies should be increased.

#### 6. Improving the quality control system

Currently, the legal aspects of product quality control are under the jurisdiction of the Standards and Quality (STAMEQ) belonging to the Ministry of Science and Technology. The management of standards, quality tests and material analysis are conducted by the Testing and Quality Assurance Center (QUATEST), which is under STAMEQ, in three locations of Hanoi, Danang and Ho Chi Minh City. The management and inspection of product quality is one of the most crucial functions of the government in developing supporting industries and strengthening their competitiveness. The capability of QUATEST must therefore be greatly upgraded.

QUATEST should also expand its public relations activity to raise the awareness of local enterprises toward product quality. At present, most Vietnamese companies regard quality inspection as the responsibility of the user of their products and exchange them only when defects are discovered. This perception is unacceptably low and must be greatly improved before they can become suppliers to foreign invested companies.

Besides the awareness campaign by QUATEST, long-term technical assistance is essential to fundamentally change the mindset of local companies toward quality. Short-term training has proved ineffective for this purpose. However, the cost of such long-term technical assistance is beyond the capacity of individual private firms. Some Japanese firms already assist local firms, but the financial and time costs of such training are enormous and cannot be sustained forever. It is more desirable to expand the official programs of dispatching technical experts, including the experts of the Japan Overseas Development Corporation (JODC) for more frequent uses by Vietnamese companies.

#### 7. Taking advantage of foreign capital and technology

A further absorption of FDI in manufacturing parts and components, including Taiwanese, will directly expand Vietnam's supporting industries and indirectly help local firms to emerge as well. Many foreign part manufacturers that come to Vietnam are small and medium size. To attract them, the provision of an open and free business environment, especially deregulation and stable policy framework, is the most important condition in addition to the usual requirements of higher labor quality, improved infrastructure and preferential tax treatment.

In summary, the above mentioned challenges should be solved one by one by the joint effort of the Vietnamese government, its related bodies and Vietnamese enterprises. It should also be supported by the Japanese government, its related agencies and Japanese enterprises. Only then, a healthy development of supporting industries becomes feasible. For Vietnam, this is an inevitable step toward the strengthening of industrial capability and competitiveness against China and other ASEAN countries.

## Appendix Figures

### [Editors' Note]

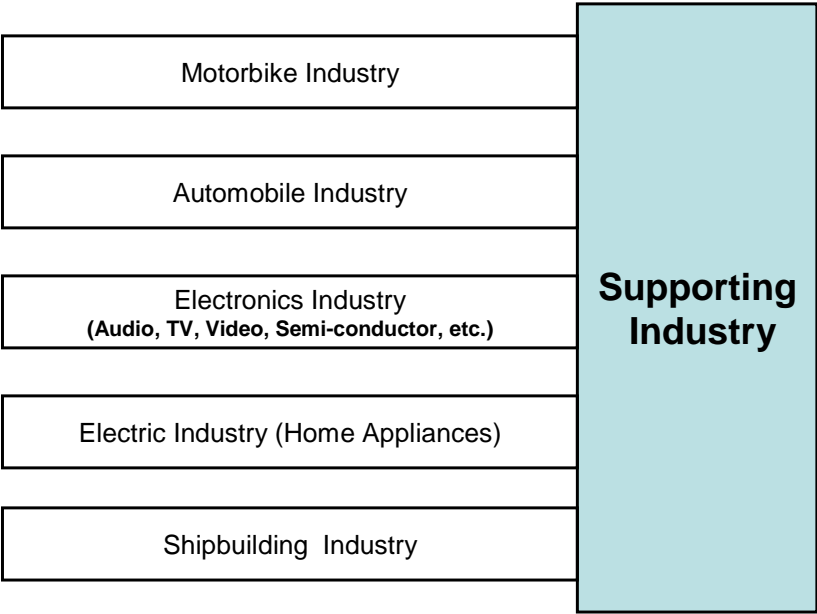
In addition to this paper, Mr. Kyoshiro Ichikawa presented a series of diagrams at conferences hosted by VDF (August 2004), the Embassy of Japan and the Ministry of Planning and Investment (November 2004), and the Embassy of Japan and the Industry Policy and Strategy Institute under the Ministry of Industry (January 2005). Since they are informative in analyzing the issues related to Vietnam's supporting industries, we reproduce them here for readers' reference.

