

VIETNAM AT THE CROSSROADS

Policy advice from the Japanese Perspective

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Foreword

This booklet contains two of my recent essays targeted at economic policy makers as well as the general public in Vietnam. Since 1995, I have had the honor of joining and later leading a series of joint research projects on Vietnam's economic development funded by the Japanese government. More recently, I have worked closely with the Japan's Ministry of Foreign Affairs to revise its ODA strategy for Vietnam. Through these years, I have thoroughly enjoyed working with talented officials and researchers in Vietnam. At the same time, I have come to a firm belief that Vietnam can—and should—do much better than today in industrialization and international integration.

The first essay, originally drafted for a newspaper, presents the essence of our policy advice in a simple and bold way. Meanwhile, the second essay explains our policy proposals in more detail with supporting information. We advocate FDI-led industrialization which fully utilizes Vietnam's superb labor force. At the same time, the Vietnamese government should strongly support domestic enterprises to establish linkage with FDI firms and their global production networks. I hope that these messages come across more clearly in the free-style writings contained here, supplementing the thicker books and reports that we have also produced.

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Sitting on Gold and Not Knowing It

Vietnam Should Become Number One in Skilled Manufacturing*

Among all developing countries of the world, Vietnam is a very lucky one. You may not believe it, but this is the impression I got from my eight years of studying the Vietnamese economy. When I make research trips to other developing countries in East Asia, Central Asia, Middle East, Africa and Latin America, my impression is further strengthened. Many of them are afflicted with severe political fights, ethnic rifts, terrorism, or bankrupt government. They receive very little FDI in manufacturing. Some are ostracized by international organizations. With such troubles, no one can even talk about development strategy. Compared with these “average” low-income countries, Vietnam’s society is very stable. Today’s Vietnam has all the conditions to undertake serious development tasks. It is one of the rare countries whose governments can concentrate mainly on economic policies. Besides, foreigners (including donors) love Vietnam.

But that does not mean that development is easy. In fact, I feel that the great advantages Vietnam has over other countries are currently being wasted instead of used to propel the country along the path to prosperity. Many business people perceive Vietnam’s growth potential but it is not yet realized. Surely, the recent economic growth of 7% plus is commendable, but this is supported by large inflows of foreign money and a real estate bubble rather than improved technology and competitiveness. It is not a homegrown development.

Social stability and a good location in East Asia are certainly strong points. But the greatest asset of Vietnam is its people. What I mean is not hospitality or kindness in general, but the quality of workers in factories and offices. Nowhere else in the world (this includes both

* A free-style article based on the author’s essay written for the Vietnam Economic Times.

the developed and developing world) do workers perform as precise and reliable duties as in Vietnam. All FDI factory managers I visited in Vietnam attest to it without exception. They also complain about the inferior quality of labor they experienced before in China, Thailand, Malaysia, Indonesia, and so on. Some even say that Vietnamese workers are better than Japanese workers.

In short, Vietnamese workers are number one in the world, and this great asset must be fully mobilized to meet the challenges of China, AFTA and WTO. But workers perform wonders only when guided by good management and good policies. The big problem now is that top-quality workers are combined with terrible management and inconsistent policies, so their potential is never realized. In the garment industry, for example, the average productivity of Vietnamese workers is much lower than in China. This is not due to clumsy hands but because of poor production management. When a state-owned garment company rearranged sewing lines using scientific analysis provided by a Japanese buyer, its productivity increased dramatically from eight to fifteen shirts per worker per day.

Another interesting phenomenon is the sharp difference between export-oriented FDI and domestic market-oriented FDI. Companies like Fujitsu, Canon, and Mabuchi consider Vietnam as a platform to supply high-tech products to the global market. They import almost all inputs, process and assemble them, and export 100% of their output. In this type of operation, official intervention is very limited and exports and imports are virtually free. These companies are greatly satisfied with their investments in Vietnam. By contrast, companies like Toyota, Honda, and Toshiba mainly target the domestic market. For this, they have to deal with a complex web of regulations, unstable trade policy, and localization requirement (which would violate WTO). These companies are very angry and frustrated. The lesson is that Vietnam is great when its bureaucracy is bypassed. Vietnamese workers directly helped by foreign technology and management are already globally competitive.

Vietnam is sitting on gold but not realizing it because of inferior business leadership. If Vietnam wishes to join the rank of

industrializing countries in ASEAN and compete effectively with China, there is no other way but to dramatically improve its management and policy-making capability. And this is precisely the area where progress is too slow.

Before 1995, Vietnam's economic policy was summarized in five-year plans. Now, after ten years of global integration, policy formulation is much more complex with external factors like China, AFTA, WTO accession, FDI slowdown, bilateral trade disputes, aid donors, currency crisis, and global price fluctuations. The world is changing faster than the speed of Vietnamese policy response. As a result, Vietnam always remains backward, relatively speaking.

When I visited Vietnam for the first time in 1995, we debated alternative strategies. One group preferred to support state-owned enterprises as the pillar of the national economy and self-sufficiency of inputs. Another group considered the burgeoning domestic private sector to be the growth engine. Meanwhile, the Japanese team argued that FDI-driven international linkage was the key to industrialization and competitiveness. What surprises me is that government officials are still debating this fundamental issue today. It is time for the government to decide what to do, and implement necessary policies. Unless the long-term vision indicating where the Vietnamese economy is headed is set out more clearly, businesses cannot invest with confidence. What is needed is not an endless debate on economic systems but action on concrete policies.

