Avoiding the Middle Income Trap:

Renovating Industrial Policy Formulation in Vietnam*

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Continued development into high income is possible only when people improve capabilities and work hard. Growth that depends on natural resources, FDI inflows or locational advantage will sooner or later come to a halt. Proactive industrial policy is needed to break this barrier. Vietnam's growth in the last one-and-half decades has been driven by the one-time liberalization effect and large inflows of external purchasing power. Now that the processes of systemic transition and global integration have deepened, Vietnam needs to create internal value to continue to grow and avoid the "middle income trap." The country has reached the point where growth towards higher income cannot be secured unless policy making is renovated significantly to activate the country's full potential. The vision of *Industrialization and Modernization* to be achieved by 2020 must be backed by realistic industrial strategies and concrete action plans, which are currently lacking. Stakeholder involvement in policy design, inter-ministerial coordination, clear directives from the top, and incentive structure for government officials must be improved. This in turn calls for radical changes in policy administration. A new style of leadership, a technocrat team directly serving the top leader, and strategic alliance with international partners are proposed as key entry points for the renovation of Vietnam's industrial policy formulation.

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This paper will analyze the situations surrounding Vietnam's industrial policy formulation, conclude that the country is likely to be trapped in middle income if the policy remains the same, and offer some suggestions to avoid this destiny. The solution will cover both policy content and policy organization.

1. The middle income trap and proactive industrial policy

Development, in its true sense, must come from the upgrading of human capital rather than a lucky endowment of natural resources or a geographical advantage for receiving foreign aid and investment. Depending on the amount of these unearned advantages, a country may rise to a low, middle or high income level with little effort but will eventually get stuck in that income category if it fails to build a national mindset and institutions that encourage constant upgrading of its human capital. This situation shall be called a developmental trap. If the country has moderate advantages in resources and geography initially, it will likely be caught in the middle income trap. After all, it is natural that any people who just provide unskilled labor in offices and factories managed by foreign general directors receive no more than a few hundred dollars per month. To earn more, they must acquire skills and knowledge demanded by the global economy, engage in innovative and value-creating activities, and send foreign general directors home.

East Asia is known as a region that achieved remarkable economic growth *on average*, but not all economies in the region have succeeded in development. Japan began to industrialize very early. Taiwan and South Korea also have sufficiently high income and industrial capability. However, Malaysia and Thailand remain at middle income although they started industrialization at about the same time as Taiwan and South Korea, namely in the 1960s. Indonesia and the Philippines have not made any visible catching up relative to the US income. Vietnam just joined the middle income group in 2008 but its future remains uncertain. Similarly, most Latin American countries, which attained "high income" as early as in the 19th century, still remain "developing." A number of African countries which do not have any initial advantages have been stuck in low income.

These different performances arise from the interaction of two key factors: *private dynamism* and *good policy*. For any country, the former is more or less given in the short run but the latter can be installed by a government guided by a visionary and well-informed leader. Required policy actions are more aggressive than the Washington Consensus, which is the standard policy recommendation of the World Bank and the International Monetary Fund consisting of deregulation, privatization, international integration and creation of a good business environment. More aggressive actions than these are required even in the 21st century when globalization has deepened and WTO rules and FTA proliferation have significantly narrowed the policy space of latecomer countries.

Even under the restricted policy space currently available, however, it is possible to design and execute meaningful strategies to accelerate industrialization. For example, the promotion of supporting industries and industrial human resources does not violate WTO rules at all. Measures to enhance technology transfer, education and training, FDI marketing, SME finance, enterprise management, infrastructure, logistics, industrial clusters, industrial estates, and so on, are also permissible under the current international regime.

We propose to use the term *proactive industrial policy* to describe what Vietnam and other latecomer countries must do to break the middle income trap. Its key components are acceptance of the market mechanism and globalization, dynamic learning by both government and the private sector, and complex and ever-changing interaction between the two sectors. More precisely, proactive industry policy must satisfy all of the conditions below:

(i) *Market-driven development under globalization*—production, investment, trade and other economic activities must be carried out primarily by the private sector under an open competitive environment generated by the market mechanism and the globalization process. Privatization, WTO rules, regional integration, and FTAs are to be positively embraced. State-owned production is not adopted except in cases where no private agents have yet emerged to take over the state role.

(ii) *A strong state*—the state assumes a strong and active role in guiding and supporting development despite the fact that all productive activities are in principle to be conducted by the private sector. The state will mobilize necessary policies to reward value creation, punish rent seeking, and lead the private sector toward a consistent national vision. A great economic transformation must be orchestrated by the state because the market cannot initiate such a transformation.

(iii) *Retaining sufficient policy instruments for latecomer industrialization*—although globalization is willingly accepted, this does not mean that all industrial policy instruments must be instantly given up and replaced by market pressure. This simply means that the policy toolbox for the 21st century is different from those of Japan, Taiwan or Korea in the past. It also implies that enlargement of the market sphere must be in proper steps to ensure the availability of necessary policy instruments, and that international pressure to open up must be consistent in scope and speed with the development strategy of the latecomer country.

(iv) *Dynamic capacity development*—improving policy capability and private dynamism, both of which are often weak in early stages of development, must be the central focus of industrial policy formulation. Policy must identify concrete goals and aim at enhancing existing or potential strengths of the country rather than improving governance or capacity generally without specific goals. The policy scope and policy measures should be gradually expanded in accordance with the enhancement of policy capability and private dynamism (Ohno and Ohno, 2009).

(v) *Internalizing skills and technology*—the principal method of attaining industrialization must be internalization of skills and technology embodied in the human capital of domestic citizens. This must constitute by far the most important part of industrial policy goals and measures. Resource extraction, FDI, ODA and geographic advantages are also important, but they must be given secondary positions in support of skill and technology development.

(vi) *Effective public private partnership (PPP)*—when a strong state guides the private sector, there is a risk of market distortion and suppressed entrepreneurship which leads to economic stagnation. To avoid this risk, effective cooperation between the government and the private sector *in substance* based on mutual trust and active engagement must be built. Holding symposiums and receiving comments are not enough. Only when this cooperation is firmly in place, the state can understand the (often diverse) intentions of private firms, and visions and strategies initiated by the state will be strongly supported by the private sector.

(vii) *Deep knowledge of the industry*—to avoid policy misjudgment and political capture, another requirement is that the government accumulate sufficient knowledge of the industries in which it intends to intervene. Leaders and practitioners of the government must go extra miles to acquire latest practical knowledge to make intelligent and well-informed decisions. Knowledge can initially be outsourced from private experts, academicians or donors, but unless it is digested by policy makers themselves the quality of industrial policy cannot be assured.

Proactive industry policy aims to strike a delicate and ever-changing balance between state guidance and market orientation, between commitment to globalization and the retaining of sufficient policy tools, and between strong leadership and the need to listen to private firms carefully. Some may consider this to be confusing and contradictory, but one needs complex policy formulation to deal with complex reality. This policy is far more difficult to implement than simply letting the market loose or planning everything by the state machinery. It is also different from big-push, infant industry protection or even FDI-led industrialization of ASEAN4 (which was accompanied by a relatively slow reduction of protection).

But proactive industrial policy is not a theoretical imagination. As a matter of fact, East Asia abounds in concrete cases of proactive industrial policy—in Singapore, Malaysia and Thailand as well as in the long-established industrial support menu of Japanese ODA.

2. Entering a new era

The Vietnamese economy has grown rapidly with the average growth rate of 7.4% in 1991-2009. In 1990, Vietnam was among the world's poorest countries with GDP per capita of $98 (ADB data). In 2009, with the GDP per capita of $1,109, Vietnam has already attained the status of a lower middle income country by the World Bank classification method[1]. The growth has been broad-based and touches virtually everyone's life and generates profound social changes in the entire country. This is quite different from the experiences in Latin America or Sub-Saharan Africa where growth occurs in limited sectors and benefits only few people while poor farmers see little improvement in their lives. However, Vietnam's achievements up to now have been driven mainly by one-time liberalization effects and external forces associated with global integration rather than internal strengths. Despite impressive growth records and reform efforts in the last one-and-half decades, local firms remain generally uncompetitive, and policies and institutions remain very weak by East Asian standards.