Figures 1 and 2 present the basic concept and content of the supporting industry. The supporting industry should be thought as a common industrial base performing overlapping functions for a large number of assembly industries, rather than a random collection of unrelated part production. Moreover, the supporting industry includes not only part production but, more importantly, production processes that help to produce metal and plastic parts, such as pressing, casting, forging, molding, etc.

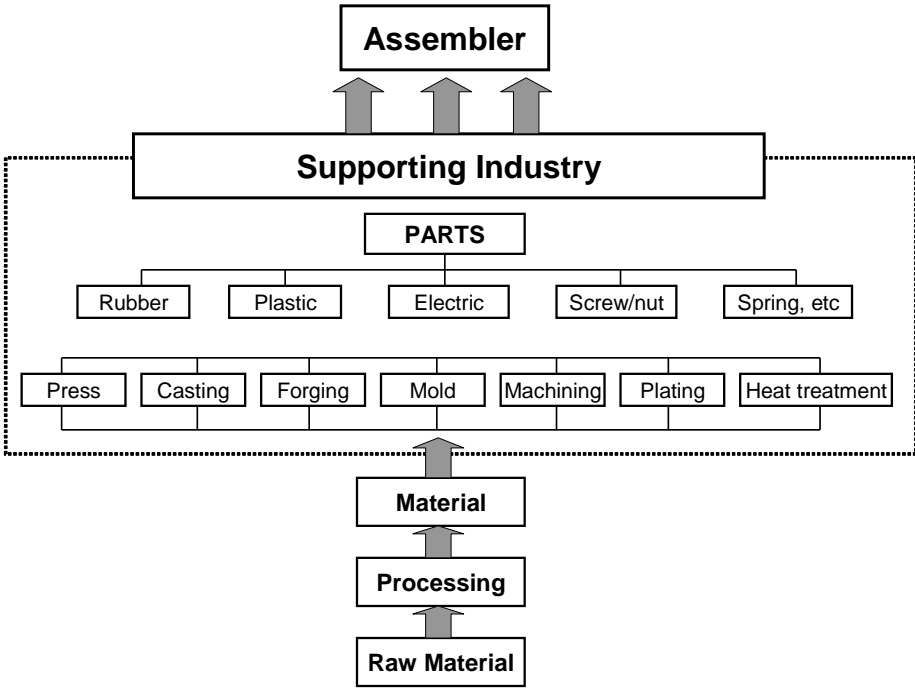
Figures 3, 4 and 5 show the current status of assemblers and supporting industries in six key assembly-type industries in Vietnam. Each industry has a different configuration regarding markets for final products, local procurement, and the export of parts. Industrial analysis and strategy for each industry should properly reflect these differences.

Figures 6, 7 and 8 graphically summarize the author's policy advice. To develop supporting industries, the following three measures are recommended: (i) encourage and support each group of firms including SOEs, private firms and foreign invested enterprises; (ii) develop human resources in middle management, engineers and skilled workers; and (iii) the government should assist in marketing and quality assurance.

