

An Approaching Middle Income Trap

How Vietnam Can Escape It



**Hanoi
December 2014
Kenichi Ohno
GRIPS & VDF**

Key Message of the Book

■ The trap is already here

We believe that Vietnam is already in a middle income trap or on the verge of falling into it.

■ Action, not talk

The important thing about the middle income trap is not to endlessly debate whether or not Vietnam is in a trap, but for government to begin to take decisive actions.

Despite many talks about a middle income trap, effective policy has not yet been taken in Vietnam.

■ Where to begin?

Value creation by Vietnamese people & firms should be the objective. We advise starting with improving FDI, SME and linkage policies. For this, policy learning from international best practices is useful.

What is a Middle Income Trap?

- A country that cannot rise from middle income to high income for a long time.
 - Data analysis for 124 countries during 1950-2010 suggests that a country staying in lower middle income for 28 years or more, or a country staying in upper middle income for 14 years or more, is in a trap (Felipe, Abdon & Kumar 2012).
 - Vietnam just attained lower middle income; it is too early to judge that Vietnam is in a middle income trap (World Bank Vietnam, 2014).
- ➔ These are statistical and *ex post* definitions
- ➔ We need a definition which is more analytical and useful for discussing causes and remedies.

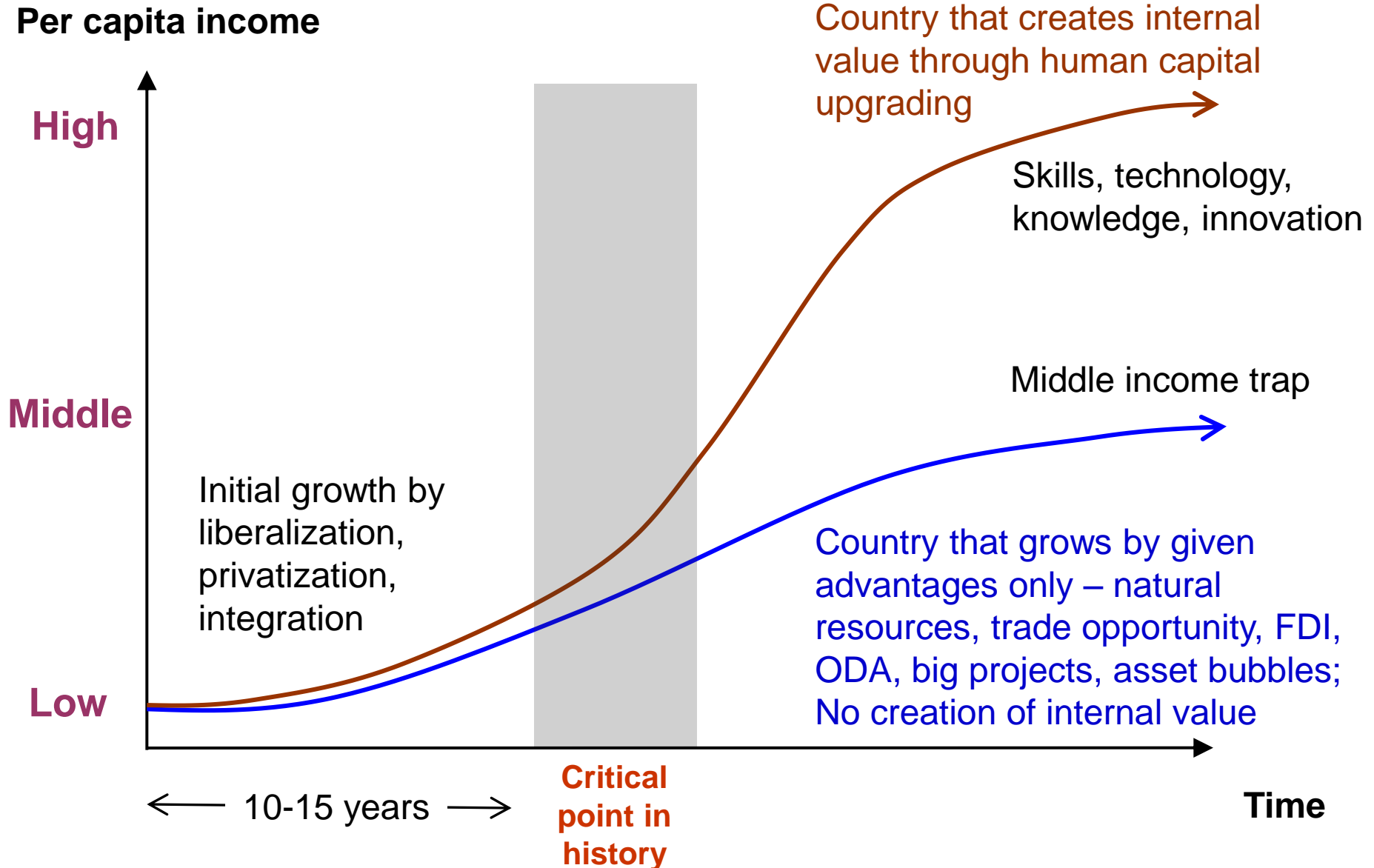
More Analytical Descriptions

- “A middle income trap is a situation where industrialization driven by **low-cost advantages** (cheap labor & capital) has come to an end. Wage that rises faster than productivity and declining investment efficiency lead to such a deadlock” (Akira Suehiro 2014).
- “After reaching middle income, a country may stagnate for a long time because it is unable to adopt a new development strategy and new growth pattern, and thus cannot find a **new source of growth**” (C.H. Kwan 2013).
- “Middle income countries in Asia are facing two difficult problems simultaneously: **how to raise productivity in key industries** and **avoiding income inequality.**” (Yonosuke Hara 2014)
- “Continued growth beyond middle income requires establishment of **high-quality institutions** in that country” (Tran Van Tho 2010).