From the mid 1980s to the mid 1990s, growth was stimulated by the incentive and re-allocation effects of internal economic liberalization (*doi moi*). Subsequently, from the mid 1990s to present, growth has been supported by new trade opportunities as well as large inflows of foreign funds. Industrial activities—especially manufactured exports—continue to be dominated by foreign firms,

[1] The World Bank revises country classification annually. Based on the World Bank's 2008 GNI per capita data, the current classification is as follows: low income countries ($975 or less); lower middle income countries ($976-$3,855), upper middle income countries ($3,856-$11,905); and high income countries ($11,906 or more). Separately, the World Bank defines IDA-only countries to be those with per capita income of less than $1,135 (using 2008 data) and lacking the financial ability to borrow from IBRD. IDA loans are deeply concessional but IBRD loans are non-concessional. Due to inflation and overvaluation, Vietnam is likely to become a "middle income country" sooner than expected, in 2008.

and value creation by local firms and workers has been limited. Now that Vietnam is nearing the final stages of systemic transition and global integration, productivity breakthrough is needed to climb further. Future growth must be fueled by skill and technology rather than a mere injection of purchasing power.

Growth statistics presented in Table 1 are consistent with this interpretation. Until the mid 1990s, the incremental capital-output ratio (ICOR) was low and the contribution of total factor productivity (TFP) to growth was high, which indicates that growth was achieved through improved efficiency—albeit from a very low level of planning years—without much investment[2]. In the latter period, ICOR rose, TFP's contribution to growth declined, and capital's contribution increased significantly. That is an indication of investment-driven growth with low efficiency in capital use.

Table 1. Vietnam: Summary of Growth Performance

	Population (million)	GDP (USD billion)	GDP per capita (USD)	Economic size relative to ASEAN4	Real GDP growth (%)	Growth accounting (%)			ICOR
						Capital	Labor	TFP	
1990	66.0	6.5	98	2.2%	5.1	6.6	43.9	49.5	3.31
1991	67.2	7.6	114	2.4%	5.8	8.4	16.9	74.7	2.92
1992	68.5	9.9	144	2.7%	8.7	13.0	14.5	72.5	2.23
1993	69.6	13.2	189	3.3%	8.1	41.5	21.6	36.9	3.25
1994	70.8	16.3	230	3.5%	8.8	39.0	18.5	42.5	3.14
1995	72.0	20.7	288	3.9%	9.5	39.9	16.2	43.9	3.12
1996	73.2	24.7	337	4.2%	9.3	36.4	1.5	62.1	3.34
1997	74.3	26.8	361	4.9%	8.2	54.9	16.0	29.1	3.80
1998	75.5	27.2	361	7.9%	5.8	64.1	18.6	17.3	5.59
1999	76.6	28.7	374	6.9%	4.8	62.2	17.4	20.4	6.59
2000	77.6	31.2	402	6.8%	6.8	47.4	13.8	38.8	4.80
2001	78.7	32.7	415	7.4%	6.9	59.9	20.6	19.4	4.89
2002	79.7	35.1	440	7.0%	7.1	44.2	27.7	28.2	5.01
2003	80.9	39.6	489	7.0%	7.3	72.1	43.7	-15.8	5.09
2004	82.0	45.4	554	7.2%	7.8	61.5	21.9	16.6	4.91
2005	83.1	52.9	637	7.6%	8.4	59.8	16.4	23.8	4.68
2006	84.2	60.9	723	7.2%	8.2	57.1	14.3	28.6	4.88
2007	85.2	71.1	835	7.4%	8.4	59.5	14.8	25.7	4.90
2008	85.3	89.1	1,047	7.7%	6.2	…	…	…	6.60
2009	85.7	95.4	1,109	…	5.2	…	…	…	8.00

Sources: General Statistical Office (GSO); Asian Development Bank *Key Indicators* (2008); For growth accounting, Tran Tho Dat, Nguyen Quang Thang and Chu Quang Khoi, "Sources of Vietnam's Economic Growth 1986-2004," mimeo, National Economics University (2005) for 1990-2004 and unofficial calculation by GSO's SNA Department for 2005-2007. Continuity between the two is not guaranteed.

[2] ICOR is computed as investment ratio (I/Y) divided by real growth (ΔY/Y). The higher the ICOR, the more capital formation is required for growth (i.e., investment is inefficient). TFP is a broad definition of productivity calculated as residual growth after the increases in factor inputs such as labor and capital are accounted for.

The “Washington Consensus” policy package prescribed by the World Bank and the International Monetary Fund such as liberalization, privatization, legal reforms, macroeconomic stability, and so on, may achieve middle income if they are properly executed, but that is not enough for continued growth to higher income. Vietnam’s growth pattern basically follows the past experiences of East Asian neighbors whose features include openness and regional integration as an initiator of growth; deepening intra-regional trade and FDI; high savings and investment; dynamic transformation of industrial structure; urbanization and rural-urban migration; and growth-generated problems such as income and wealth gaps, congestion, pollution, financial bubbles, and so on. At the same time, a number of new elements for Vietnam, such as faster integration than ASEAN4, must also be acknowledged.

Within this dynamic East Asian context, Vietnam must successfully conduct three crucial policies to sustain growth, namely: (i) generation of internal value; (ii) coping with new social problems caused by rapid growth; and (iii) effective macroeconomic management under financial integration. The first promotes drivers of growth while the second and the third prepare political stability and social support without which industrialization and modernization cannot be sustained. Around 2008, the risks of social problems such as traffic congestion and environmental destruction as well as macroeconomic imbalance such as asset bubbles and price instability became evident in Vietnam. Management of industrialization in this broad sense must be installed to face new challenges, or the entire process of industrialization may stall (Murakami 1992, 1994). While all three tasks are important, the present analysis focuses on the first issue of internal value creation while leaving the discussion of the remaining two to other occasions.

3. Divergent performance within East Asia

A low income country which has gone through a war, political turmoil, socialist planning, or severe economic mismanagement is usually characterized by a fragile economic structure. It relies heavily on extractive resources, monoculture export, subsistence agriculture, or foreign aid. Internal value created by traditional industries such as mining and agriculture is small, but the absence of vibrant manufacturing activities makes them loom large in production and trade shares. This is stage zero on a long road to industrialization.

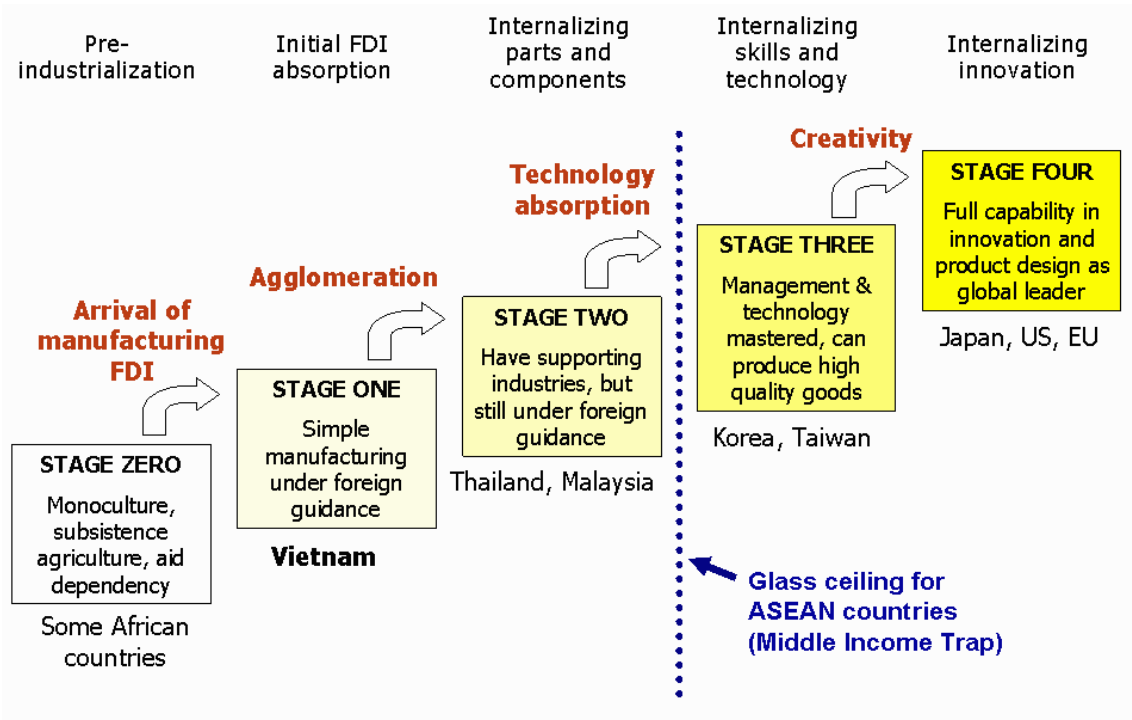
From the East Asian perspective, economic take-off starts with the arrival of a sufficient mass of manufacturing FDI firms that perform simple assembly or processing of light industry products for export such as garment, footwear, and foodstuff. Electronic devices and components may also be produced this way. In this early stage (stage one), design, technology, production and marketing are all directed by foreigners, key materials and parts are imported, and the country contributes only unskilled labor and industrial land. While this generates jobs and income for the poor, internal value remains small and value created by foreigners dominates. Vietnam’s industrialization up to now is basically characterized by this situation.