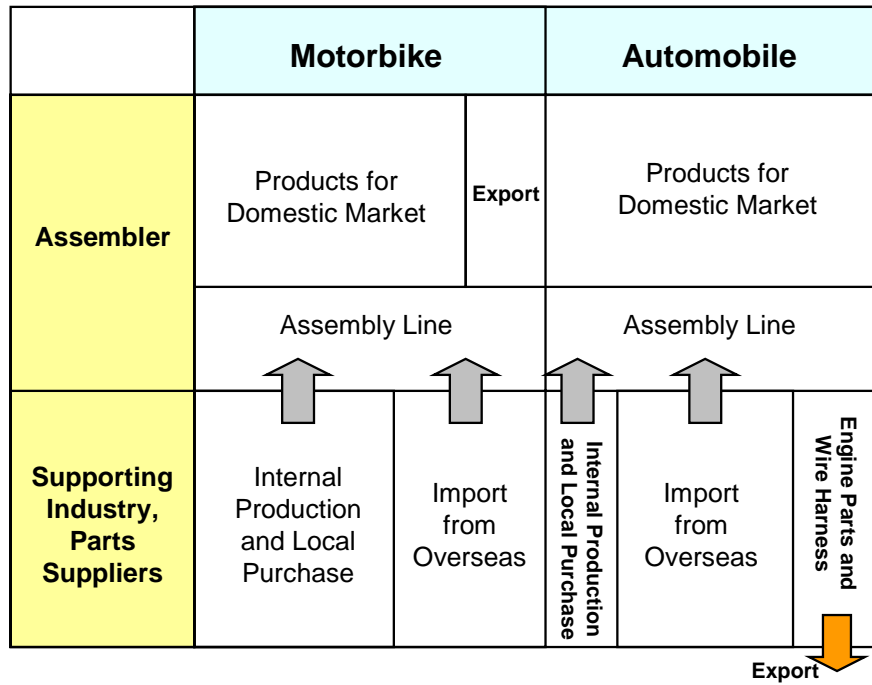
**Figure 1. Concept of Supporting Industry**



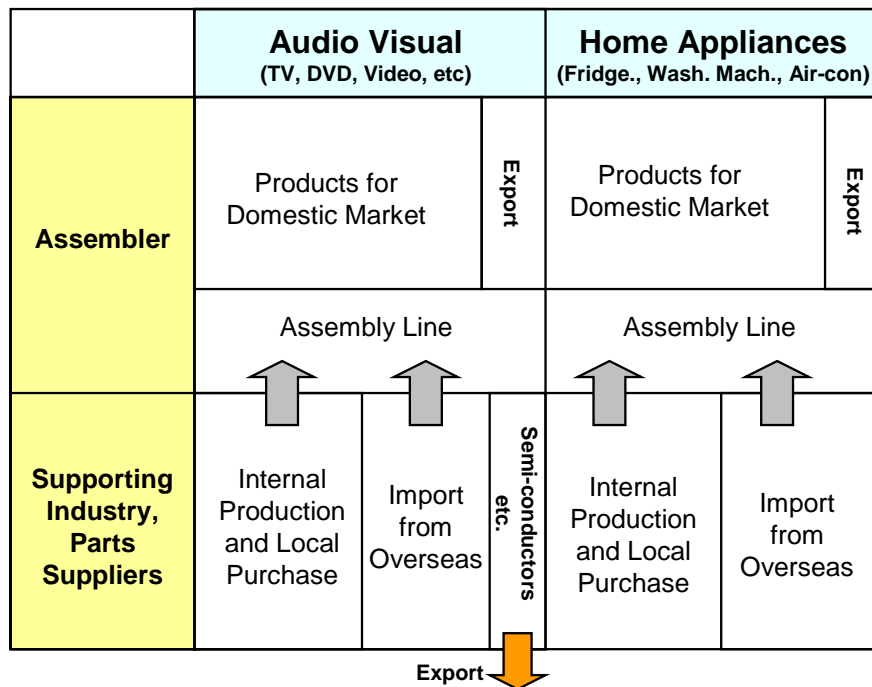
**Figure 2. Supporting Industry Includes Parts and Processing**



