Avoiding the Middle Income Trap:

Renovating Industrial Policy Formulation in Vietnam

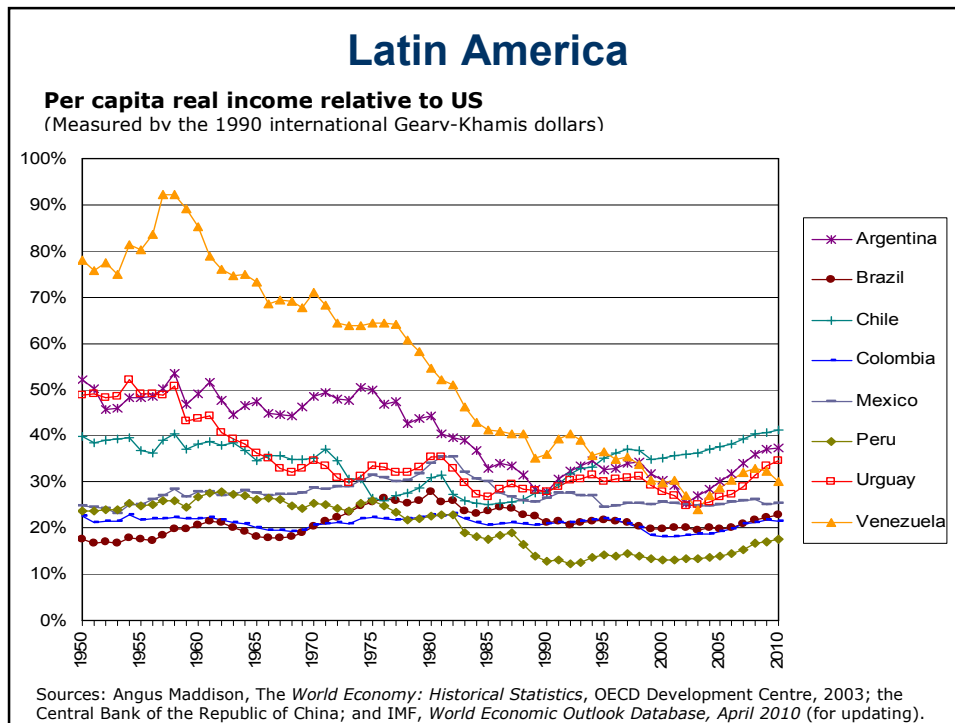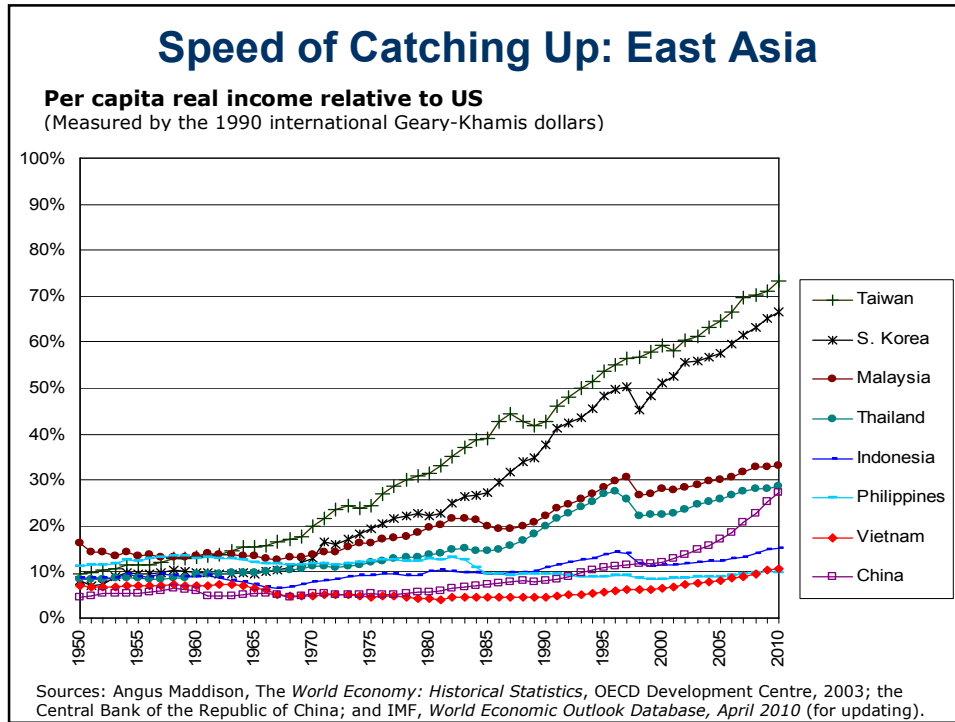**Kenichi Ohno (VDF/GRIPS)**
Revised October 2010