In the second stage, as FDI accumulates and production expands, the domestic supply of parts and components begins to increase. This is realized partly by the inflow of FDI suppliers and partly by the emergence of local suppliers. As this occurs, assembly firms become more competitive and a virtuous circle between assemblers and suppliers sets in. The industry grows quantitatively through the internal supply of physical inputs. Internal value creation rises moderately, but production basically remains under foreign management and guidance. Obviously, local wage and income cannot rise very much if all important tasks continue to be performed by foreign hands. Thailand and Malaysia have already reached this stage.

The next challenge is to internalize skill and knowledge by accumulating industrial human capital. Locals must replace foreigners in all areas of production including management, technology, design, factory operation, logistics, quality control, and marketing. As foreign dependence is reduced, internal value rises dramatically. The country emerges as a dynamic exporter of high-quality manufactured products challenging more advanced competitors and re-shaping the global industrial landscape. Korea and Taiwan are such producers.

In the final stage, the country acquires the capability to create new products and lead global market trends. Japan, the United States, and some members of the European Union are such industrial innovators.

Figure 1. Stages of Catching-up Industrialization



However, progress is not guaranteed for all. A large number of countries that receive too little manufacturing FDI stay at stage zero[3]. Even after reaching the first stage, climbing up the ladders becomes increasingly difficult. Another group of countries are stuck in the second stage because they fail to upgrade human capital. It is noteworthy that none of the ASEAN countries, including Thailand and Malaysia, has succeeded in breaking through the invisible "glass ceiling" in

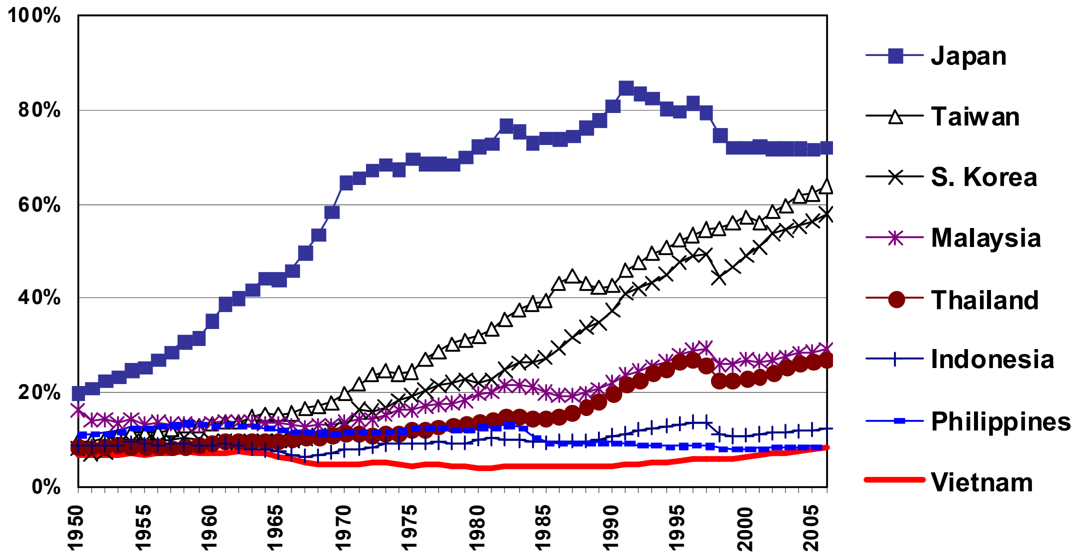
3 Low-income countries may receive FDI in mining, telecom, power, tourism, or property development. While such projects based on locational advantages are lucrative for investors and can generate jobs for the poor and provide basic infrastructure for the nation, these alone cannot put the country on a dynamic path of structural transformation as manufacturing does.

manufacturing between the second and the third stage[4]. A majority of Latin American countries remain middle income even though they had achieved relatively high income as early as in the 19th century. This phenomenon can be collectively called the *middle income trap*.

East Asian growth performance has differed significantly in depth and speed even among countries that are considered "successful." There should be a clear distinction among Taiwan and South Korea (high achievers), Malaysia and Thailand (middle achievers), and Indonesia and the Philippines (low achievers). The first group is far ahead of the second or the third in terms of income and industrial capability.

Figure 2. Different Speed of Catching Up

(Percent of US real income)



Sources: Angus Maddison, *The World Economy: A Millennium Perspective*, OECD Development Centre, 2001; the Central Bank of the Republic of China; and IMF *International Financial Statistics* (for updating 1998-2006).

Note: Per capita real income relative to the United States as measured by the 1990 international Geary-Khamis dollars.

Figure 2 shows per capita real income of selected East Asian economies relative to the United States level. Until the mid 1960s, these economies (except Japan) showed no clear sign of catching up. However, Taiwan and Korea, which started from equally low levels, took off in the late 1960s and have improved income dramatically. In comparison, the catching up of Malaysia and Thailand looks less impressive, and Indonesia and the Philippines failed to improve their positions vis-à-vis the United States. In addition, there are economies which are not even on our radar screen—those that

[4] Within ASEAN, the two small nations of Singapore and Brunei have achieved high income through non-manufacturing industries (high-value services and oil and gas, respectively) and are therefore beyond the scope of our analysis. Figure 1 illustrates manufacturing, especially assembly-type manufacturing such as electronics, automobiles, motorcycles, industrial machinery and precision equipment which has played a key role in East Asia's growth dynamism.

continue to struggle at the bottom of income ladders such as Cambodia, Laos, Myanmar, East Timor, Myanmar, and North Korea. Divergent performance comes from different speed of catching up rather than delayed starts (except Vietnam where wars and socialist planning prevented economic take-off until the early 1990s). ASEAN4 are taking much longer to reach the industrial capability that Taiwan and Korea had achieved in the 1980s and 90s.

Starting from a very low level, Vietnam is currently in the first stage of industrialization trying to reach the second in Figure 1. Large FDI inflows, a necessary condition for this transition, are already happening. Neighboring ASEAN countries even fret about losing FDI to Vietnam. While Vietnam's short-term goal is the attainment of physical expansion of the industrial base, it should also simultaneously prepare to avoid the middle income trap in the next stage. For this, front-loaded and well-targeted policy action for upgrading industrial human resources is the key.

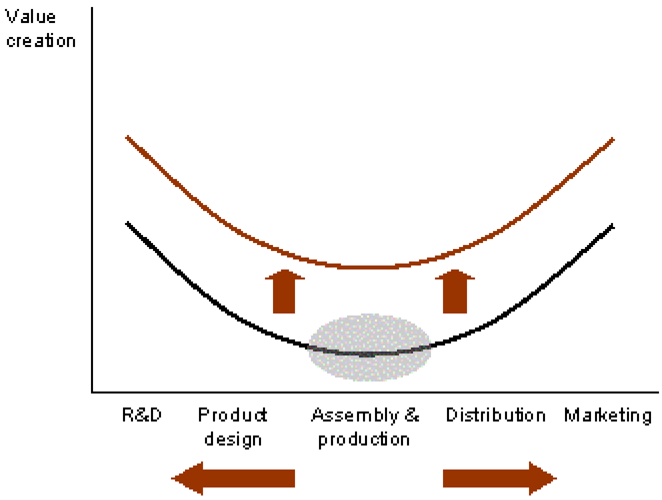
4. Some related arguments

The fact that developing countries must acquire skill and technology, rather than just offering factory space and cheap labor, can be stated in various ways. Four such arguments are presented below.