**Figure 3. Linkage between Assemblers and Supporting Industry (Part 1)**



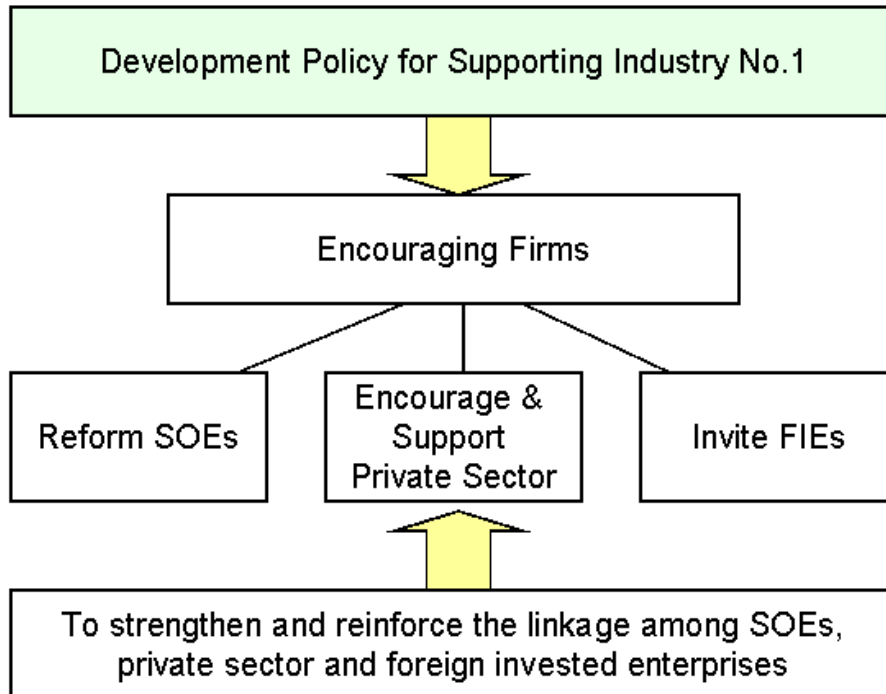
**Figure 4. Linkage between Assemblers and Supporting Industry (Part 2)**



**Figure 5. Linkage between Assemblers and Supporting Industry (Part 3)**

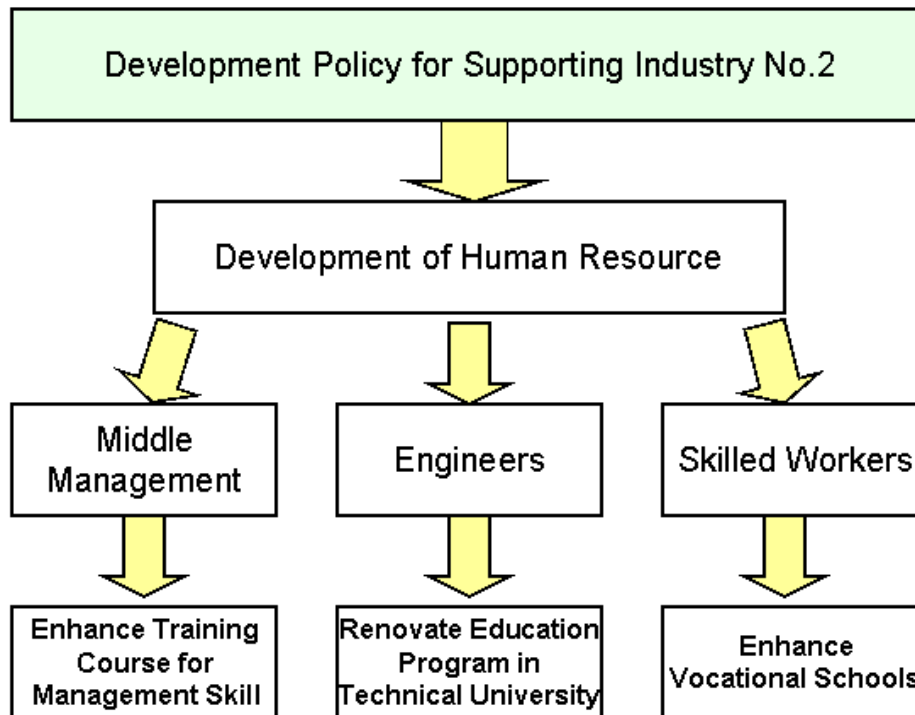
	<b>Office Machines (Printer etc)</b>	<b>Other (Mini Motor, Mini Fan, PCB)</b>	
<b>Assembler</b>	Export Only So Far	Export Only	
	Assembly Line		Assembly Line
<b>Supporting Industry, Parts Suppliers</b>	Internal Production and Local Purchase	Import from Overseas	Internal Production and Local Purchase
	Import from Overseas	Internal Production and Local Purchase	Import from Overseas

**Figure 6. Promotion Policy (Part 1)**





**Figure 7. Promotion Policy (Part 2)**



**Figure 8. Promotion Policy (Part 3)**