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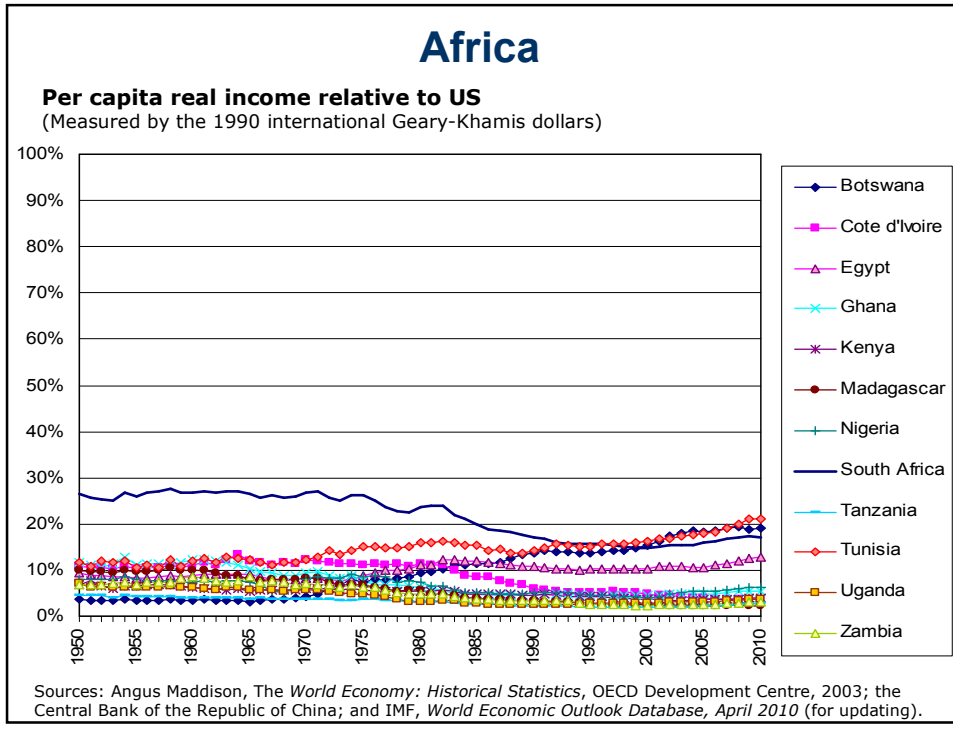o Malaysia's "New Economic Model"