First, at the general level, it can be argued that the only way for a country to remain competitive is to improve labor productivity faster than wage increase. Competitiveness depends on the difference between the two, not on the absolute wage level. Wage increase should be a boon to workers, and there is no reason to fear it as long as productivity is improving in tandem. In the context of Vietnam, this point has consistently been made by Professor Tran Van Tho of Waseda University since the mid 1990s. Under wage pressure, Malaysia and China have already stopped inviting labor-intensive FDI projects and turned to more "high-tech" investors. Vietnam is also experiencing rising wages as a result of large concentration of labor-intensive FDI in some areas such as northern Dong Nai as well as an inevitable response to the 2007-08 inflation. If wages begin to rise rapidly now, Vietnam may not have enough lead-time to improve productivity.

Second, the concept of *manufacturing plus plus*, which governed Malaysia's Second Industrial Master Plan (IMP2) 1996-2005, is instructive because it concisely states what middle income countries should do to climb up to stage 3. Manufacturing plus plus expresses the two dimensional desire for domestic industries to (i) expand along the value chain to encompass higher value-added activities; and (ii) uplift the whole value chain by raising productivity (Figure 3). Since Malaysia started industrialization as a conventional assembler, which was the lowest point in the value chain, it wanted to master R&D, design, product development, distribution, marketing, and so on horizontally, and improve the skills of all these activities vertically. In principle, this is what Vietnam—and all other latecomers—should do. IMP2 selected eight industrial clusters to be thus strengthened: electronics and electricals, textiles and apparel, chemicals, resource-based industries, food processing, transportation equipment, materials, and machinery. However, Malaysia did not succeed greatly in achieving this goal during the implementation period of IMP2 (Ohno 2006).

Figure 3. The Manufacturing ++ Strategy of Malaysia



Source: Economic Planning Unit of the Prime Minister's Department, Malaysia (re-drafted by author).

Third, the Japanese concept of *monozukuri*, which literally means "making things," may give some hints on the direction to go. Monozukuri is manufacturing for the primary purpose of achieving customer satisfaction through high quality in the spirit of a proud and dedicated artisan, rather than just making profits. To achieve this, long-term relationship and internal accumulation of skill and knowledge are institutionalized within each company as well as among partner companies (between assemblers and suppliers, for example). Practical means of productivity improvement such as 5S, QCD[5], *kaizen*, *shindan,* just-in-time method, and quality control circles have been established and available to companies in the developing world through experienced instructors and manuals. In the policy realm, the concept of monozukuri is often highlighted by the Japanese government for the purpose of upgrading domestic manufacturing capability and spreading the Japanese business model abroad (Tsai 2006).

Fourth, the theory of business architecture advanced by Takahiro Fujimoto and his research team at the University of Tokyo elaborates how firms in developing countries can form strategic alliance with Japanese manufacturing firms (Fujimoto 2004, 2006; Fujimoto and Shintaku, 2005). According to this theory, business models can be divided into two broad categories: *modular* and *integral*. Modular manufacturing is characterized by easy assembly of globally common parts and components (for example, a desktop computer) while integral manufacturing features unique design of parts and components for each model based on long-term collaboration among assemblers and suppliers (for example, a passenger car). The former is suitable for realizing quick profits under flexible combination of outsourced business components while the latter permits a continuous

[5] The 5S is the most elementary yet important way to improve production efficiency by keeping the factory tidy and well organized. Its elements are *seiri, seiton, seiso, seiketsu,* and *shitsuke,* which roughly mean remove unnecessary things, arrange tools and parts for easy view, keep the work place clean, maintain personal hygiene, and behave with discipline. Meanwhile, QCD means Quality, Cost and Delivery (zero defects, cost reduction, and on-time delivery without failure). Japanese manufacturing firms recognize them as the general source of competitiveness as well as the criteria for selecting business partners and subcontractors.

pursuit of high quality over time. Fujimoto argues that the United States and China are appropriate production partners because they both practice modular manufacturing. Meanwhile, Japan is an integral producer without an effective international partner. For developing countries, integral manufacturing is harder to learn but eventually more rewarding as production technology is internalized rather than outsourced. While none of the ASEAN countries has acquired sufficient skill and technology for integral manufacturing, Fujimoto regards Thailand and Vietnam as likely candidates for Japan's future monozukuri partner provided that they level up their internal capability (Fujimoto and Ohno, 2006).

While the Malaysian experience or the Japanese business theory may not fit every country, they point clearly to the importance of internal value creation through skill and technology and the existence of concrete strategies and methods to attain it.

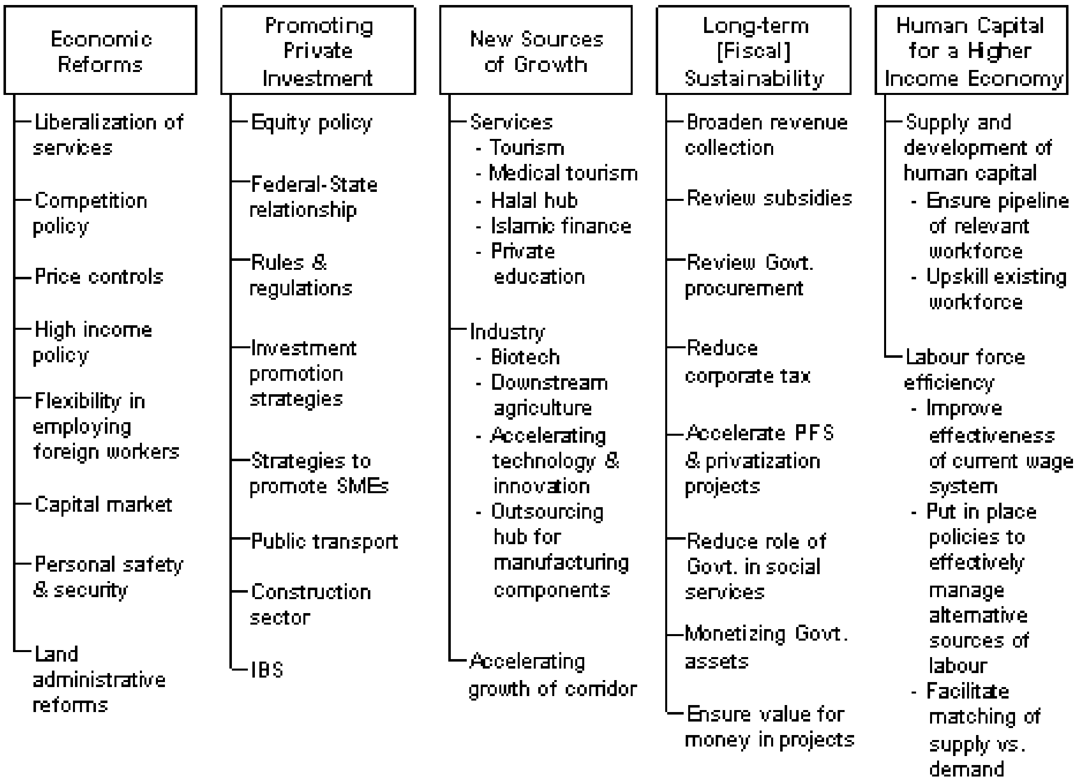
5. Middle income traps of Malaysia and Thailand

The middle income trap is a future possibility for Vietnam, but it is already reality in some countries. In the ASEAN region, Malaysia, with the per capita GDP of $7,750 (preliminary national data for 2009), and Thailand, with the per capita GDP of $3,973 (IMF estimate for 2009), may be its victims. In particular, Malaysian Prime Minister Najib Tun Razak, who assumed power in April 2009, regards the overcoming of the middle income trap, pointed out by a World Bank report, as the most important economic goal of his government. The World Bank (2009) says:

> The overriding medium-term challenge is for the Malaysian economy to join the select group of high-income countries. Malaysia has experienced solid growth over the last decades, but has relied on an economic model predominantly based on capital accumulation… In spite of these past successes, Malaysia's growth performance has lagged behind that of other regional economies. The economy seems to be caught in a middle-income trap—unable to remain competitive as a high-volume, low-cost producer, yet unable to move up the value chain and achieve rapid growth by breaking into fast growing markets for knowledge- and innovation-based products and services. (World Bank, 2009, pp.52-53)

To attain his goal, Mr. Najib wants to mobilize available policies and resources to (i) further liberalize the economy, (ii) promote private investment, (iii) generate new value-creating sectors, (iv) reform budget, and (v) develop human resources as the five pillars of his New Economic Model (Figure 4). While Bumiputra policy (giving favors to ethnic Malays over economically powerful ethnic Chinese or Indians) initiated in 1971 will not be dismantled any time soon, emphasis is shifting from administrative quotas to equal opportunities among all ethnicities.