A Middle Income Trap (My Definition)

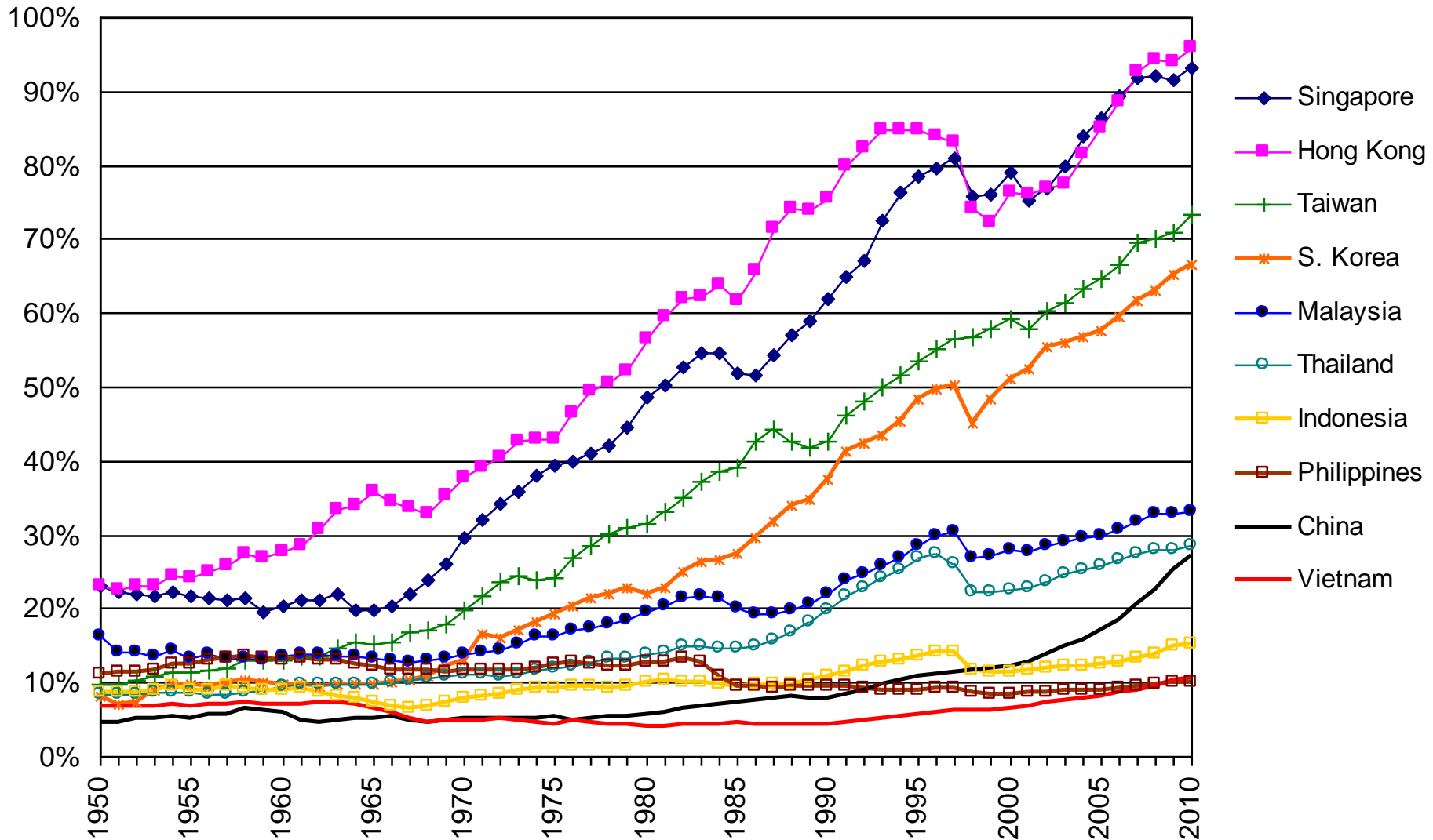
- A country is in a trap if it attains an income level corresponding to **given advantages** (natural resources, trade opening, FDI, ODA, big projects, etc.) but cannot rise further because its **people do not create value**.
- Any country whose people cannot create value-added should be considered “trapped.” A middle income trap occurs when a country’s advantages are of average size. There can also be a trap at low income and high income.
- The key question is whether there is **true development** (wealth creation, not given advantages). It is produced by human effort (skills, technology, knowledge, innovation).
- You don’t have to wait 28 or 14 years to judge whether a country is creating value. The answer is clearly visible at any moment.

Why Do Countries Diverge?



Speed of Catching Up in East Asia

Percentage of US per capita real income
(International Geary-Khamis Dollar)



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).

Three Actions Required to Avoid A Middle Income Trap

1. Creating growth sources

Entrepreneurship, skilled engineers, internationally competitive enterprises and industries

2. Solving growth-caused problems

Income gaps, regional gaps, environmental destruction, urban & traffic congestion, asset bubbles, materialism, corruption, family & social change, political reform, etc.

3. Macroeconomic management under globalization

Coping with global & regional recessions, financial crises, protection against external shocks & ameliorating damage

All of the above must be accomplished in order to sustain growth into high income.

Components of Growth Sources

- Private dynamism (individuals & enterprises)
- A wise and active national leader
- The learning of policy method (content, procedure, organization & documents)

These components are important in this order. But the first two are not easy to change in the short run. The third (policy method) however can be learned and improved in a relatively short time.