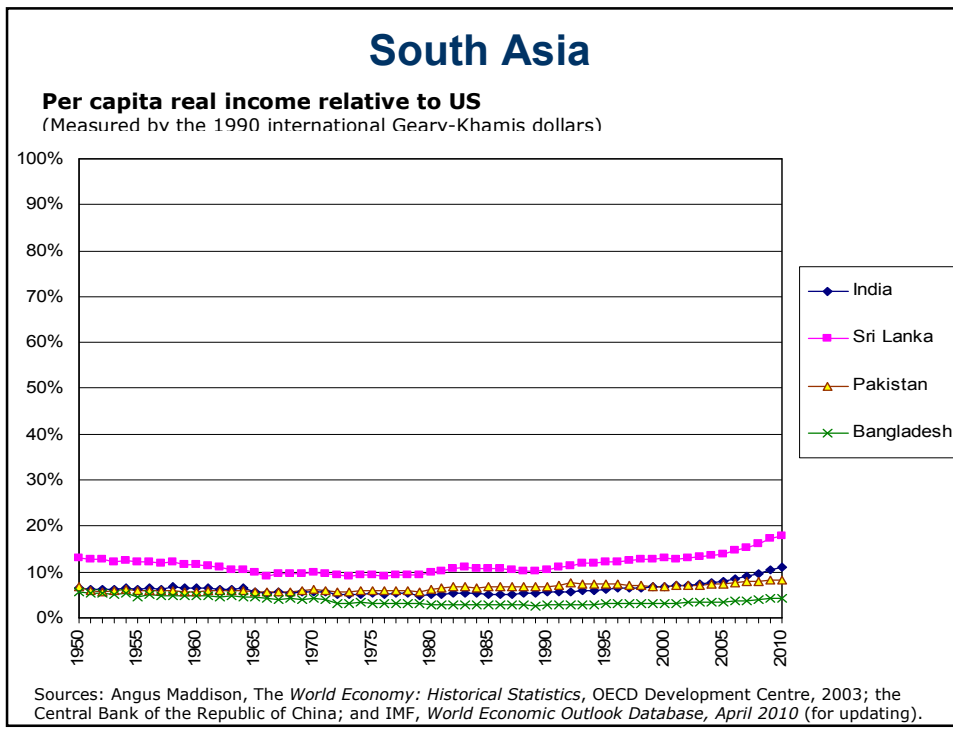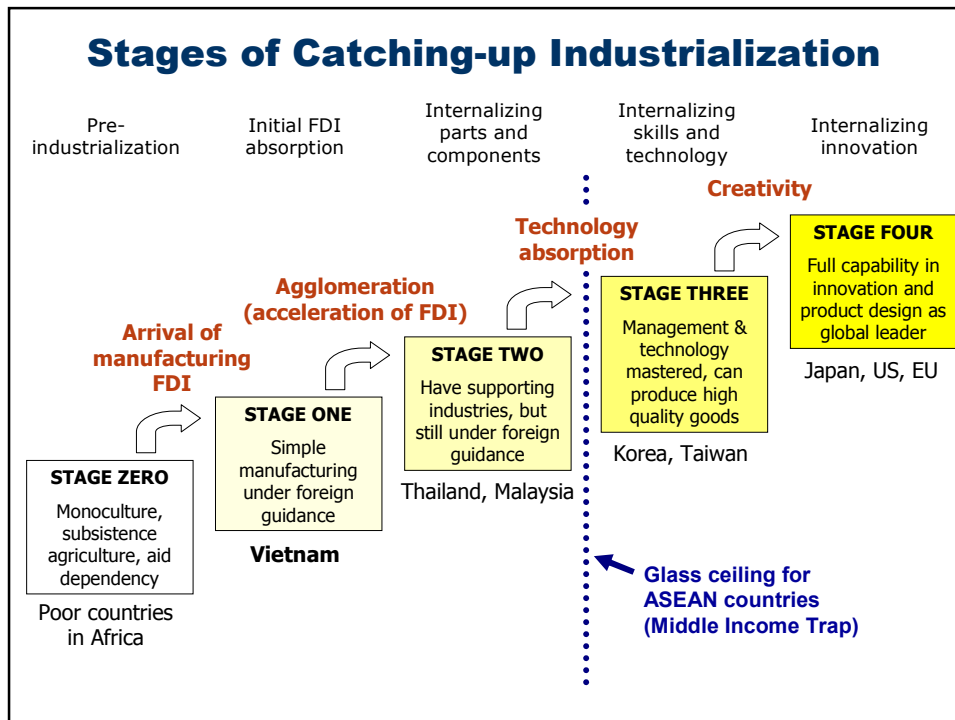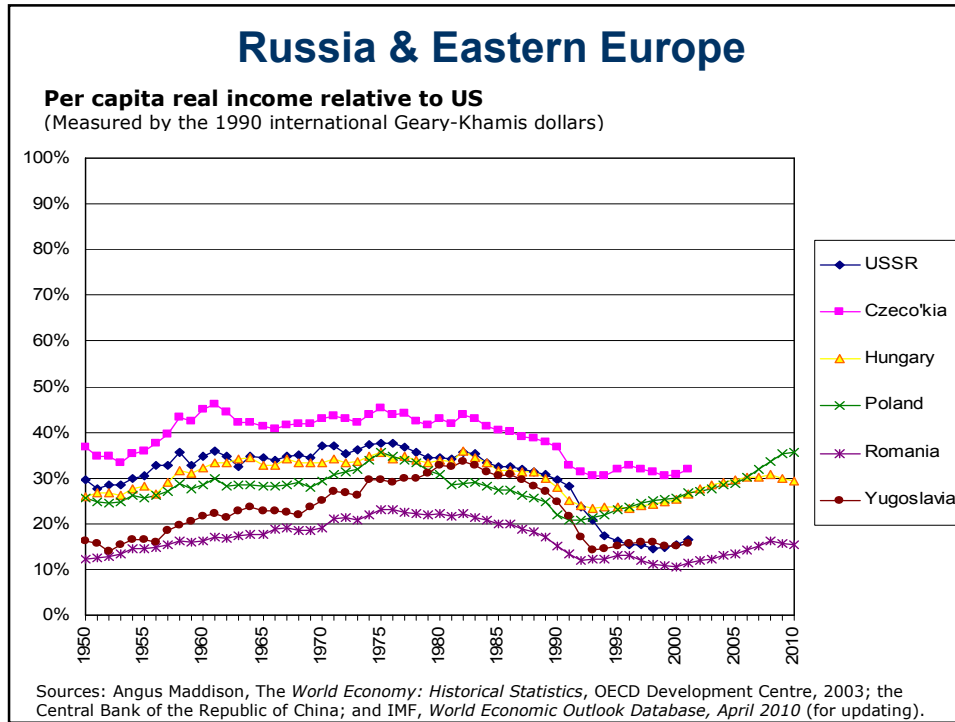o Recommended actions for Vietnam