Figure 4. New Economic Model of Malaysia



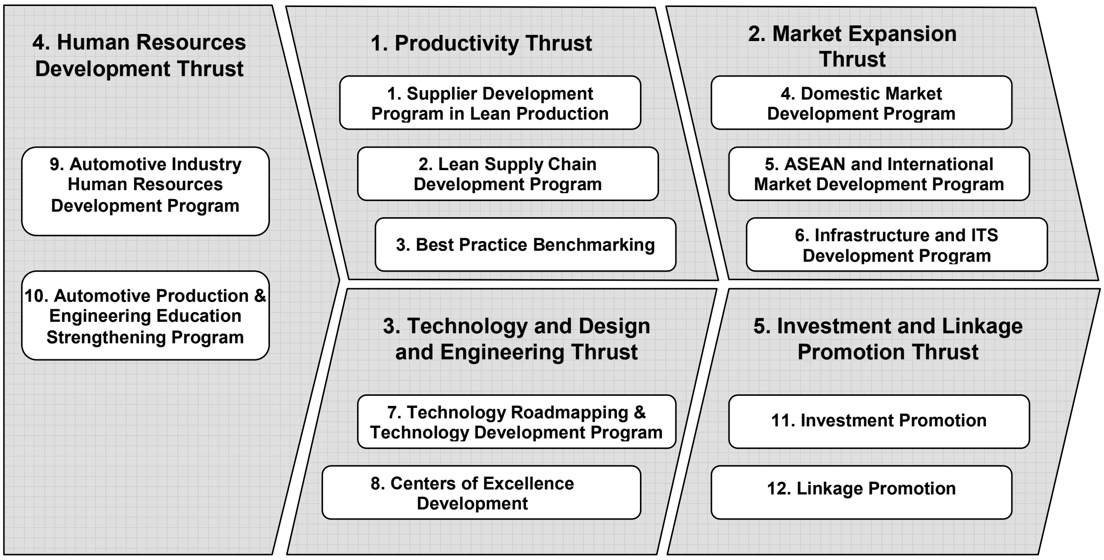
Source: Economic Planning Unit of the Prime Minister's Department, Malaysia (January 2010).

In fostering innovation, Malaysia places high hope and expectation on the strong emergence of innovative high-tech SMEs independent of MNCs. For this reason, SME promotion has been upgraded to become the core of industrial policy formulation in recent years, and responsible organizations have been restructured and integrated for efficient coordination. SME sectors expected to emerge are not only manufacturing but also high-value tourism, medical services, finance, education, biotech, logistics and distribution, and so on. At the same time, policy interest in the traditional strategies of absorbing a large amount of manufacturing FDI to form the nation's industrial base, strengthening supporting industries and forging linkages between local and FDI firms seems to be waning. Although the electronics and automotive sectors remain the largest industrial activities in Malaysia, they are no longer the frontline concern of the Malaysian government.

By contrast, Thailand is trying to climb the industrial ladder by staying on the old path. It still welcomes manufacturing FDI, promotes die and mould technology, and tries to strengthen the capabilities and linkages of local component manufacturers. The continued upgrading of the automotive cluster, which is the largest in ASEAN, remains the principal pillar of Thai industrial policy (Figure 5). One of the projects to support this effort is the Automotive Human Resource Development Project currently in progress with comprehensive assistance from four big Japanese automotive companies. Another policy direction is the development of Eco-Cars. At the same time, Thailand also encourages new areas such as medical and high-value tourism, biotech and ITC.

Building on past achievements, Thailand adopts the two-pronged approach of developing the old industrial base and seeking new sources of growth simultaneously.

Figure 5. Five Strategies and Twelve Action Plans for the Thai Automotive Sector



Source: Thailand Automotive Institute, *The Automotive Industry Master Plan 2007-2011 Executive Summary*, p.4.

Another salient difference between the two countries can be seen in the basic thrust of industrial policy. Thailand fully embraces markets and globalization, tries to build an open and liberal business environment, and do not have a strong desire to create national brands. In contrast, Malaysia often utilizes directives and administrative measures to guide the private or foreign sector toward certain directions, which includes creation and promotion of national brand cars. Malaysia's revised National Automotive Policy of October 2009 restricts entry and tries to merge vendors for scale economy, collects special auto registration fees to support ethnic Malay firms, and protects Proton's brand name and its domestic market share in seeking an international strategic partner. Whether such a forceful approach is effective and consistent with accelerating integration is an open question.

Malaysia is betting on leapfrogging while Thailand is staying on the old incremental path. Both hope to escape from the middle income trap but the way each has chosen to attain this goal is quite different. Between these two strategies, Vietnam should opt for the Thai model at least in the near future. Vietnam has received a large volume of manufacturing FDI which can serve as a potential base for further industrialization. Vietnam has not even started to seriously build supporting industries or industrial linkages, and such a strategy should not be abandoned without even trying. Creation of innovative and independent SMEs is a difficult task even for Malaysia at the upper middle income. Vietnam at the early stage of industrialization should not adopt it as the main industrial strategy.

6. Policy vision and orientation

In high performing economies in East Asia, industrial policy has usually taken a goal-targeting form. The top government leader launches a long-term national vision which shows a general direction without specifying details. To realize this, appropriate government organizations are designated or newly created to draft feasible strategies and execute concrete action plans. Action plans may take the form of readable documents and matrices or may remain a process without such documentation. Strategies and action plans may be revised as circumstances change, but the long-term vision remains intact.

Japan in the 1960s had the goal of doubling income within the decade as well as competing effectively with Western multinationals as trade barriers were lifted. The Ministry of International Trade and Industry (MITI) together with the Japan Development Bank coordinated and assisted private efforts in improving productivity. In Malaysia, *Vision 2020*, an aspiration to become a "fully developed country" by 2020 set by former Prime Minister Dr. Mahathir in 1991, remains the overarching goal. The Economic Planning Unit (EPU) of the Department of the Prime Minister directs national effort to concretize this vision under a system of overlapping policy documents and cascading organizations[6]. Thailand under Prime Minister Thaksin Shinawatra (2001-2006) put up industrial visions which were both ambitious and ambiguous, such as becoming the "Detroit of Asia," the "Hub of Tropical Fashion," or the "Kitchen of the World," while leaving the details to be worked out among relevant ministries, private businesses, and experts. For execution, industry-specific committees and industry-specific institutes were established, and the private sector additionally had direct access to the prime minister when necessary (Ohno 2006).

This policy formulation method, which has been the hallmark of successful East Asian development policies, can be summarized as working backwards from broad goals to phased strategies and concrete action plans, while making necessary adjustments and accumulating experience and confidence along the way. This pragmatism, which we prefer to call *Dynamic Capacity Development*, allows the gradual building of policy capability as concrete problems and challenges are encountered over time.

At the beginning of industrialization, most East Asian countries had weak governments. In 1960, the Korean civil service was widely viewed as a corrupt and inept institution (World Bank 1993). Similarly, in 1959, Thailand was given a low mark for the absence of investment planning and an acute shortage of qualified personnel (World Bank 1959). But through trials and errors and learning by doing, their administrative capacity has greatly improved. This hands-on approach is in sharp contrast to the current global aid practice, such as the Good Governance drive and the Doing Business index of the World Bank[7], where all countries are urged to correct their weaknesses *ex ante* relative to some international norm without reference to any concrete national goal and before

[6] Dr. Mahathir advanced nine general challenges without further elaboration: national unity, confidence, democracy, moral and ethics, tolerance, science and technology, caring culture, economic justice, and prosperity. To achieve this, Malaysia drafts multiple layers of policy documents such as industrial master plans (Ministry of International Trade and Industry), Outline Perspective Plans (EPU), and Malaysia Plans (i.e., five-year plans, EPU). Under MITI, special agencies such as MIDA (FDI policy), SME Corp (SME promotion), MATRADE (trade), MPC (productivity) and SME Bank (finance) have been established.