→ Start with learning policy method (entry point)

Policy Quality Hypothesis

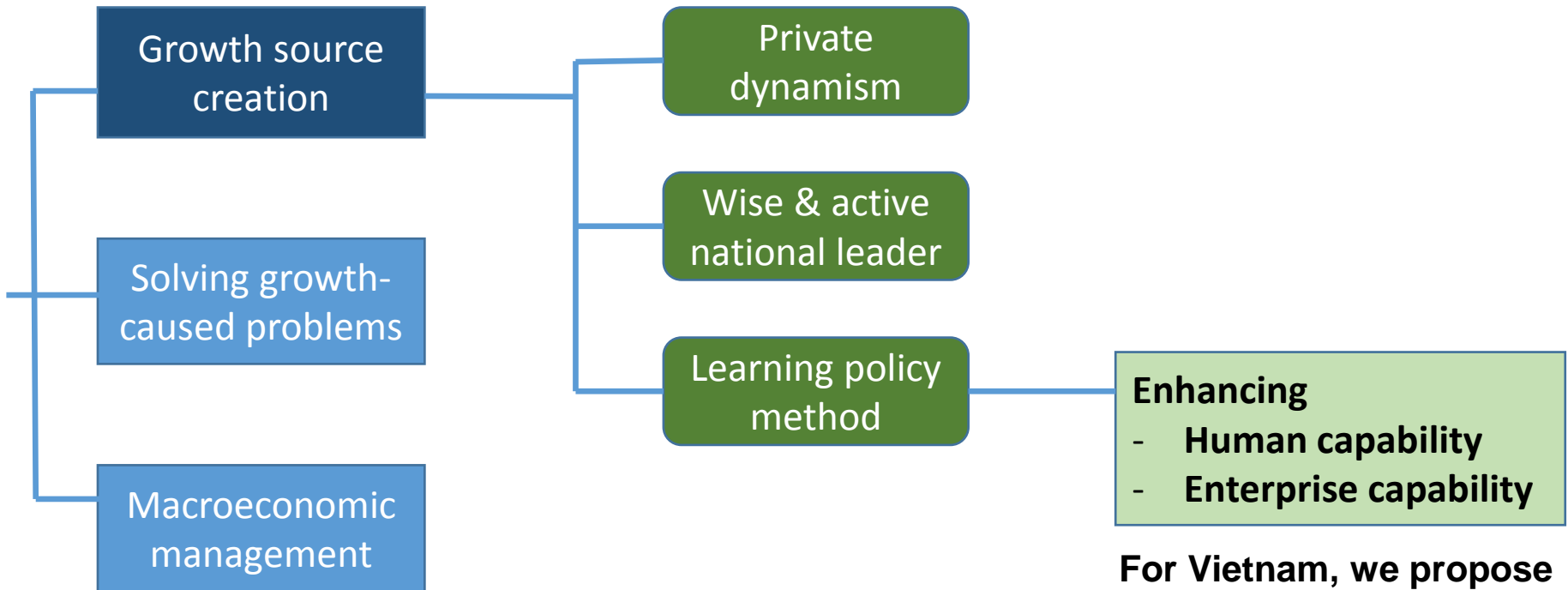
- For today's developing countries, **policy quality** is the key factor that allows a country to overcome a middle income trap (not resources, geography, FDI or ODA).
- The most important policy is **enhancement of human and enterprise capabilities**. Other things (infrastructure, business climate, legal framework, capital inflow, ODA) are important but not as critical as human and enterprise factors.
- There is a strong correlation between achieved income and the quality of industrial policy.
- Latecomers equipped with high policy capability have already achieved high income (Japan, Singapore, Taiwan, Korea).
- Other developing countries must engage in **policy learning**. By studying best policy practices around the world, a country should acquire **general capability to create the most suitable policy package** for its context and circumstances.

Summary: Overcoming MIT = Value Creation

3 required actions

3 components

Core focus



For Vietnam, we propose upgrading
1/ FDI policy
2/ SME policy
3/ Linkage policy
through policy learning.