What Is a Middle Income Trap?

○ The developmental trap occurs when a country is stuck at the income dictated by given resources and initial advantages, and cannot rise beyond that level (only luck and no effort).

○ The level of income where the trap may occur depends on endowment of resources and advantages.

Low endowment ➔ Poverty trap

Moderate endowment ➔ Middle income trap

High endowment ➔ High income

Middle Income Trap (cont.)

○ Countries can reach middle income by liberalization and integration, but reaching higher income requires strong policy effort to stimulate private dynamism.

○ Growth based on FDI, big projects, natural resources, or locational advantages will eventually end. The true source of development is value creation by humans (knowledge, skills, technology).

○ Policies and institutions must promote human capital formation. Such policies are possible even under globalization, but they are different from past policies. I call it "proactive industrial policy."

Speed of Catching Up: East Asia

Per capita real income relative to US
(Measured by the 1990 international Geary-Khamis dollars)

Legend: Taiwan, S. Korea, Malaysia, Thailand, Indonesia, Philippines, Vietnam, China

Sources: Angus Maddison, The *World Economy: Historical Statistics*, OECD Development Centre, 2003; the Central Bank of the Republic of China; and IMF, *World Economic Outlook Database, April 2010* (for updating).

Latin America

Per capita real income relative to US
(Measured by the 1990 international Geary-Khamis dollars)

Legend: Argentina, Brazil, Chile, Colombia, Mexico, Peru, Urguay, Venezuela

Sources: Angus Maddison, The *World Economy: Historical Statistics*, OECD Development Centre, 2003; the Central Bank of the Republic of China; and IMF, *World Economic Outlook Database, April 2010* (for updating).

South Asia

Per capita real income relative to US
(Measured by the 1990 international Geary-Khamis dollars)

Legend: India, Sri Lanka, Pakistan, Bangladesh

Sources: Angus Maddison, The *World Economy: Historical Statistics*, OECD Development Centre, 2003; the Central Bank of the Republic of China; and IMF, *World Economic Outlook Database, April 2010* (for updating).

Africa

Per capita real income relative to US
(Measured by the 1990 international Geary-Khamis dollars)

Legend: Botswana, Cote d'Ivoire, Egypt, Ghana, Kenya, Madagascar, Nigeria, South Africa, Tanzania, Tunisia, Uganda, Zambia

Sources: Angus Maddison, The *World Economy: Historical Statistics*, OECD Development Centre, 2003; the Central Bank of the Republic of China; and IMF, *World Economic Outlook Database, April 2010* (for updating).