[7] Good Governance is measured by the World Bank's Worldwide Governance Indicators (WGI) consisting of six dimensions: voice and accountability, political stability, government effectiveness, regulatory quality, rule of law, and control of corruption. Each country is evaluated and ranked annually according to these criteria. The Doing Business index is a quantitative measure of how easy it is to start and conduct business in each country. It covers regulations on construction permits, employment, property registration, credit, investor protection, taxes, export and import, contract enforcement and business closure.

formulating a specific growth strategy.

From this perspective, Vietnam's industrial vision leaves much to be desired. Vietnam already has a long-term vision of attaining *industrialization and modernization* by 2020. The ambiguity of this vision does not worry us too much as with the case of Dr. Mahathir's 2020 vision or Mr. Thaksin's call for becoming the Detroit of Asia. However, the problem with Vietnam is the lack of proper strategies, action plans, and institutions to follow up on this vision. The present administrative system does not permit necessary policies to be drafted and implemented.

It is essential that Vietnam formulate as soon as possible a clear roadmap of industrialization to inform and guide its people, investors, and policy makers. It should outline a strategic path towards the 2020 vision backed by concrete action plans. Vietnam should declare, among other things, its strong resolve and clear plan to secure an important position in the East Asian production network. It should affirm that the private sector, not the state or state-owned conglomerates, should be the agent of production and investment; that growth should be driven by the skill, technology, and hard work of the Vietnamese people; that openness and the market mechanism are defended as a matter of principle; and that the state will actively support and coordinate the private sector without dictating its business plans; Policy orientation in the areas of savings mobilization, financial development, usage of foreign resources, income gaps and other emerging social issues, and sectors under external competitive pressure should be clarified.

At present, Vietnam does not have an overall industrial master plan. The industrial chapters of the Five-year Plan and the Ten-year Strategy do not offer a consistent industrial vision. As a result, many important policy questions remain unanswered, including the future roles of SOEs, private firms, and FDI, respectively; the choice between export orientation and import substitution under deepening integration; and the scope and extent of official support to emerging as well as declining industries. Sectoral master plans for steel, automobiles, motorcycles, electronics, textile and garment, and so on, are being drafted and approved without overarching principles at a higher level. Private investments and official aid pour in without knowing exactly where Vietnam is headed in the coming decades. In this connection, it should be noted that some countries, with much lower income levels than Vietnam, already have industrial visions and action plans which are more consistent and far more detailed than those of Vietnam[8].

Vietnam has not clearly stated whether or how it wants to promote such industries as automobiles, audio-visual devices, home electronics, and general machinery. Under the current situation in which discriminatory measures are no longer permitted under WTO rules, refraining from supporting such industries and letting the market decide their fate is one option. But if the Vietnamese government

8 Ethiopia, one of the poorest countries with the per capita income of $160 in 2007, established the vision of *Agriculture Development Led Industrialization* (ADLI) in 1991. Its contents are further specified in the Ethiopian Industrial Development Strategy (2003) and other sectoral strategies. This industrial strategy asserts the leading role of the private sector, agricultural development as the source of industrialization, export-orientation, importance of labor-intensive sectors, the need for strong state guidance, and so on. Prioritized sectors are meat, leather and leather goods; textile and garment; agro processing; construction; and micro and small enterprises. The master plans for leather products and textile and garment have been drafted and are being implemented with the help of UNIDO, GTZ, USAID, and other donors. The monthly Export Steering Committee reviews the performance of key industries, and the Ministry of Trade and Industry regularly talks with firms, industrial associations, and national and regional chambers of commerce. Involvement of the private sector is further activated by the enhanced Public-Private Forum.

wants to promote them, it must do some serious thinking to see what realistic goals are and what strategies and action plans can be adopted without violating international commitments.

7. Policy making procedure and organization

Vietnam's failure to produce effective industrial strategies and action plans comes mainly from the structural weaknesses in policy making. Vietnam's policy formulation is saddled with the legacies of planning days and cannot cope effectively with problems in the age of global competition. After the growth bout of the 1990s and the early 2000s driven by economic liberalization and large capital inflows, Vietnam has reached the point where further progress towards higher income is increasingly difficult without a radical reform in policy formulation procedure and organization.

The problems associated with Vietnam's industrial policy making are many. However, instead of presenting a long list of problems, we will highlight just two procedural problems and two organizational problems which are inter-related and constitute the main sources of formalism and the general lack of creativity and responsiveness in policy making. These problems are unique to Vietnam in the sense that they are not observable in East Asia's other high performing economies[9].

The most serious procedural problems in designing and executing industrial strategies and action plans are the *lack of involvement of the business community* and the *lack of inter-ministerial coordination*, which together render approved policies ineffective and even unimplementable. In any developing country, policy implementation is a big challenge due to shortages of budget, human resources and proper mechanisms. However, the proportion of unimplemented policies in Vietnam is exceptionally high not only in industrial matters but also in other policy areas. It can even be said that very few policies are actually implemented as stipulated in Vietnam because of delays in preparing "implementation details;" the non-provision of necessary budget, personnel or equipment; the lack of support from the business community; and the lack of ability or interest among responsible ministries to solve these problems[10].

The policy making process in Vietnam is closed within the government with little involvement of other stakeholders. Within each ministry, an order to draft a master plan is handed down to a drafting team, which normally consists of a middle-ranking official supported by a few experts in the ministry. The team collects internal data and data from other ministries, and may commission additional analyses to experts in other ministries or research institutes. The budget for each master plan is fixed by an inter-ministerial circular and used mainly for securing external data and analyses as well as conducting domestic travel, interviews and hearings. The master plan is drafted internally by the team members and submitted to the minister or the vice minister in charge for internal review. After that, it is circulated among relevant ministries for comment (which is rarely substantive) and then submitted to the prime minister for final approval. Significant delay may occur at internal review or final approval. Requests for revision are also common. In this process, debates on the

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[9] In 2005 and 2006, the Vietnam Development Forum (VDF) and Vietnam's Ministry of Industry (MOI) organized joint research missions to Thailand, Malaysia and Japan to study the design, implementation and monitoring of industrial policies of respective countries. In 2009 and 2010, additional VDF missions were sent to Malaysia and Thailand to update information. For missions' findings, see Ohno (2006) and VDF (2010).

[10] In response to the protestation by FDI firms about certain parts of an industrial master plan, an official who drafted it reassured them that there was no need to worry because master plans in Vietnam were not implemented.

fundamental direction or crucial issues rarely take place. The drafting team is routinely overworked with a large number of master plans to finish each year, which does not allow sufficient time (or money) to think creatively, interact with non-government stakeholders, or publicize the final result. Approved master plans are neither translated into English nor uploaded for dissemination although summary versions for the prime minister's approval, in the Vietnamese original, are usually available on the web.

If a domestic or foreign firm wants to raise its voice, it must devise its own way since the current procedure does not allow meaningful involvement of the business community. Although enterprise hearings are becoming more popular in recent years, sufficient details of the master plan draft are not revealed at such hearings and enterprises therefore can only make general requests. If a firm later finds certain points in the master plan objectionable (for example, demand forecasts, taxes and import duties, numerical targets for production or export, designation of producers for certain products, and so on), it needs to seek meetings with responsible ministries, use symposiums and media to make the point, or write a letter to the prime minister, to request a change in the already approved policy. This situation is in sharp contrast to Malaysia, where private sector participation is institutionalized as members of the steering committee and task forces in drafting the Industrial Master Plan; Thailand, where the private sector decides targets and action plans and the government merely accepts them; or Japan, where business decisions on technology, products, investment and so on are left to individual firms and the government provides only supplementary services such as trade negotiation and setting standards for quality, safety, environment, and industrial property (Ohno, 2006).