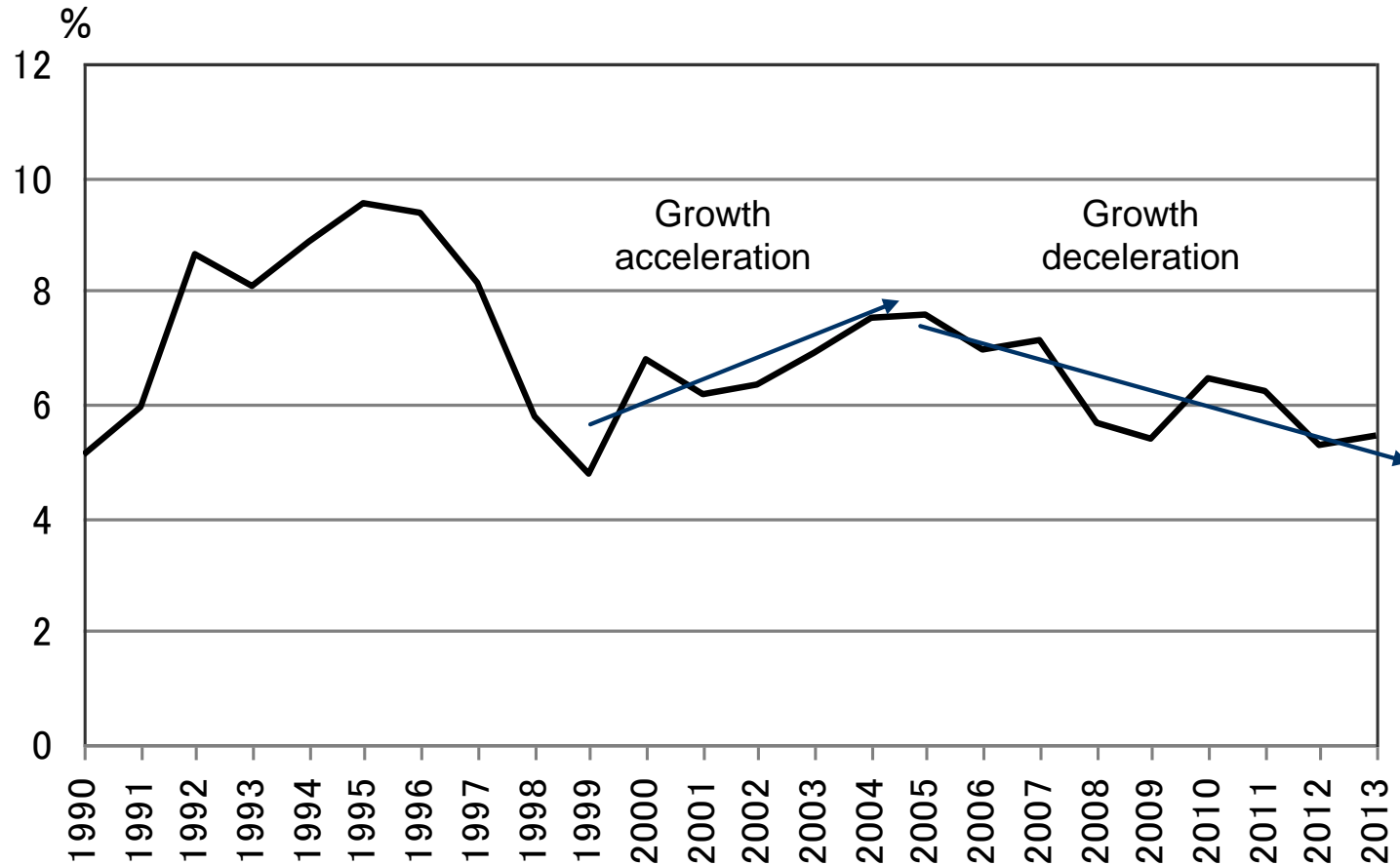
A Middle Income Trap Is Here

- In 2008, Vietnam reached an income per head of over \$1,000 and became a lower middle income country (World Bank criteria).

Note: WB threshold for 2014: low income (\$1,045 or less), lower middle income (\$1,046-\$4,125), upper middle income (\$4,126-12,746), high income (\$12,747 or more).

- But since then, signs of a middle income trap have become evident.
 1. Growth slowdown
 2. Weak productivity performance
 3. Superficial structural transformation
 4. Stagnant global ranking
 5. Emergence of growth-caused problems