Russia & Eastern Europe

Per capita real income relative to US
(Measured by the 1990 international Geary-Khamis dollars)

Legend: USSR, Czeco'kia, Hungary, Poland, Romania, Yugoslavia

Sources: Angus Maddison, The *World Economy: Historical Statistics*, OECD Development Centre, 2003; the Central Bank of the Republic of China; and IMF, *World Economic Outlook Database, April 2010* (for updating).

Stages of Catching-up Industrialization

Pre-industrialization — Initial FDI absorption — Internalizing parts and components — Internalizing skills and technology — Internalizing innovation

Arrival of manufacturing FDI

Agglomeration (acceleration of FDI)

Technology absorption

Creativity

STAGE ZERO
Monoculture, subsistence agriculture, aid dependency
Poor countries in Africa

STAGE ONE
Simple manufacturing under foreign guidance
Vietnam

STAGE TWO
Have supporting industries, but still under foreign guidance
Thailand, Malaysia

STAGE THREE
Management & technology mastered, can produce high quality goods
Korea, Taiwan

STAGE FOUR
Full capability in innovation and product design as global leader
Japan, US, EU

Glass ceiling for ASEAN countries (Middle Income Trap)

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Vietnam's Challenge

○ Thanks to Doi Moi and large inflows of FDI and ODA,
Vietnam has reached lower middle income (pc GDP of
$1,200 in 2010). But policies to upgrade human capital
are not yet established.

○ Vietnam does simple assembly with unskilled labor. FDI
will leave and de-industrialization will occur as wages
rise and integration deepens. Without domestic value
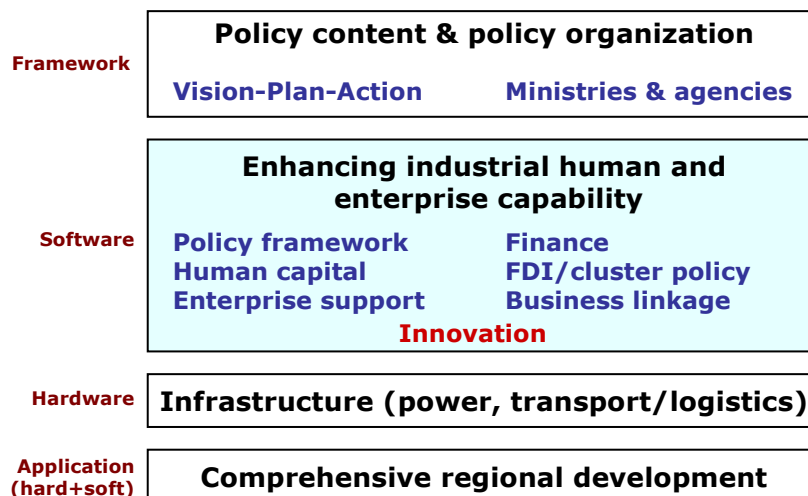creation, Vietnam will surely face a middle income trap.
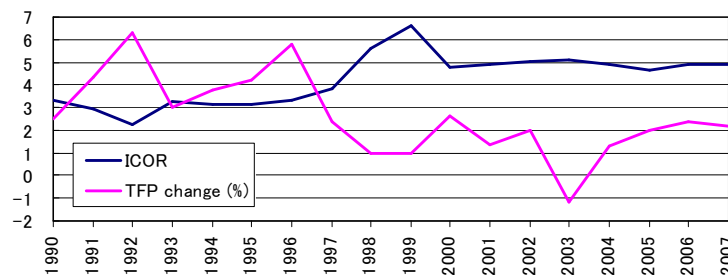
Proactive Industrial Policy:
Seven Required Features

1. Strong commitment to global integration
   and private sector driven growth
2. A wise and strong government guiding
   private sector
3. Securing sufficient policy tools for latecomer
   industrialization
4. Constant policy learning through concrete
   projects and programs
5. Internalization of knowledge, skills and
   technology as a national goal
6. Effective public private partnership
7. Collection and sharing of sufficient industrial
   information between government and
   businesses

Proactive Industrial Policy (cont.)