Another procedural problem is the absence of inter-ministerial coordination on policy substance as well as implementation details, which in turn comes from the lack of mechanism to force different ministries to work together. Compartmentalization of the government along ministerial lines is a common problem around the world, but most governments manage to somehow ameliorate it. One solution is to have a strong top leader with a good economic mindset who directs various ministries and becomes the hub of policy making himself. In this case, policy components become mutually consistent even though ministries still fail to talk to each other (Thailand under Thaksin Shinawatra, 2001-06; Ethiopia under Meles Zenawi, 1991-present). Another way is to establish a powerful technocrat team directly serving the president or the prime minister which makes key policy decisions while ministries become executing agents of the plans emanating from this team (South Korea's Economic Planning Board, 1961-1994; also see below). Still another way is to let a super ministry, with sufficient policy authority and instruments at its disposal, lead industrial policy making and be responsible for it (Japan's Ministry of International Trade and Industry in the 1960s). Finally, it is also possible to install a mechanism to guarantee the representation of all relevant ministries and non-government stakeholders in the official drafting process as well as in informal exchange (Malaysia's drafting of the Industrial Master Plan at present). In Vietnam, though all policy documents specify a leading ministry and a list of related ministries, the mechanism to make them work as one is entirely missing.

We can go deeper to see why it is difficult to ensure involvement of non-government stakeholders and inter-ministerial coordination. Behind these problems lie fundamental issues in policy making organization. The most serious ones in this regard are the *lack of clear directives from the top* and the *distorted incentive mechanism among government officials that causes brain drain*.

It is well known that Vietnam's decision making is based on consensus. Checks and balances are in place horizontally (across ministries and departments), vertically (between central and local levels) and geographically (North, South, Middle and remote areas). There are three top national leaders and the Party and the Government interact in a complex manner. This system can produce stability and continuity but it is not suitable for staging bold reforms or responding quickly to the changing world. Policies remain mostly reactive rather than proactive. Development effort centered on a clear roadmap towards a national vision with concrete strategies and action plans, which is the hallmark of East Asian industrialization, is missing in the Vietnamese policy process.

The Vietnamese government copes with urgent issues—be it inflation, global financial crisis or traffic jam—in a bottom-up fashion and without a clear focal point of leadership or responsibility. When a serious problem is identified, an inter-ministerial committee is called and its chair is appointed. Each ministry proposes solutions from its perspective, which are summarized into general policy recommendations without execution details. Bureaucracy can supply broad ideas touching every aspect of the problem, but it does not lead to prioritization or selectivity for real action. This approach must be supplemented by a person or an organization that decides on a short list of actions and sequencing of measures among many proposals. There should be an interaction between the high level and the implementing level of the government to produce policies which are both realistic and sharply focused.

Another problem which is common in many countries and also becoming highly visible in Vietnam is the decline of quality and morale among government officials, prompting an exodus of talented people to other sectors. Vietnam's public service must overcome the problems of overstaffing, low salary, prevalence of second jobs, formalism, rigidity, nepotism, corruption, relation-based promotion, and ODA-related benefits (foreign travel, training, benefits associated with supervising aid projects, etc). These were the legacies of the subsidy system existing up to the 1980s, where the public sector was the provider of jobs, minimum income and social security for all and where no alternative employment opportunities were available in the private or foreign sectors with far more attractive salaries and rewarding duties. Under the present circumstance of market orientation and global integration, the public sector only attracts people who want stability, people who genuinely believe in the importance of public service, or people who want to take advantage of official privileges to study abroad or receive training as a stepping stone to a better-paying job in the future. As a result, highly qualified and motivated people are becoming difficult to recruit or retain.

This problem cannot be solved by minor repairs or ad hoc adjustments. ODA-supported training programs of government officials may only worsen the brain drain without raising the average level of official competency. To reverse the hollowing-out of the Vietnamese government, far reaching reforms to completely remake the public administration is needed as soon as possible. This should encompass, among others, a significant down-sizing of the public sector through leaner organization, forced retirement, and outsourcing of non-essential services; a competitive and transparent recruitment system; a higher and performance-based salary schedule and promotion linked to transparent personnel evaluation; and clear rules regarding the conduct of public servants and their interaction with citizens, businesses, and service providers. Obviously, these are not easy because of the magnitude of required tasks and political resistance. But they are also absolutely necessary for Vietnam to move forward. Vietnam's public administration lags far behind other successful economies in the region such as Singapore, Malaysia, and Thailand. It should also be mentioned that the initiative for such reforms must come from the top rather than the bottom. No bureaucracy can transform itself so radically without the order from a strong leader.

8. How to break a solidified system

To propose a solution is one thing. To carry it out is quite another. Even if Vietnam knows the best policy formulation procedure and organization, how can it make sure that they are actually adopted?

According to comparative institutional analysis, a branch of institutional economics that relies heavily on evolutionary game theory, a society may get stuck in a bad equilibrium owing to *institutional complementarity*, *strategic complementarity* and *path dependence* (Aoki 2001a, 2001b). Institutional complementarity means that any social system has resilience to shocks because its institutional components enhance each other. For example, Vietnam's education, recruitment, salary and promotion systems are mutually complementary to produce relation-based rent sharing. Strategic complementarity means that individuals in such an institutionally solidified society have little incentive to deviate from the dominant behavior. Finally, path dependence underscores the importance of the beginning. Once installed by chance or design, any social system requires a large amount of political and social energy to change it. Together, these concepts point to institutional inertia and difficulty of reforming any established system.

Policy impasse arises when an inefficient method of policy formulation is set up and then solidified, and institutional components and people's attitude to support it have formed. Removing one person or reforming one organization does not improve the situation because of institutional and strategic complementarities mentioned above. Changing the policy formulation method in a fundamental way, as proposed by this paper, will surely require enormous energy and meet fierce resistance.

However, this does not mean that there is no way out. There are times when a social system jumps to another social system. Comparative institutional analysis suggests the following occasions and agents of change.

> (i) *Collective mutation*—a large number of people inside a society may mutate simultaneously, as if their DNA has changed. If only a few people behave differently, they are simply called "crazy" or "silly" and the system remains unchanged. But a sufficiently large mass begin to behave differently, institutional and strategic complementarities of the old type stop working and rules and customs start to change. This is a spontaneous and internally driven change, which may occur when a large number of people feel suppressed or victimized under the existing system. In a rapidly growing economy, this may also happen when a generation with new values and behavioral patterns grow up, or when people begin to have new demands and expectations from the government as a result of successful development and higher income. A small incident may trigger a large social movement by letting accumulated public discontent to come to the open.
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> (ii) *Foreigners*—foreign governments, firms and individuals follow different systems and are not bound by the behavioral code of the domestic society. They bring and sometimes even force new elements, which causes friction and inconsistencies with the indigenous system. In low income countries, bilateral donors and international organizations are particularly powerful. Foreign firms and investors as well as international migration and human exchange may also produce foreign pressure on a society. If this prompts a change

in a direction that generates healthy development, such pressure is highly welcome. However, not all foreign influences are good from the viewpoint of social evolution. For this reason, the government must guide and coordinate foreign pressure to prevent undesirable changes.

(iii) *Policy*—even without domestic or foreign pressure, the government as *Deus ex machina*[11] can start a change from inside the system by introducing policies that upset existing calculations and complementarities. Here the key question is who will activate such policies. As noted before, it is extremely difficult for bureaucrats to initiate a bold reform. Their power within the government is miniscule compared with enormous institutional and strategic complementarities they face. Drastic policy shifts are usually introduced when a new, strong top leader comes to power. Leadership equipped with strong will and economic literacy is crucial for this to succeed. When such leadership skillfully and strategically aligns with foreign partners who want go in the same direction, even a very bold reform becomes possible.

In view of these theoretical implications, let us identify three players that may make institutional reforms possible in the Vietnamese context. They are *leadership*, *the technocrat team*, and *foreign partnership*.

Leadership

Crucial importance of leadership is made sufficiently clear in the discussions above. Leadership is the prime force of change while other necessary conditions can be created or reshaped by the leader if they do not already exist. In countries with advanced political systems, policy initiative can also emerge from various domestic groups such as civil society organizations, intellectuals, interest groups, and political parties because legal mechanisms to capture and reflect their opinions are firmly in place. However, in developing countries where political systems are less well developed, only a small number of channels of effective participation are available. For all practical purposes, initiative for bold change in these circumstances must come from the top leader. When such leadership is combined constructively with the aspiration of domestic groups and foreign pressure, reforms become possible. For the leader to play proper roles in development, it is not always necessary to change the existing political regime or expending social energy to change it. The Vietnamese political regime at present is flexible enough to allow a strong leader with political savvy to emerge and orchestrate policies.