So what should be done? Our advice is for Vietnam to (i) maximize FDI inflows without selectivity by lowering the cost of doing business (removing localization requirement is especially important); (ii) create a linkage of local firms to FDI firms; and (iii) absorb technology, management skills, marketing, etc. from this linkage. At each step, policy assistance is required since Vietnam's market economy is severely underdeveloped. The need to foster domestic "supporting industries" which supply parts to assemblers is widely recognized, but Vietnam has not mastered the policy skill to actually accomplish this feat. We cannot jump to the later steps unless the first step is achieved. Some policy makers want to establish

supporting industries even before there is a sufficient mass of assemblers, but we think this is unrealistic.

There is a feeling among many Vietnamese that FDI-driven growth is not an autonomous growth. They want Vietnamese companies to lead industrialization rather than foreign ones. This sentiment is understandable, but not practical. We must squarely face the reality of the global economic game instead of being confined to narrow domestic knowledge. At present, Vietnam's industrial capability unassisted by foreign partners is very low and can hardly compete globally. Vietnam's industrialization must proceed by making a full use of foreign technology and networks, but the development strategy itself must be owned by Vietnam. If the policy is yours, using foreign help does not necessarily lead to the loss of economic autonomy.

I am a little annoyed by the attitude of some Vietnamese officials who say, "we understand your ideas, but we need more concrete proposals." But is it not the role of the Vietnamese government, rather than foreign advisors, to design and implement concrete policies? A country that only listens and does not act on its own is unlikely to industrialize. We are happy to discuss details and set an example at first, but you must do most of the work the next time. The ultimate purpose of learning from foreigners is to graduate from it. If you can do it the sooner the better.

Vietnam at the Crossroads

The Need for Dramatic Improvement in Investment Climate*

This paper presents the ideas frequently discussed among Japanese officials, scholars and business people interested in Vietnam. While the author alone is responsible for the contents below, it is hoped that the paper will provide a useful background for understanding why Japan recommends certain actions by Vietnam.

I. Where Vietnam Stands

Prosperity without competitiveness

While Vietnam's per capita income is only about \$400, its streets are full of fashionable motorbikes and new shops are coming up everywhere. This is a scene rarely seen in other similarly poor countries. One big puzzle of the Vietnamese economy is: *where does the money come from?* How can a poor country like Vietnam sustain strong consumption and construction booms, and grow above 7% per year?

It is not because Vietnam is already competitive in the global economy. The main reason for strong domestic demand is the large inflow of foreign money relative to economic size. Apart from export earnings, Vietnam receives over \$10 billion (about 1/3 of GDP) of foreign exchange every year. A country receiving so much foreign money can certainly build new houses and buy expensive motorbikes. Once injected, these funds start to circulate in the national economy through activation of local businesses and real estate bubbles. Through this process, many people get rich.

* Based on an unpublished letter to Vietnam's policy makers written in September 2003.

Vietnam Receives Foreign Exchange (2001)	
Viet Kieu remittances ¹	\$ 4.0 billion
FDI implementation	\$ 2.3 billion
ODA disbursement	\$ 1.5 billion
Tourism receipt	\$ 1.5 billion
Workers' remittances	\$ 1.5 billion
TOTAL	\$ 10.8 billion

Can Vietnam sustain this situation? Surely not, if Vietnam fails to improve competitiveness quickly as trade liberalization proceeds. Most of these funds come to Vietnam expecting a bright future of the Vietnamese economy. If their hopes are dashed, capital inflow will slow down. Prosperity without competitiveness is fragile.

From 1996 (when AFTA started) until now, Vietnam has not succeeded in creating new industries with international competitiveness. The majority of exports are either primary commodity based or manufactured under the supervision of foreign firms. Vietnam is making many efforts but still remains relatively behind because China is rising faster and the global market is moving far ahead.

Another worry is low efficiency of investment. Compared with the past, Vietnam's investment-to-GDP ratio has now greatly increased to 34.3 % (GSO data for 2002). However, with this level of investment, the country should be growing nearly 10% per year. The

¹ Viet Kieu money data is imprecise due to the existence of the informal channel (brought-in cash) in addition to the formal channel (bank transfers). Receipt of Viet Kieu money is concentrated in the south of the country.

fact that Vietnam only grows just above 7% signals low capital efficiency.² Vietnam's current growth is characterized by quantitative expansion rather than quality improvement.

Will Vietnam fly high or slow down?

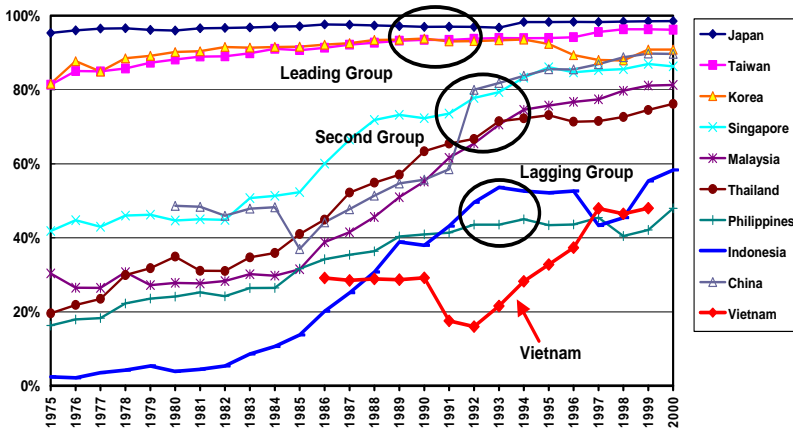
Since late 2002, in Tokyo, the Japanese government had many internal discussions on Vietnam. The three key ministries in charge of ODA, namely the Ministry of Foreign Affairs (MOFA), Ministry of Finance (MOF), and Ministry of Economy, Trade and Industry (METI) and the ODA executing agencies, namely the Japan Bank for International Cooperation (JBIC) and Japan International Cooperation Agency (JICA) have been deeply involved. The Japanese Embassy, JICA, JBIC, Japan External Trade Organization (JETRO), and Japanese Business Associations in Hanoi and HCMC also participate in these discussions. This move reflects the new orientation of Japan's ODA policy in general, as well as the recent events in Vietnam that worry Japan, including the motorbike problem in 2002-2003. The majority view which has emerged among the Japanese concerned, as the author sees it, can be summarized as follows:

“Vietnam has a good potential to grow fast and catch up with other East Asian countries, and we want to support this process. But Vietnam's potential is not yet realized due to inferior policy environment. FDI is the key to industrialization and Vietnam should improve FDI climate *quickly and dramatically*.”

This view was also clearly stated by Japanese Ambassador Norio Hattori at the CG meetings in Hanoi, December 2002.

² The ratio of the investment/GDP ratio to the growth rate is called the incremental capital-output ratio (ICOR) and measures the macroeconomic efficiency of investment. In Vietnam's case, ICOR is 4.9 (=34.3% / 7.0%) in 2002, which is a bit too high (i.e., inefficient).

Manufactured Exports (% of total exports)



Source: ADB, *Key Indicators of Developing Asian and Pacific Countries*, 2001/1993; IMF, *International Financial Statistics Yearbook 1990*. For Japan, *Japan Statistical Yearbook 2002/1999*, Statistics Bureau/Statistical Research and Training Institute, Ministry of Public Management, Home Affairs, Posts and Telecommunications, Japan.

Even among East Asian countries, economic success is not uniform. Taiwan and Korea have already reached a point where R&D, production and marketing can be conducted by themselves with little foreign assistance. Malaysia and Thailand have also raised income and industrialized greatly, but they still rely heavily on foreign technology and management. On the other hand, the Philippines and (to some extent) Indonesia seem to be unable to soar beyond a certain level of industrialization. The main reasons for this are political instability and hostile investment climate.

Compared with other East Asian countries, Vietnam has the advantages of (i) great human resources; (ii) ideal location between China and the rest of ASEAN; and (iii) political and social stability. But these advantages are not yet fully utilized because of the two well-known problems associated with Vietnam's investment climate, namely, *poor infrastructure* and *policy inconsistency*.

Of these two weaknesses, improvements in infrastructure are being made steadily. Japanese ODA also contributes greatly to building Vietnam's transport and power sectors. Even so, infrastructure

service still remains inadequate, and it is clear that patience is required before the quality reaches a satisfactory level. But we are confident that it will be done; it is only a matter of time.

But we are not so confident about policy inconsistency. There is no guarantee that policy will greatly improve, unless the government has the strong resolve to do so. Moreover, if the government has the will, very rapid improvements are surely possible. Japan now wonders if ODA is really effective in a developing country where policy quality remains deficient. For this reason, Japan wants to discuss growth strategy and its linkage with ODA through deepened policy dialogue with the Vietnamese government.

Needless to say, Vietnam faces a large number of development problems. Why focus on investment climate alone, and not on other problems? The reason is as follows. First, Vietnam should concentrate on a small number of issues instead of trying to solve all problems at once, which is impractical. Second, we believe investment climate is the best policy entry point for accelerating growth, since the issue attracts much attention of the Vietnamese government, domestic and foreign businesses, and donors including Japan. Third, investment-led growth, if realized, will facilitate the solution of other socio-economic problems including poverty, unemployment, technology, SOE reform, SME promotion, rural development, and so on. For these reasons, we believe that *dramatic improvement of investment climate* is the most suitable policy goal for Vietnam at this moment. We also believe it is certainly achievable.

Japan's desire to see a greatly improved investment climate in Vietnam is manifested in a number of programs that Japan is pursuing, including:

- New country assistance program for Vietnam (to be approved in late 2003)
- Vietnam-Japan Joint Initiative to Improve Business Environment with a View to Strengthen Vietnam's Competitiveness (agreed

between two Prime Ministers and scheduled to be completed by December 2003; see below)

- NEU-JICA Joint Research Project on Vietnam's Industrialization under Integration (2000-2003)
- Vietnam-Japan Investment and Trade Working Group meetings (annual and monthly)

FDI dynamics and the importance of policy

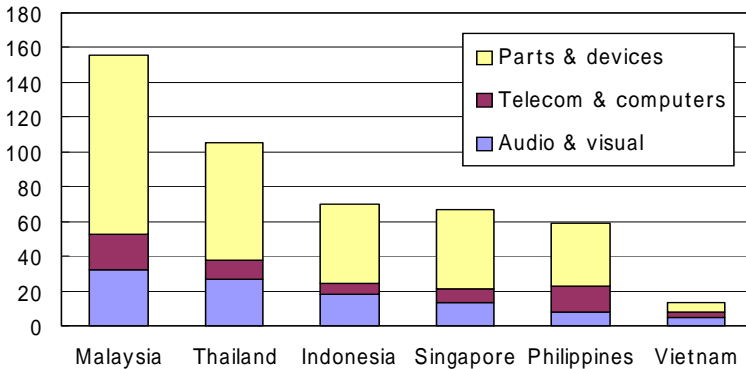
The most urgent task for Vietnam's industrialization is the attraction of a critical mass of FDI. To attract FDI when China and other ASEAN countries are also vying for it, simple opening of the economy is not enough. To overcome the negative image of Vietnam as an FDI destination requires a bold move and a clear signal, backed by a thorough understanding of global market trends and the needs of foreign investors. For this purpose, gradual improvements are not sufficient. Vietnam should surprise the world by offering the best investment climate in East Asia.