1. Growth Is Slowing Down



未富先老

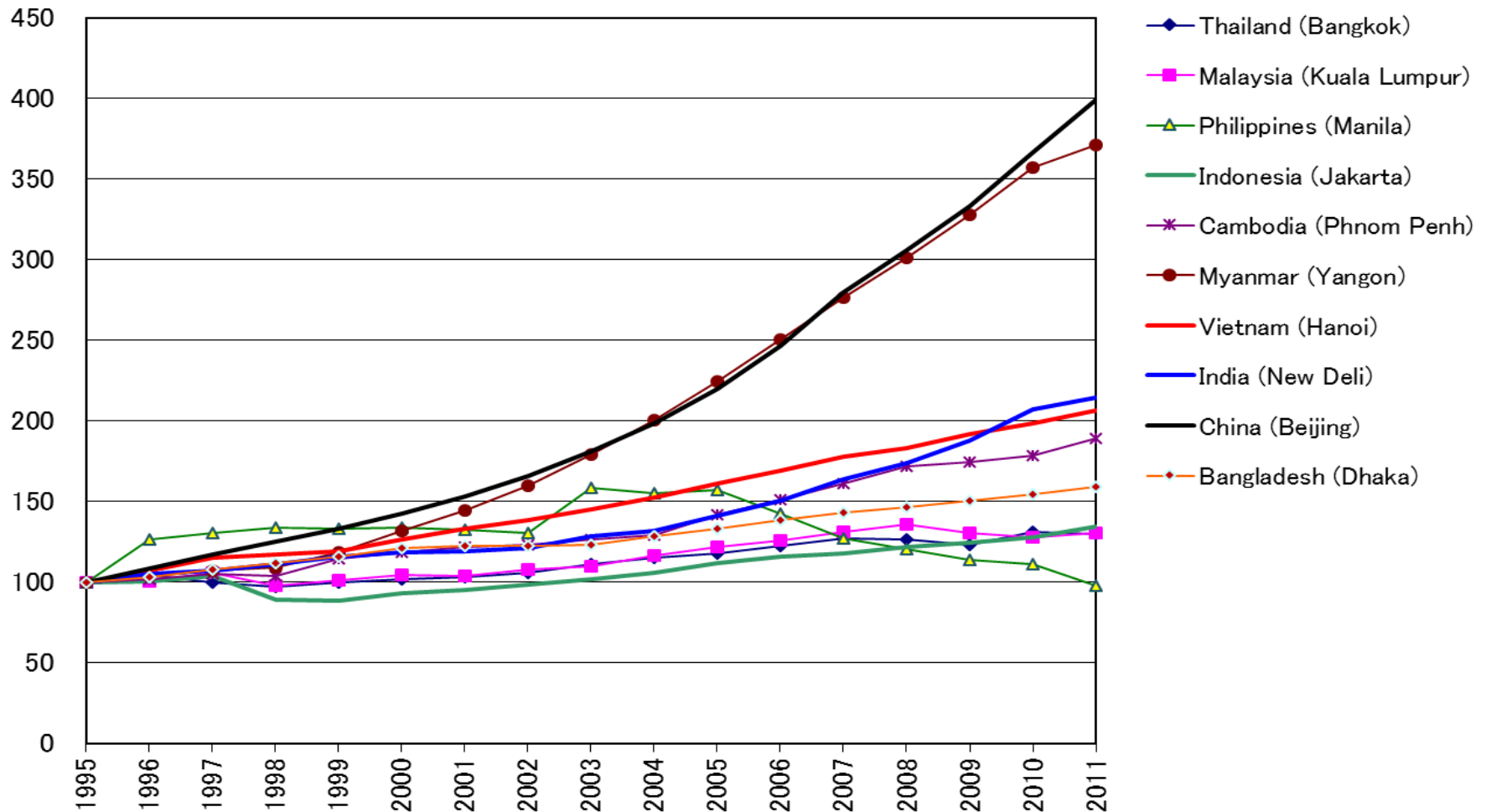
Chưa
Giàu
Đã
Già

- At lower middle income, it is too early to slow down.
- Indonesia: “Growth below 6% is intolerable because it worsens unemployment and other social problems” —also Vietnam?