○ Infant industry promotion by tariffs and export subsidies is no longer allowed today.

○ PIP strikes a balance between state and market, and is consistent with globalization. But it requires policy learning.

○ PIP is already practiced widely, especially in East Asia. Systematic analysis of concrete PIP measures is needed.

○ There is a standard policy menu for enhancing industrial capability. But selectivity and adjustment are required to adapt to the unique features of each country.

Standard Policy Menu for Enhancing Industrial Capability

Framework

Policy content & policy organization

Vision-Plan-Action   Ministries & agencies

Software

Enhancing industrial human and enterprise capability

Policy framework   Finance
Human capital   FDI/cluster policy
Enterprise support   Business linkage
Innovation

Hardware

Infrastructure (power, transport/logistics)

Application (hard+soft)

Comprehensive regional development

Enhancing Industrial Human and Enterprise Capability: Standard Menu

Main objectives	Sub items
(1) Legal and policy frameworks	Laws and regulations
	Ministries/agencies for promoting SMEs, FDI, etc. with sufficient capability and authority
	Inter-ministerial coordination mechanisms
	Effective public private partnership (PPP)
	Mechanism for business-government-academia linkage
	Policy system consisting of visions, roadmaps, action plans, and monitoring
	Standards for quality, safety, skills, environment, etc.
	Mechanisms for protecting and utilizing Intellectual property rights
	Strengthening of industrial statistics
	Strategic mobilization of international cooperation
(2) Local capacity building (industrial human resource and local enterprises)	Universities of technology and engineering, industrial colleges
	Short-term courses for enterpreneurs
	Technical support on specialized skills for engineers
	Technical and vocational training for new or current workers
	Skill certification, competition, and awards
	Subsidies and incentives for targeted activities (worker training, technology transfer, die and mold, marketing, ITC, etc)
	Management or technical advisory service (by visiting consultants, short-term)
	Enterprise evaluation and advice system (institutionalized shindan system or technical extension services) - also related to SME finance
	Local enterprise networks

(Cont.)

(3) Finance	Development financial institutions
	Subsidized commercial bank loans for targeted firms (two-step loans)
	Credit guarantee system
	Equipment leasing
	Venture capital
	Enterprise credit information system
	Enterprise evaluation and advice system (same as in (2))
(4) FDI marketing	List of priority products and activities and a system of investment incentives
	Investment promotion seminars and missions
	Effective investor information package and website
	Investment promotion offices abroad
	One-stop services and enteprise support (before and after investment)
	Upgrading infrastructure service quality (power, transport, water, etc)
	Environmental control and facilities (incl. waste water treatment)
	Industrial estates with sufficient infrastructure services and administrative services (incl. specialized industrial parks)
	Labor support (training, recruiting & matching, housing/domitories, commuting, health care, etc.)
	Prioritized and targeted FDI marketing
	Inviting individual target company ("anchor firm") and provision of required conditions
(5) Linkage (learning by working with global standard firms; market development)	Trade fairs and reverse trade fairs
	Enterprise databases (SMEs, supporting industries, sectoral)
	Official intermediation/promotion of subcontracting
	Incentives/subsidies for FDI-local firm linkage
	Domestic and export market development support
	Establishment and enhancement of industry associations

Thailand:
Supporting Industry Master Plan 1995

Proposed program	Outcome
1. Policy & legislation 1.1. Basic law of SME development 1.2. Law of subcontracting promotion 1.3. Restructuring of DIP for SME & SI promotion 1.4. Preparation of industrial statistics (SI database)	**1.** 1.1. SME Promotion Act 2000 1.2. (no action) 1.3. Establishment of DSIP & OSMEP 1.4. n.a.
2. Market development (Linkage) 2.1. Expansion of BUILD activities 2.2. Subcontracting assistance program	**2.** 2.1. BUILD (1993-1997) 2.2. NSDP (1994)
3. Technology upgrading 3.1. Technology extension service program (shindanshi sys.) 3.2. Expansion of occupational skill standard system 3.3. Public technical center activation program 3.4. Joint industry-university training schools	**3.** 3.1. (no action) 3.2. (no action) 3.3. TAI, TGI, etc. 3.4. TNI, TGI, etc.
4. Financial support 4.1. Improvement of SME financing schemes 4.2. Assistance for SME in machinery leasing	**4.** 4.1. SME Bank, loan agent network 4.2. Credit guarantee, machine fund
5. Upgrading of management 5.1. Entrepreneur re-education program 5.2. Continuation of technopreneur development project	**5.** 5.1. TNI, TGI, etc. 5.2. n.a.
6. Investment promotion 6.1. Grouped investors attraction program 6.2 Entrepreneur incubation program 6.3. Assistance for new comers penetration	**6.** 6.1. Amata Industrial Estate 6.2. OSMEP 6.3. OSMEP