FDI flows have become extremely dynamic in recent years. One tendency observed today is *agglomeration*, namely, concentration of producers in a place where such concentration initially starts. The other tendency is *fragmentation*, namely, international division of labor of different production processes to manufacture one product. These two tendencies interact in complicated ways to create winners and losers in FDI absorption.

At present, Vietnam's absorption of FDI is far below a critical mass required to accelerate industrialization. In the second half of the 1980s, Thailand and Malaysia received hundreds of FDI projects from Japan and became major exporters of electronics. China received over \$400 billion of FDI during the last decade. By contrast, Vietnam has so far received only \$15.7 billion of manufacturing FDI (by end 2002), and Japanese electronics FDI into Vietnam counted only 13 by the year 2000. To become an industrialized economy, Vietnam must attract FDI which is one order of magnitude greater than this.

Japanese Electronics FDI in ASEAN

Cumulative number of manufacturing establishments



Source: Electronic Industries Association of Japan (2000), quoted by Yumiko Okamoto, "Electronics and Electrical Industries," in K. Ohno & N. Kawabata, eds, *Industrialization Strategy of Vietnam*, Nihon Hyoronsha (2003).

The traditional factors to attract FDI include low wage, large domestic demand, and availability of natural resources. These factors are still relevant, but in the context of East Asian dynamism, there are other factors that are even more crucial for attracting FDI: (i) open and stable policy environment; and (ii) overall reduction of the *cost of doing business*. The important point is that, unlike the traditional factors, these are not given by initial conditions but can be created by policy. To achieve global competitiveness, multinational corporations constantly seek a location which offers high flexibility and low cost. For them, policy environment is far more important than the availability of local demand or natural resources.

Some argue that Vietnam should maximize the use of domestic resources instead of relying heavily on FDI. The fear of foreign economic dominance is understandable, but such a strategy is impractical. The technology gap between Vietnam and abroad is too large and Vietnam has little chance of winning global competition by itself. No ASEAN country has succeeded in industrialization through self-sufficiency. In East Asia, inward orientation and economic stagnation are strongly correlated. We believe that Vietnam's policy

autonomy can be maintained even if its industrialization is FDI-driven. That depends critically on how well Vietnam uses FDI to its advantage. The option of not absorbing FDI in large quantity is not available, especially in the early stage of industrialization.

Foreign investors' perception

Vietnam is a very popular destination among Japanese tourists. After the initial visit, there are many repeaters. But Japanese businessmen are more cautious. They also love Vietnam, but they complain bitterly about its policy. Many Japanese firms consider investing in Vietnam, but few actually come.

To be more precise, there are two groups of FDI. Export oriented FDI firms such as Fujitsu, Canon, and Sumitomo Bakelite are generally satisfied with Vietnam's investment conditions. They operate in virtually free trade and use Vietnam as a base for exporting high-tech products to the global market. By contrast, domestically oriented FDI firms such as Honda, Toyota, and Toshiba are often extremely frustrated with Vietnam's policy (although they still love Vietnam as a nation). I have visited hundreds of firms operating in Vietnam since 1995, and this divided perception is very clear and persistent.

The Nikkei Shimbun is a newspaper every Japanese business person reads, and it is also the most important source of information about the Vietnamese economy in Japan. In 2002, the Nikkei carried many articles about the motorbike problem, which seriously hurt our perception of Vietnam as an FDI host country. The Japanese government and business community were alarmed at the "worsening" of Vietnam's investment climate. Good news is easily forgotten, but bad reputation will stay forever. The satisfaction of export-oriented firms is ignored because of this unfortunate incident. Although the Nikkei now publishes brighter news about Vietnam, it will take a huge effort to reverse the negative image created in previous years.

For Japanese manufacturers considering FDI in East Asia, the question is roughly as follows. The fundamental choice is between China and ASEAN. On the one hand, China is huge, dynamic and very attractive, and it is in fact the most preferred destination for almost all investors. But putting all eggs in one basket is risky. Japanese firms which already operate in China want to diversify its production base. On the other hand, ASEAN is the traditional destination of FDI for Japan with extensive Japanese production networks already in place. While ASEAN looks weaker than China at present, Japanese manufacturers will not abandon it; instead, they want to strengthen their ASEAN production base and invest in China simultaneously. Operating from two locations allows more flexibility in business strategy.

If ASEAN is chosen as an investment site, the next question is which country in ASEAN? At present, Indonesia and the Philippines are too unstable politically. Malaysia's wages are too high. For these reasons, most Japanese investors are interested in the choice between Thailand and Vietnam. Thailand has long received Japanese FDI and boasts a reasonably good investment climate. Vietnam's policy and infrastructure are far inferior, but its economy is younger and more dynamic. Therefore, safety-oriented investors go to Thailand while seekers of excitement and risk come to Vietnam. This means that Vietnam can surpass Thailand and become the best FDI destination in ASEAN *if policy environment improves significantly*.