2. Weak Productivity Performance

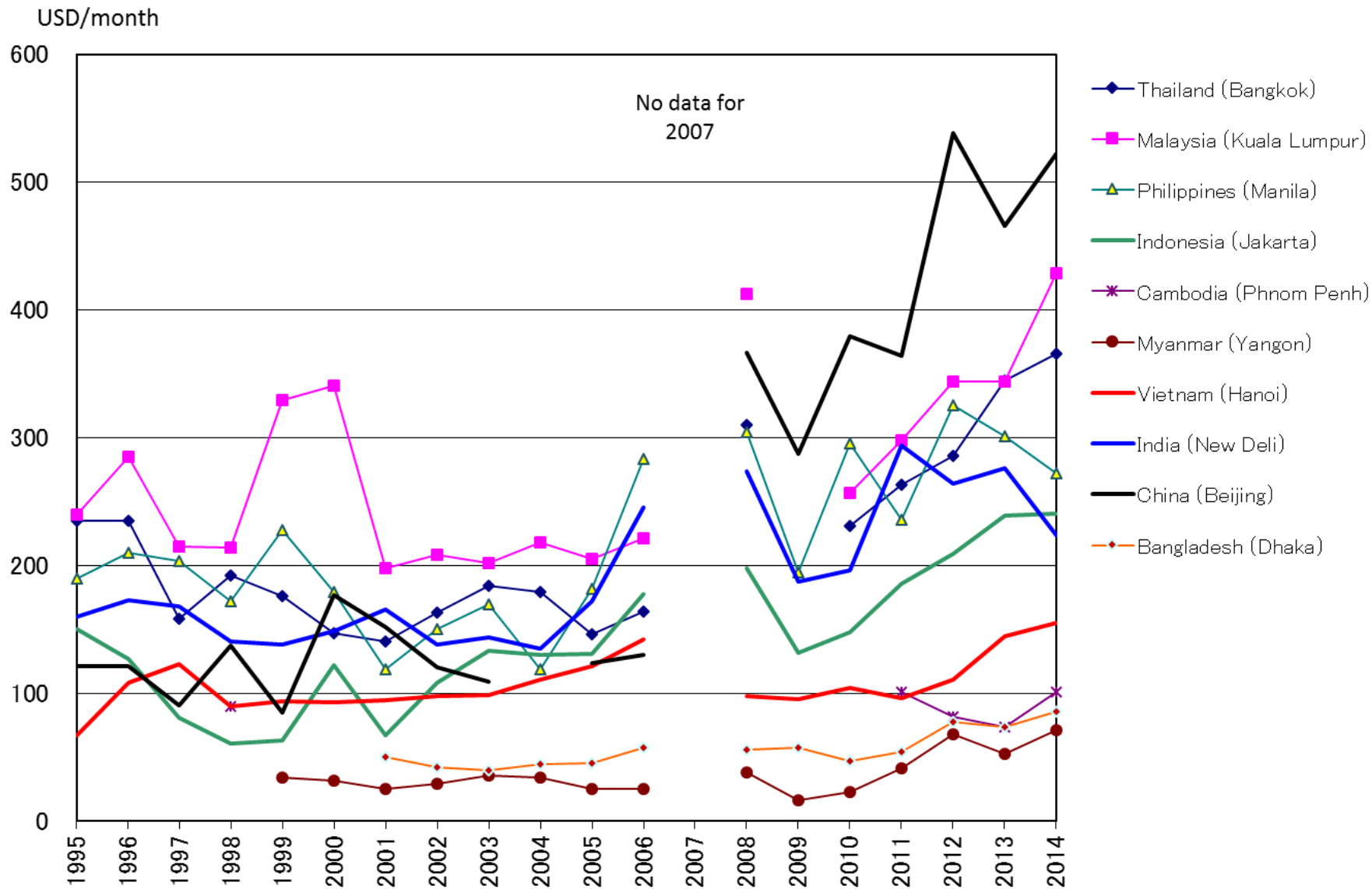
Labor Productivity

Base year = 1995



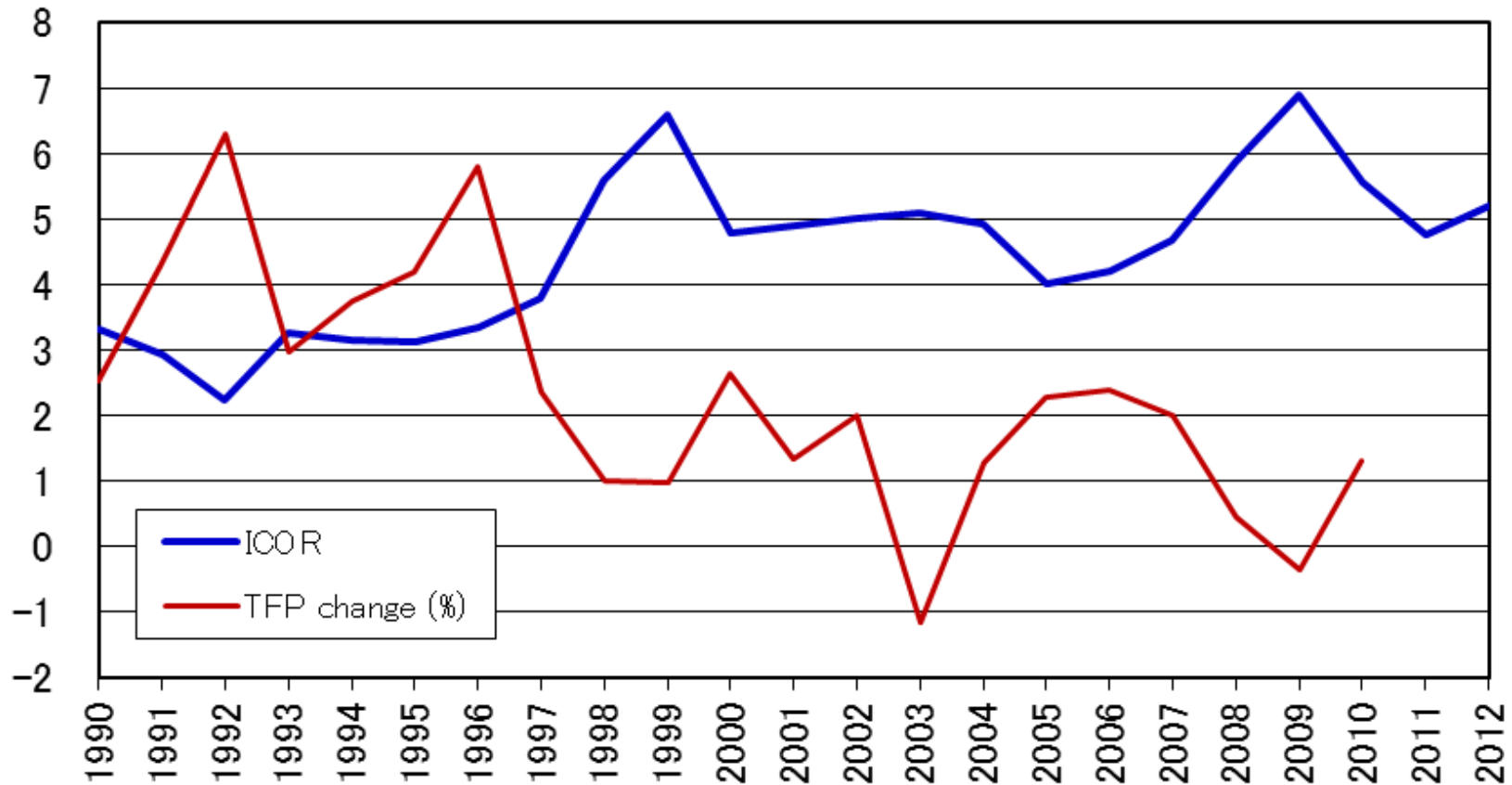
Source: Asian Productivity Organization website. Labor productivity based on employment is shown. Results are similar for labor productivity based on hours worked, but such data are available for fewer countries.

Monthly Wage for Unskilled Workers



Source: JETRO Annual Survey on Comparison of Investment-related Costs among Major Cities and Areas in Asia, various years.

Vietnam: Investment-driven Growth with Little Productivity Improvement



- **ICOR** measures capital efficiency (required capital per 1% growth)
- **TFP** is an overall productivity measure adjusted for input increase

Vietnamese Wage Rising Faster Than Labor Productivity

Annual change in Vietnam (2009-2012)

	Wage	Labor productivity	ULC (difference)
All sectors	25.9%	3.2%	22.7%
Manufacturing	23.4%	5.1%	18.3%

Annual change in Japan (1955-1970)