Vietnam's Supporting Industry Action
Plan Proposed by Japan (June 2009)

- Vietnam's action and Japan's support are specified in parallel.
- Short-term (mid 2010), medium-term (end 2011), long-term (end 2015).

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Policy framework	Definitions of SI, award system, inter-ministerial mechanism, SME laws, etc.
Human resource	Pilot TVET projects for engineers & managers, skill certification system, monozukuri university, etc.
Finance	Low-interest loans, subsidies, tax exemption, shindan system, etc.
FDI marketing	Investment seminars, SI industrial parks, linkage between FDI and locals, etc.
Business linkage	SI database, trade fairs, industry associations, etc.

**PM Najib
Tun Razak**

Malaysia's "New Economic Model"
(Announced in March 2010)

o "We are caught in a middle income trap; we are not amongst the top performing global economies." (pp.3-4)

o Malaysia's vision for 2020—(i) market-led, (ii) well-governed, (iii) regionally integrated, (iv) entrepreneurial, (v) innovative

o Three Goals
  High income ($15,000-20,000)
  Inclusiveness (everyone benefits)
  Sustainability (fiscal, environmental)

Malaysia's Old and New Approach

Old approach	New approach
Growth primarily through capital accumulation	Growth through productivity
Dominant state participation in the economy	Private sector-led growth
Centralized strategic planning	Localized autonomy in decision-making
Balanced regional growth	Cluster- and corridor-based economic activities
Favor specific industries and firms	Favor technologically capable industries and firms
Export dependence on US, EU and Japanese markets	Asian and Middle East orientation
Restrictions on foreign skilled workers	Retain and attract skilled professionals

Source: NEAC, "New Economic Model," p.15.
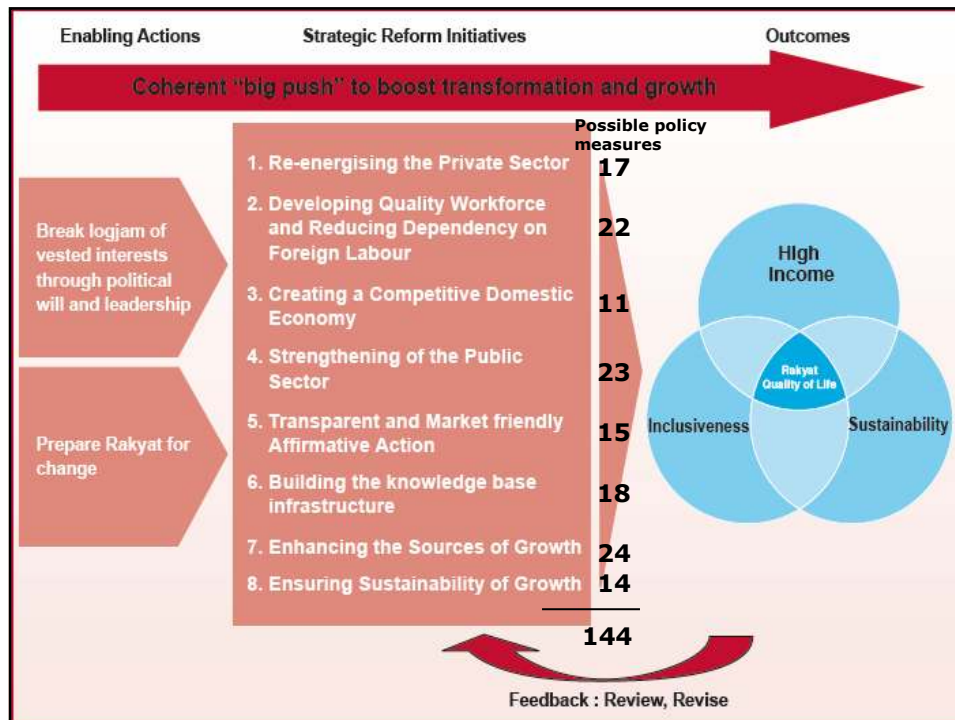
Strengths and Weaknesses of the Malaysian Approach