The most recent survey conducted by the Nikkei Shimbun and the Japan Center for Economic Research confirms this. The survey covers 606 Japanese firms operating in East Asia. In evaluating production bases on a scale from 0 to 10, the top five locations were three coastal regions of China, plus Thailand and Vietnam. When asked how they plan to shift production bases, the most popular answer was moving from one place to another within China. However, there were also many Japanese firms considering a move from China or ASEAN5 to "Other Asia" (including Vietnam).

Which location do you think is the most attractive production base?	Points
(1) China (Central Coast)	7.2
(2) China (Southern Coast)	6.9
(3) Thailand	6.3
(4) China (Northern Coast)	5.9
(5) Vietnam	5.8
From which location to which location do you plan to move production base?	Percent
(1) From China to China	23.3%
(2) From ASEAN5 to China	17.9%
(3) From Taiwan to China	11.8%
(4) From ASEAN5 to Other Asia	8.4%
(5) From China to Other Asia	7.4%
Source: <i>Survey on China and Asia After Five-to-Ten Years</i> , Nikkei Shimbun and Japan Center for Economic Research. Reported in Nikkei Shimbun, September 15, 2003.	

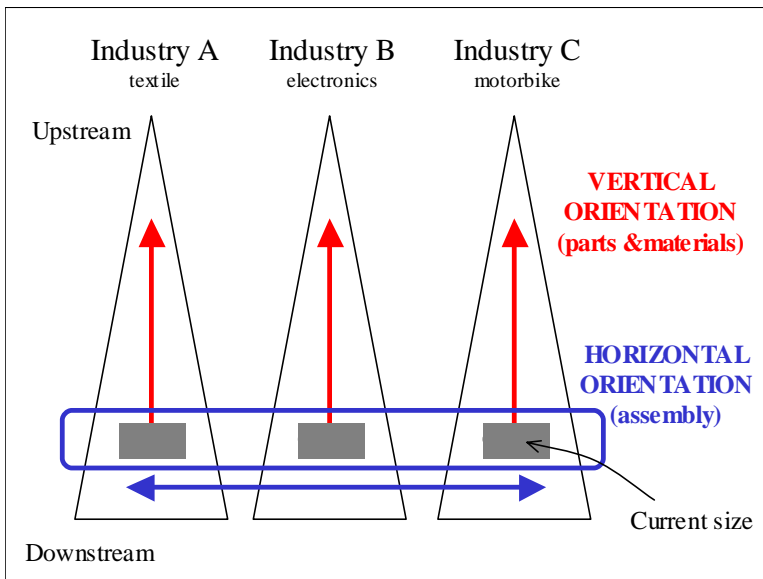
The survey also notes that Japanese large firms already have a sufficient number of production bases in East Asia. Any further reorganization will be relocation of existing ones rather than new additions, and that will be driven by careful comparison of locational advantages across different countries.

II. Critical Issues

Vertical versus horizontal orientation

In the course of joint research between Japan and Vietnam since 1995, we have hosted many workshops, symposiums and policy dialogues. On these occasions, the same policy question comes up again and again regardless of which industry is being discussed, whether electronics, motorbike, textile and garment, or steel.

At present, Vietnam's modern industries are small and concentrated in labor-intensive assembly-type processing (gray ovals below). This sector, which lies relatively downstream in the production process, is currently dominated by FDI firms and SOEs with foreign connection. Industrial agglomeration is still small even in this sector. Beyond this sector, Vietnam's ability to design, produce parts and materials, and market internationally is severely limited. Given this primitive industrial structure, two alternative strategies are debated.



(i) ***Vertical orientation.*** The first strategy is to accelerate the growth of domestic upstream industries (vertical arrows). The use of domestic inputs is strongly promoted by various policy measures. Local contents requirement which penalizes non-compliance is a typical example. If private investment is not forthcoming, the state is urged to invest in desired upstream industries. According to this strategy, the market mechanism should be modified actively to achieve the national goals, which typically include "balanced" industrial structure, alleviation of balance-of-payments pressure arising from importation of inputs, and national self-sufficiency. It is argued that growth which depends heavily on FDI and market forces will be too slow and biased toward simple manufacturing with low value-added.

(ii) ***Horizontal orientation.*** The second strategy contends that Vietnam should refrain from aiming at vertical industrialization in the age of globalization. Instead, this view recommends full utilization of its abundant and highly skilled labor and doing what it already does even better (horizontal arrow). More specifically, garment, footwear, electronics assembly, food processing, furniture, handmade goods, and other light industries should be the driving force of Vietnam's industrialization. Even though exports of these products are rising, they still suffer from low efficiency and lack of marketing. If great skills of Vietnamese workers are combined with professional management and marketing, Vietnam can become the global champion of light industries. The country can grow much faster and create much more jobs by specializing in downstream processing where it excels, instead of investing a huge sum in capital-intensive industries. Vietnam's dynamic comparative advantage lies in labor- and skill-intensive industries, and not in capital-intensive upstream industries.

These are two diametrically opposed views on how Vietnam should cope with the forces of international integration. In the many meetings we have hosted, Vietnamese participants were often split between the two views while the Japanese team invariably upheld the second view.

Localization

There is a constant call for creating “supporting industries” that supply parts and intermediate materials to final assemblers. At present, Vietnam has very little capability of producing such inputs. While the goal is easy to endorse, experts disagree as to how that should be achieved. One view advocates a relatively strong state leadership in enforcing local contents requirement, while the other view wants to rely mainly on dynamism of the private sector (especially FDI). Clearly, state and market must be combined wisely in the development process. But more concretely, what is the right mix in the Vietnamese context?