The technocrat team

In high performing economies of East Asia, the existence of a technocrat team directly under the top leader (the president or the prime minister) has played a crucial role. This team is created from the brightest officials from various ministries as well as the smartest returnees who have studied or taught abroad. Prominent business leaders with strong policy mindset may also be mobilized. The team receives full confidence and responsibility from the top leader to concretize the policies that this leader envisions. It also acts as the command post for all ministries which are obliged to implement the policies that this team drafts. It acts as the nation's brain for development without

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[11] *Deus ex machina* is a Latin phrase for "god out of machine" in ancient Greek plays. This god arrives suddenly and out of context on a crane-like machine to give a forceful solution to an entangled situation.

which even excellent leaders cannot function. The Economic Planning Board in South Korea, the Kuomintang technocrats in Taiwan, the Economic Planning Unit (EPU) in Malaysia, the National Economic and Social Development Board (NESDB) in Thailand, the so-called Berkley Mafia in Indonesia, and the National Economic Development Authority (NEDA) in the Philippines, all aimed to fill this need at certain critical points in their economic development with varying degrees of success. Japan's Ministry of International Trade and Industry (MITI), although being one of the ministries rather than above all ministries, also operated effectively to strengthen the competitiveness of Japanese manufacturing industries in the high growth period of the late 1950s and the 1960s.

Vietnam also had the Prime Minister's Research Commission (PMRC) until recently, but it was an advisory group rather than a central policy making body entrusted with the power to lead the entire government. Its responsibility was too weak and its members were experienced but perhaps too old. Nor does Vietnam have a super-ministry such as Japan's MITI to centrally coordinate development effort; the Ministry of Planning and Investment (MPI) is not strong enough in terms of authority, capability and policy instruments to undertake this task. It is strongly suggested that Vietnam create a new dynamic technocrat team within the government as a focal point of policy making authority and responsibility. In its design, experiences of other East Asian countries, with necessary modifications, should be referenced. Vietnam needs such a team at least for the next few decades to climb to higher income and cope with growth-generated problems and instabilities.

Foreign partnership

Vietnam's foreign policy shifted dramatically in the early 1990s when the close ties with the Soviet bloc were replaced by multi-directional diplomatic relations and re-integration into the global economy. Since then, interaction with foreign actors has exerted indirect and subtle influences on Vietnam's development orientation although the Vietnamese government never allows foreigners to take the driver's seat (I. Ohno, 2005). Bilateral and multilateral donors have registered their desire to see faster reforms and more administrative transparency and efficiency on such occasions as the semi-annual consultative group (CG) meetings, comments on the Five-year Plan and the Ten-year Strategies, policy dialogue for the Comprehensive Poverty Reduction and Growth Strategy (CPRGS) and the Poverty Reduction Support Credit (PRSC), and so on. Foreign businesses also have pressed the government to improve the legal and policy framework, the tax and import duty system, and other business-related matters through the Vietnam Business Forum, government-business dialogue, trade fairs, and symposiums. As Vietnam graduates from the status of a low income transition country into the status of an industrializing middle income country, the focus of foreign concern should also shift from the removal of the negatives to the creation of Vietnam's unique strengths.

As the leading economy in East Asia, Japan has also contributed significantly to Vietnam's development through trade, investment, aid, and human and knowledge exchange. Japanese businesses and officials are particularly interested in bolstering Vietnam's industrial competitiveness and have initiated a number of bilateral programs to this end. They include the building of infrastructure especially in power and transportation, education and training of industrial human resources, and a series of action-oriented bilateral policy dialogues (Table 2).

Table 2. Vietnam-Japan Bilateral Policy Dialogue for Industrial Competitiveness

Program	Period	Principal actor(s)	Content
Ishikawa Project (Study on the Economic Development Policy in the Transition toward a Market-oriented Economy in Vietnam)	1995-2001 (3.5 phases)	MPI-JICA	Joint research on macroeconomics, finance, agriculture, industry, integration, currency crisis, SOE reform, private sector development (PSD); based on the principle of country ownership and mutual respect, with emphasis on long-term real sector issues.
New Miyazawa Initiative (Economic Reform Support Loan)	1999-2000	JBIC	Quick disbursing loan (20 billion yen) with conditionalities in PSD, SOE auditing, and tariffication of non-tariff barriers. Action plans in PSD were monitored and evaluated.
Vietnam-Japan Joint Initiative to Improve Business Environment with a View to Strengthen Vietnam's Competitiveness	2003-2009 (3 phases, ongoing)	MPI-4J	Bilateral agreement and implementation of concrete action plans which were monitored and reported to high-level, with focus on removal of FDI/business impediments, strengthening of local capabilities, and drafting of missing industrial strategies.
Joint Work between Vietnam and Japan to Strengthen the Competitiveness of Vietnamese Industries	2004	MPI-4J	Analyses by Vietnamese and Japanese experts as inputs to the drafting of the Five-year Plan 2006-2010, with attention on industrial policy formulation and competitiveness issues of individual industries (automobile, electronics, supporting industries, etc).
Joint drafting of Motorcycle Master Plan under MOI and VJJI2	2006-2007	Joint Working Group (MOI, VDF, producers, experts)	Drafting of master plan following new content and method, with active participation of large motorcycle assemblers and interaction with other stakeholders; VDF serving as facilitator. Master plan approved in August 2007.
Vietnam-Japan Monozukuri Partnership for Supporting Industries	(Under preparation)	(To be decided)	Build strategic partnership for monozukuri (high-skill manufacturing) with Japan transferring its know-how to Vietnam. Action plans for supporting industry promotion to be implemented with joint effort.

Abbreviations: 4J (Japanese Embassy, JICA, JBIC, JETRO), JICA (Japan International Cooperation Agency), JBIC (Japan Bank for International Cooperation), JETRO (Japan External Trade Organization), MPI (Ministry of Planning and Investment), MOI (Ministry of Industry), VJJI2 (Vietnam-Japan Joint Initiative Phase 2), GRIPS (National Graduate Institute for Policy Studies), NEU (National Economics University), VDF (Vietnam Development Forum), PSD (private sector development), SOE (state-owned enterprise).

These bilateral dialogues aim to improve Vietnamese policies where Japan has particular interest or comparative advantage. At the same time, they have the additional purpose of institutionally correcting the weaknesses of Vietnam's policy formulation by introducing new procedures and organizations. For example, concrete action plans are bilaterally agreed and rigorously monitored to prevent non-implementation (the New Miyazawa Initiative, the Vietnam-Japan Joint Initiative, and the proposed Vietnam-Japan Monozukuri Partnership). Inter-ministerial cooperation is ensured by making the leading ministry, typically MPI, responsible for the participation of all other ministries (the Ishikawa Project, the Vietnam-Japan Joint Initiative, and the proposed Vietnam-Japan Monozukuri Partnership). Active involvement of non-government stakeholders (especially major manufacturers) was enforced throughout the joint drafting process of the Motorcycle Master Plan—perhaps for the first time in Vietnam's master plan drafting. Japanese officials and businesses are well aware of the structural shortcomings of Vietnam's policy making, and they are willing to spend time and energy to work with the Vietnamese side to solve them, without which they know their dialogue will not lead to meaningful actions.

These policy dialogues have so far been initiated mainly from the Japanese side. It is suggested that the Vietnamese government should be more proactive in reforming its policy formulation and inviting Japan (and other countries) to participate in the effort.

9. Concluding remarks

While Vietnam's past achievements as a developing and transition country are great and many, this paper has focused on the future and offered candid evaluation and advice so that Vietnam might develop its potential to the fullest extent. I trust that the Vietnamese people and government are not satisfied by merely achieving MDGs or stopping at middle income. Their aspiration must be set higher, and it is surely attainable if the nation clearly identifies its present shortcomings and squarely faces its challenges. The key message of this paper can be summarized as follows.

Vietnam has reached the point where further progress towards higher income can be secured only if internal value creation is enhanced. This calls for proper government action, rather than laissez-faire, to guide and complement private sector dynamism and avoid the middle income trap. To improve policy quality, Vietnam needs to change the policy formulation process. This in turn requires a radical change in the public administration system. The scope and sequencing of reforms must be chosen carefully to minimize the political and social energy needed to change the system while maximizing their positive impacts. Enlightened and strong leadership, a new technocrat team, and strategic partnership with foreigners have been proposed as effective starting points that satisfy these conditions.

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