- Competent leader (PM), technocrats (EPU and others), and officials.
- Clear vision, goals, and policy direction.

BUT

- Issues and policy measures are too many and too broad – selectivity is required due to human and financial constraints.
- For Malaysia, the critical problem is lack of private sector response to good policies. Improving policies further will not solve this problem.

Recommended Actions for Vietnam

1. Collect and study concrete international experiences in industrial capability enhancement
2. Identify a small number (less than 10) of priority issues for *Industrialization and Modernization* by 2020
3. Create specialized mechanism for each priority issue
4. Let these mechanisms design and implement policy actions
5. Progress review by highest level

(1) Study International Experiences

For example, Vietnam can study:
1. Engineering education and training at TPA, Thai-Nichi Institute of Technology, King Mongkut University, Thai-German Institute (Thailand), Nanyang Polytechnic (Singapore)
2. Quality and productivity policies of SPRING (Singapore) and MPC (Malaysia)
3. National SME Development Council of Malaysia
4. Automotive Institute and Automotive Industry Association of Thailand
5. FDI and business linkage policies of Malaysia and Thailand
6. Die and mold industry promotion in Indonesia
7. Enterprise diagnosis and advisory (*shindan*) system of Japan

(2) Select Priority Issues for Action

Possible issues include:
1. Promoting engineering education with a roadmap and numerical targets
2. Revamping SME policy
3. Strengthening supporting industries
4. Transport and logistic efficiency
5. Agro and marine product exports with globally highest quality and safety
6. Comprehensive regional development based on industrial clusters

(Note: promotion of high-tech or global value chain may be too general for Vietnam.)

(3) Create Specialized Mechanisms

Different ways to create mechanisms:
- Permanent technocrat group directly under PM to make key policies
- Monthly national committee headed by PM (2 or 3 in number)
- Committee headed by minister and supported by task forces
- Specialized "institute" or "center" to serve as a policy making hub

(Note: drafting master plans within each ministry, as currently done in Vietnam, carries little authority and cannot ensure implementability.)

(4) Draft Concrete Policy Actions
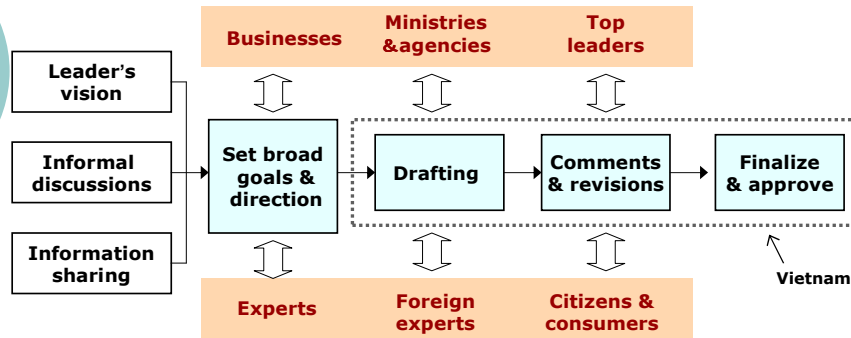
Ensure:
- Stakeholder involvement (esp. businesses)
- Inter-ministerial coordination
- Sufficient mandate, budgeting, staffing, and legal framework

(5) Monitoring by Top Leader

- Top leader must be personally committed to priority policies and use his/her authority to push and publicize them.
- Progress should be regularly reported to the leader (monthly or quarterly official meetings).
- When a problem is identified, the leader should assign relevant minister for immediate action and result reporting.