In our workshops, Vietnamese parts producers frequently criticize FDI firms for buying imported parts and being unwilling to use domestic parts. FDI firms reply that they are trying very hard to procure domestically but cannot find local producers with sufficient quality. While some local firms claim that their products are already internationally competitive, they are hardly so in the eyes of Japanese producers.

Another debate often heard goes as follows: Japan requests the abolition of local contents requirement and the reduction of parts tariffs to zero. This is needed to create a favorable business condition to compete in the global market. Meanwhile, the Vietnamese side asks, “How can we create supporting industries if we don’t use parts tariffs and local contents requirement?”

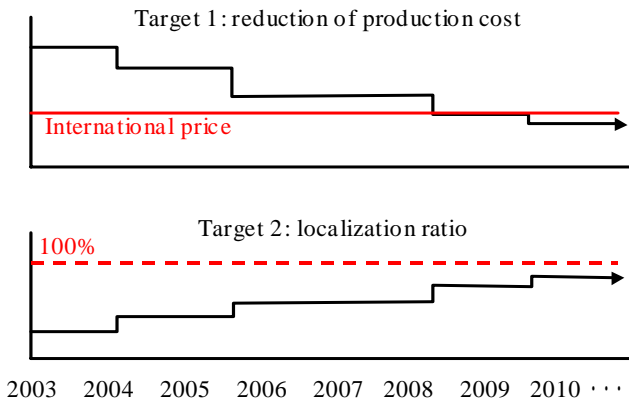
It should be emphasized that all foreign assemblers of the import-substitution type³ (consumer electronics, motorbike, automobile, etc.) desperately want to procure domestically for their survival. This is because parts occupy the largest share (normally 70-80%) of their production cost, and international competitiveness is never achieved unless parts cost is reduced. This requires a shift from imported parts which are expensive and slow to arrive to using domestic parts which

³ By contrast, export-oriented FDI firms which import and export 100% are not constrained by a complicated web of localization policy.

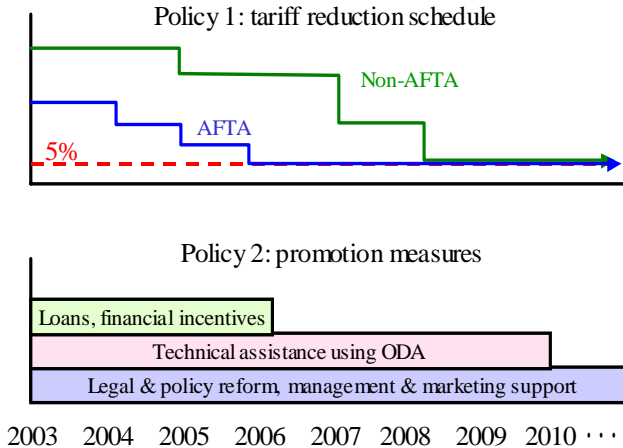
are cheaper and quick to arrive. For them, reduction of labor cost is not very crucial since it only accounts for 5-10% of total cost.

The Vietnamese side and the Japanese side share the common goal of higher localization, but they continue to disagree because their perceptions and business models are different. There is a serious communication failure between them. They should be provided with opportunities for mutual talk and understanding. More importantly, we strongly recommend *constructive engagement* between the two parties. This means that FDI firms should offer business targets in terms of cost reduction and localization which are ambitious but achievable. In return, the government should support them with consistent tariff design and promotion measures. When these actions mesh nicely, industrialization is accelerated. Such constructive engagement should be based on the in-depth analysis of global markets and consistent with Vietnam's external commitments including AFTA, USBTA, WTO, and East Asian FTAs (in the future). The following diagrams visualize such constructive engagement for a hypothetical industry.

Conditional business targets that might be indicated by FDI firms (example)



Conditional policy actions that might be offered by Vietnamese government (example)



Localization policy can be good or bad, and the difference between them is very subtle. Good localization must be:

- Demand-led and natural (not forced or against market)
- Predictable with long-term schedule (not ad hoc revisions)
- Based on constructive engagement between producers and government as stated above (not mutual distrust)

If localization is forced and unnatural, such policy will have the unintended effect of driving both assemblers and parts producers out of Vietnam. If that happens, Vietnam's industrialization will stall.

Tariff design

There are only a few years left before the AFTA completion date of January 2006. Up to now, AFTA was easy since it had little impact on domestic prices or producers. But in the last stretch of AFTA implementation, Vietnam faces a real challenge. The remaining process will hurt.

In July 2003, the Vietnamese government announced a revised CEPT schedule with expanded tariff lines. But even now, the AFTA impact is relatively small and Vietnam seems to be playing delay tactics. CEPT tariffs on many sensitive items are now set to 20% until the end of 2005 (will they be lowered to 0-5% at the last moment?). There is no clear policy regarding parts tariffs or non-AFTA tariffs. Prospects for removing localization requirement and other regulations are uncertain. There is a rumor that some products (motorbike?) will be placed in the General Exception List. Thus, fundamental uncertainty surrounding Vietnam's tariff structure remains unchanged. Under such circumstances, no business can invest confidently.

In the last several years when AFTA was progressing, Vietnam should have acted vigorously to restructure existing industries and create new ones with international competitiveness. But policy was ineffective and very little has been achieved toward this goal. Even today, Vietnam desperately lacks preparation for AFTA. We are worried that the day of reckoning will come in January 2006. If AFTA is fully implemented under weak competitiveness, there will be bankruptcies and unemployment which leads to social instability. If this is to be avoided, Vietnam will be forced to retract AFTA commitments and regress to ad hoc protection. Neither prospect is attractive. This is a dilemma generated by the absence of long-term integration strategy.

It is very late and little time is left to improve competitiveness against the AFTA challenge. Nevertheless, late action is better than no action at all. We recommend the following rules to improve Vietnam's tariff design.⁴ They should be useful even after 2006.

- i. *Comprehensiveness*: the whole tariff structure should be a part of overall industrial strategy and consistent with other policy components (master plans, promotion measures,

⁴ For numerical examples of alternative tariff reduction proposals for individual industries, see our website listed at the end.

- budget, infrastructure, SOE reform, education and training, etc.)
- ii. *Stability*: Once announced, a tariff reduction schedule should be carried out without change (unless external emergency occurs; see (vii) below).
 - iii. *Vertical consistency*: parts tariffs should be lower than tariffs on finished products (this rule is sometimes violated in Vietnam).
 - iv. *Evaluation of cost impact*: the fact that tariff protection will hurt downstream users and consumers should be taken into account.
 - v. *Free trade in inputs*: there should be no tariffs on inputs of export-oriented firms (even better: no tariffs on all industrial inputs).
 - vi. *Start-up protection*: when an industry is newly established, a modest and temporary tariff to cover initially low operation and interest payments is acceptable for a few years.
 - vii. *Emergency protection*: a developing country should be allowed to protect itself against global market instability or unfair trade practices of other countries (though such protection must be implemented carefully lest it should become excessive or permanent).

In addition to these general rules, there is a tough policy question of how to design tariffs for uncompetitive industries. There should be a special strategy for import substitution industries which are weak and have been protected behind the wall of trade barriers. The AFTA impact will fall mainly on them. They include materials industries such as steel, paper and chemicals, as well as domestic market-oriented FDI projects such as consumer electronics, motorbike and automobile. The policy toward uncompetitive industries should be conditional, dynamic, and backed by up-to-date information on these industries and global markets. Removal of protection should be at the right speed to bestow incentives to restructure while avoiding social confusion. It should be neither too fast to cause massive

unemployment nor too slow to protect them forever. This is indeed a very delicate task.

Tariff reduction for weak industries must be pre-announced and implemented without revisions (whether or not the industry succeeds in improving efficiency). The ultimate fate of the industry should be determined by market competition and the effort of each firm. However, the government should assist firms with realistic restructuring plans in the transition period. How such support should be designed differs from one industry to another. For this purpose, we have studied the steel industry in detail in our joint research.

Land marketing

One of the things that Vietnam lacks almost completely is the capability in international marketing. Many people still think that physical production is the main activity of manufacturing industries, and well-executed production should lead to large profits. But the fact is production itself does not create much value in the international value chain. Most value is created in the designing (upstream) and marketing (downstream) processes. To increase value, Vietnam should look at these aspects rather than simply increasing the number of domestically produced products.

Moreover, marketing is not just for physical products. To attract FDI, land marketing is equally essential but very few Vietnamese organizations practice it. In the south of the country, there are many industrial parks managed by Vietnamese with relatively good results.⁵ However, without overseas marketing, their names are totally unknown to potential Japanese investors. These industrial parks hope to attract big-name FDI firms and some have distributed English pamphlets to JETRO (Japanese business organization). But

⁵ For example, Tan Tao, Vinh Loc and Cat Lai II are very popular industrial parks among local firms but virtually unknown in Japan. At Tan Tao, a large number of Taiwanese firms came by word of mouth. Vinh Loc also attracts foreign firms including Chinese, but only one small Japanese firm invested in it. With an ideal industrial location in the future, Cat Lai II is already full but has attracted very few FDI firms.

others have not yet produced any pamphlets. They seem to have little practical knowledge of how land marketing should be done. Professional assistance is required to perform effective marketing. The existence of a wonderful industrial park means nothing unless it is effectively advertised to potential customers.

The same problem is also observed at the national level. The government hopes to receive as much FDI as possible but there is very little professional marketing of Vietnam as an FDI host country. General formulation and supervision of policy by MPI is important, but that alone is insufficient. There should be another organization, at the operational level, to assist individual foreign investors *before* and *after* they come to Vietnam. Before they come, there should be well-targeted marketing to provide all information that investors require. After they come, there should be regular dialogue and assistance so that their factories run smoothly. If there is any problem, it should be fixed promptly. Such customer-oriented marketing and after-service are currently missing in Vietnam's FDI policy.

An industrial park specialist who created Thang Long Industrial Park states that the following three factors are essential for a successful industrial park:

- *Location*: this is the most important factor in any real estate development. Good location must offer proximity to port (and airport), availability of engineers and workers at reasonable cost, and urban amenities. Suburbs of Hanoi and HCMC offer the best conditions. Most industrial parks planned in remote areas may have to be closed.
- *Infrastructure service*: manufacturing firms require various inputs including electricity, telephone, internet, water, sewage treatment, transportation, customs clearance, residence, etc. A good industrial park must offer all of them in stable supply, high quality and low cost.
- *Management capability*: An industrial park must be efficient and responsive. Pre-investment marketing and post-investment services as mentioned above must be offered in a professional way.

Many Vietnamese industrial park managers agree with this view. This lesson should also be helpful in marketing Vietnam as a FDI host country.

One must be assertive in advertising. Vietnam should reach out abroad and drag foreign investors into Vietnam, rather than waiting at home for customers' arrival. Spreading information is the task of host countries, not FDI firms. In China, local industrial park officials overwhelm you with smiles, well-arranged tours, and food and drinks, making you feel like an emperor. In Vietnam, we do not feel such a strong pull. Investors are not sure if Vietnam really wants them to come.

For attracting Japanese firms, we suggest hiring people who speak Japanese fluently and know Japanese business practice. In addition, hire a professional to design a marketing strategy targeted especially at Japan. But these are just the beginning. There are many other things to be done in order to attract a critical mass of FDI (see below).

III. Suggestions for Immediate Action

No one expects Vietnam to become an investors' paradise overnight. Japanese manufacturing firms understand that Vietnam is a latecomer country and needs a substantial amount of time to solve its development problems. However, investors need an assurance that Vietnam is keenly aware of its inferior investment climate and taking realistic steps to correct it as a top national priority. If, on the contrary, Vietnam lacks awareness or determination, investors are not willing to wait. Therefore, the most important thing in attracting FDI is to send the right signal. Changing the image of Vietnam is more important than what Vietnam can actually do today. In this sense, it is a psychological game. Market psychology can be changed quickly even though roads and ports cannot be upgraded immediately. Many Japanese firms are interested in Vietnam, but few actually come to invest. The main reason is not the poor infrastructure, but because they cannot detect a strong will of the Vietnamese government to make things better.

On the one hand, the current effort by the Vietnamese government, while commendable, is not enough. On the other hand, with limited human and financial resources, Vietnam cannot solve all problems at once. Efforts must be sharply focused and strategically sequenced. We propose the following seven actions for immediate consideration. If there is a will, each can be executed quickly without incurring a huge financial cost. These actions are mutually related, and will together help to create an effective mechanism to solve policy issues inside the Vietnamese government. When they are initiated (even before they are completed), investors will see that the Vietnamese government has become very serious.

(1) Declare a national campaign to become No.1 FDI host country in ASEAN

The Prime Minister should declare this goal as a top national priority in the next five years. By setting this official goal, Vietnam commits itself in a position where no easy way out is possible, domestically and internationally. This enhances policy credibility and investor confidence. The success of this goal should be measured by the amount of FDI inflows.

(2) Concentrate authority for economic policy formulation

Currently, economic policy making is too diffused and no one takes responsibility. Policies lack consistency, and response is slow when speed is needed. Vietnam has many bright people but they are scattered and without decision-making authority. We propose a small group of young and highly talented professionals under the Prime Minister who design economic policies and supervise relevant ministries. Such top-down decision-making was adopted for a few decades by virtually all East Asian countries which succeeded in industrialization.

(3) Mobilize foreign expertise

There are many things that Vietnam alone cannot achieve and therefore require foreign help. Overseas marketing of products

and land is the area which is very important but often ignored. Design of realistic industrial strategies also requires inputs from foreign experts. Such inputs should be integrated into an overall development strategy. At present, there is too much waste in using foreign expertise. Foreign opinion and pressure can also activate domestic policy debate, so use them wisely and strategically.

(4) Execute the Vietnam-Japan Joint Initiative well

This initiative, agreed by the two Prime Ministers and conducted by MPI Minister Vo Hong Phuc and Japanese Ambassador Norio Hattori, is an important channel for bilateral policy dialogue. The action plans are to be finalized by December 2003, followed by implementation and monitoring. This initiative provides a good opportunity to improve Japan's perception of Vietnam, especially in matters related to FDI.

(5) Create VNIPA

The recent JICA report urges creation of the Vietnam Investment Promotion Agency (VNIPA) which specializes in land marketing and post-investment service for FDI firms.⁶ These are the functions completely lacking in Vietnam today (the MPI re-organization in July 2003 was good but not enough). Foreign expertise is indispensable in VNIPA's initial operation. Whether VNIPA reports directly to the Prime Minister or operates under MPI is up to the Vietnamese government to decide.

(6) Create a few bright spots and advertise effectively

There are many demands from foreign investors, but they cannot be implemented at once. Instead of trying to solve everything slowly, concentrate effort on a few small areas which are easy to improve, and publicize the results loudly. For example,

⁶ JICA, "The Study on FDI Promotion Strategy in the Social Republic of Vietnam," March 2003.

- Reduce industrial electricity tariffs to lowest levels in East Asia (immediately)
- Reduce telephone charges to lowest levels in East Asia (immediately)
- Create the fastest and cheapest internet environment in ASEAN (Hanoi and HCMC should become as good as Singapore within a few years)

These are my suggestions. Instead of these, other improvements are also possible. But they must be dramatic.

(7) Policy debate on public utility charges

A related issue is the pricing of public utilities such as electricity, telephone, water, port service, roads, and bridges. Some international organizations demand price increase to cover cost. Each supervising ministry will surely resist any price reduction. But these services are inputs to all industries and greatly affect Vietnam's overall competitiveness. At present, these costs are too high to attract FDI. Whether each public utility corporation should have a sound budget, or certain subsidies are warranted to stimulate private investment, is a fundamental policy question in a developing country like Vietnam. I do not have the right answer yet. But there should be a serious debate on this matter.

There are many other development problems that Vietnam must cope with. But the actions above should provide a good starting point. Once the government has clearly signaled its resolve to improve investment climate, national budget, bank loans, technical assistance, and donor support required to execute these actions—and other development policies—should be more easily forthcoming.

(For more, please see <http://www.grips.ac.jp/module/vietnam>)