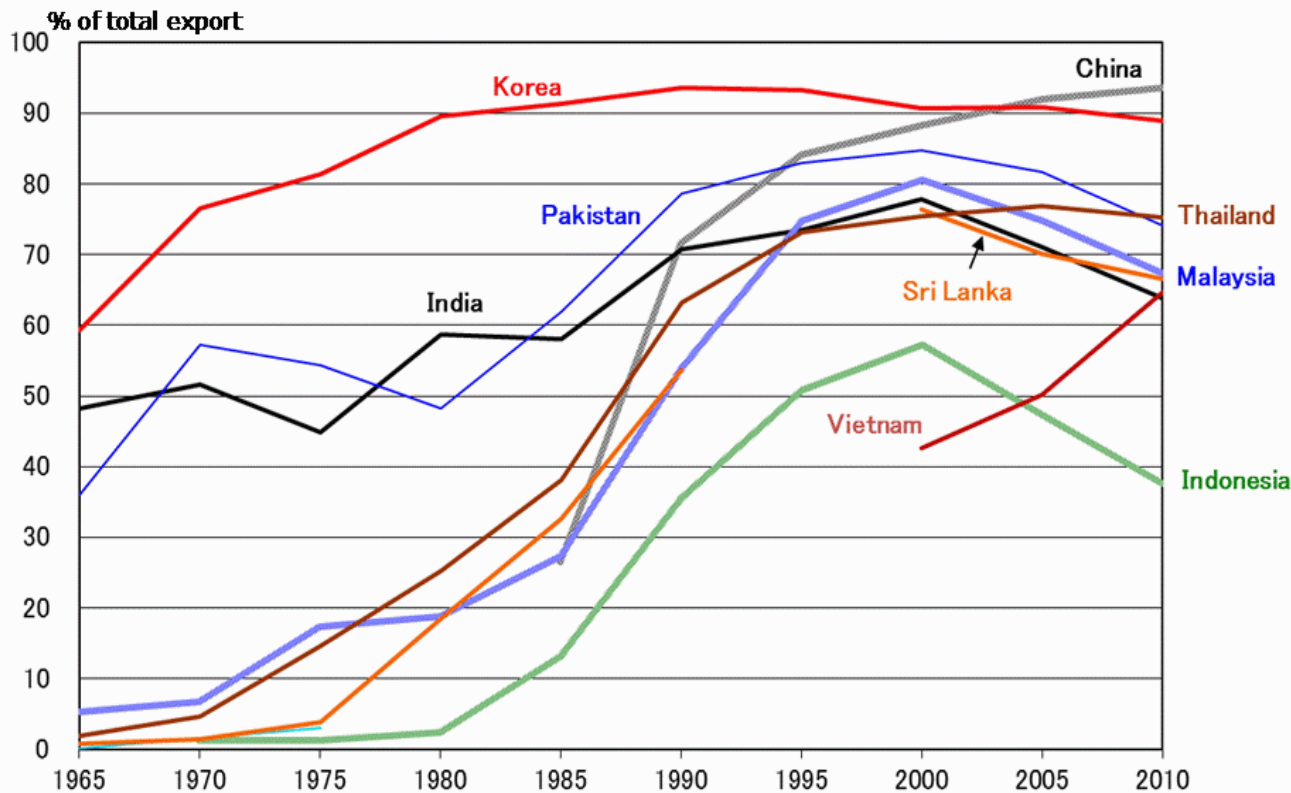
	Wage	Labor productivity	ULC (difference)
All sectors	9.8%	10.1%	- 0.3%
Manufacturing	10.2%	10.0%	+ 0.2%

Note: Unit labor cost (ULC) is productivity-adjusted wage, and measures true labor cost to producers. Japan's all sectors excludes services.

3. Superficial Transformation

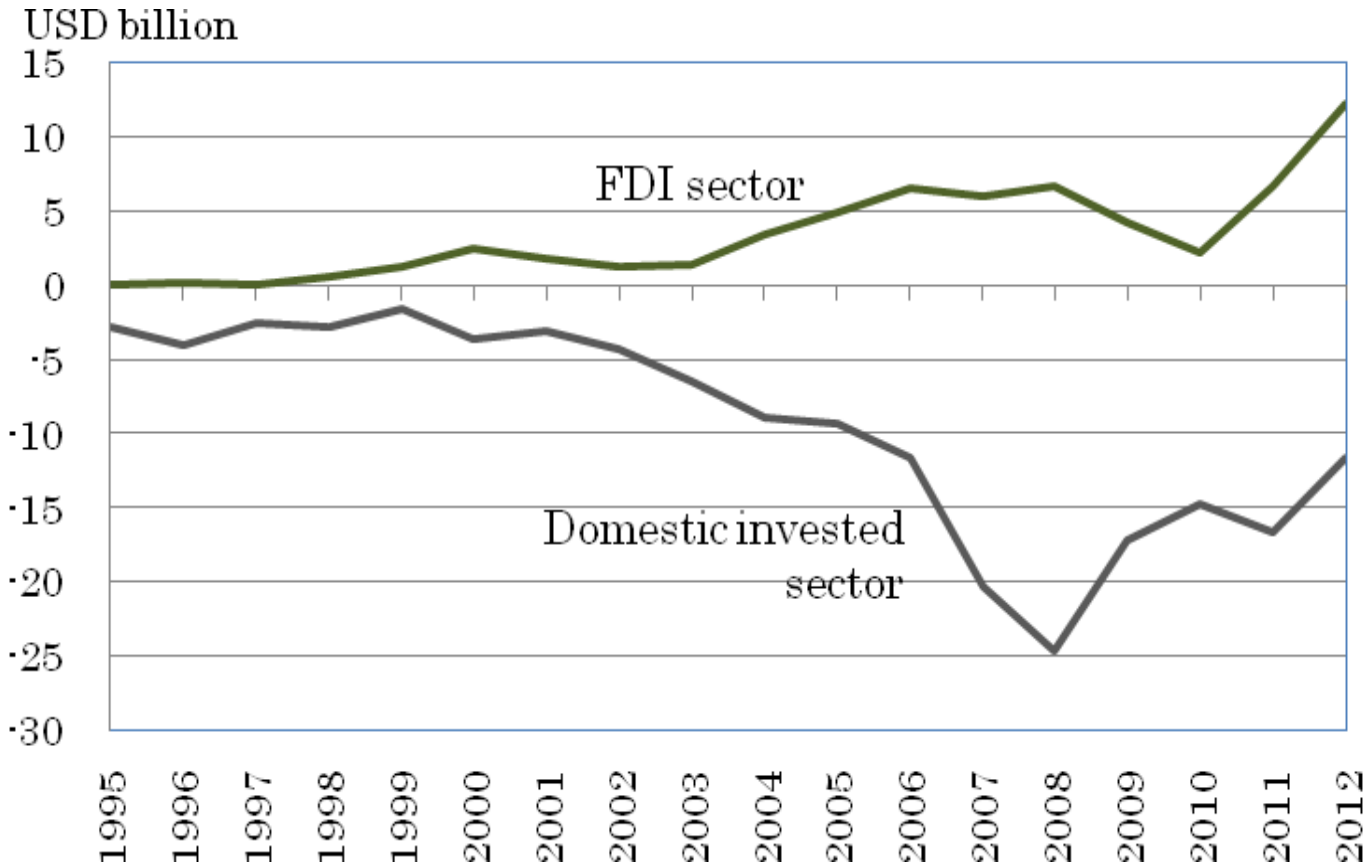
Although output & export structure is rapidly industrializing, transformation is fragile because:

- FDI, not Vietnamese firms, is the agent of change
- Industrial export depends heavily on industrial imports (weak supporting industries)



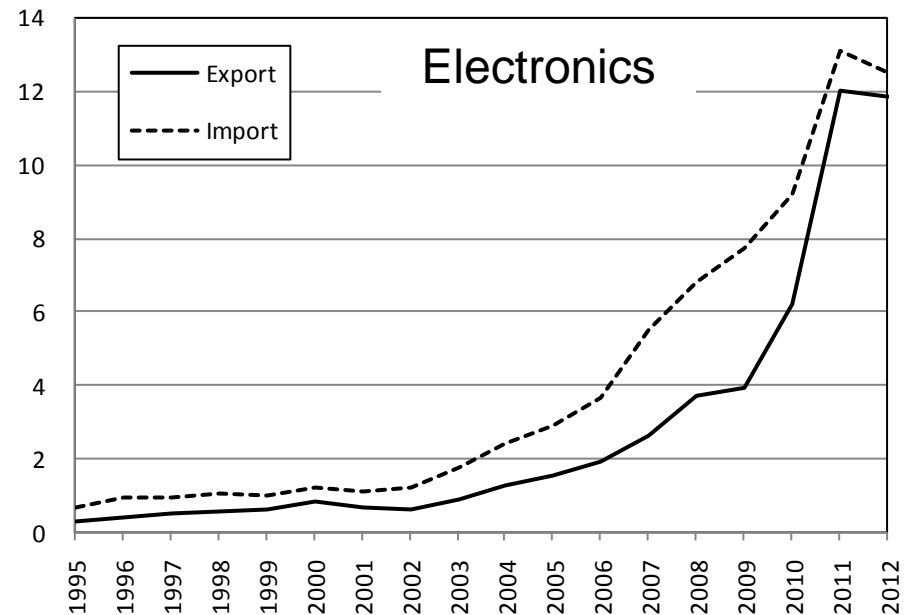
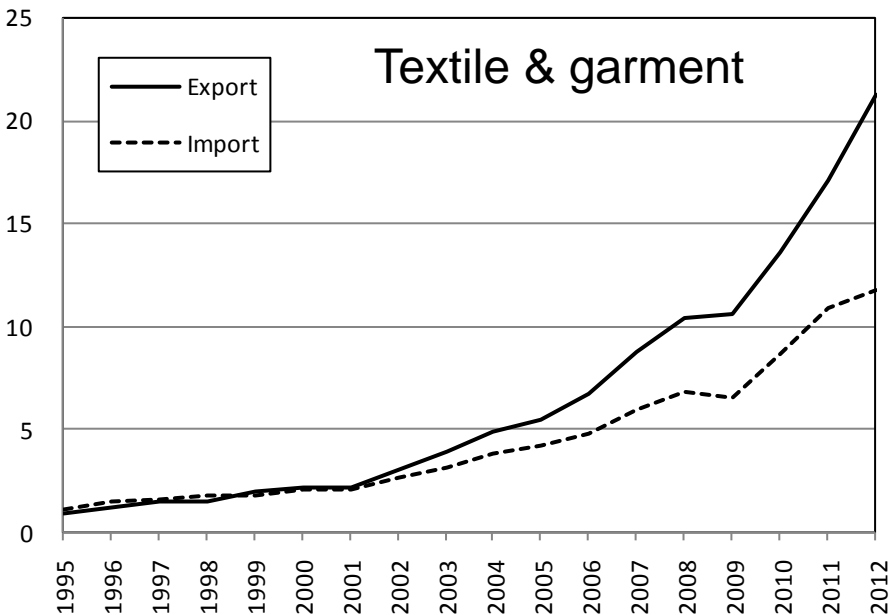
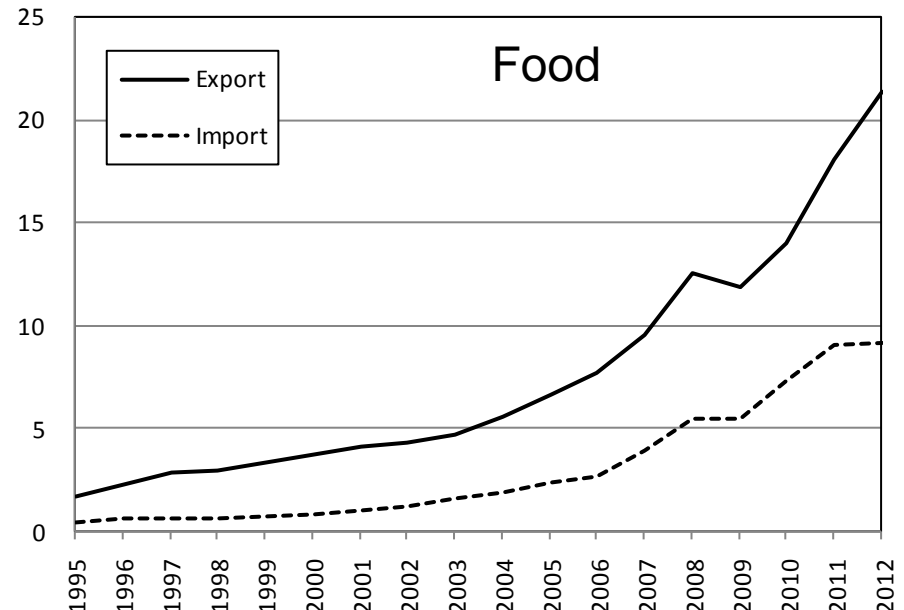
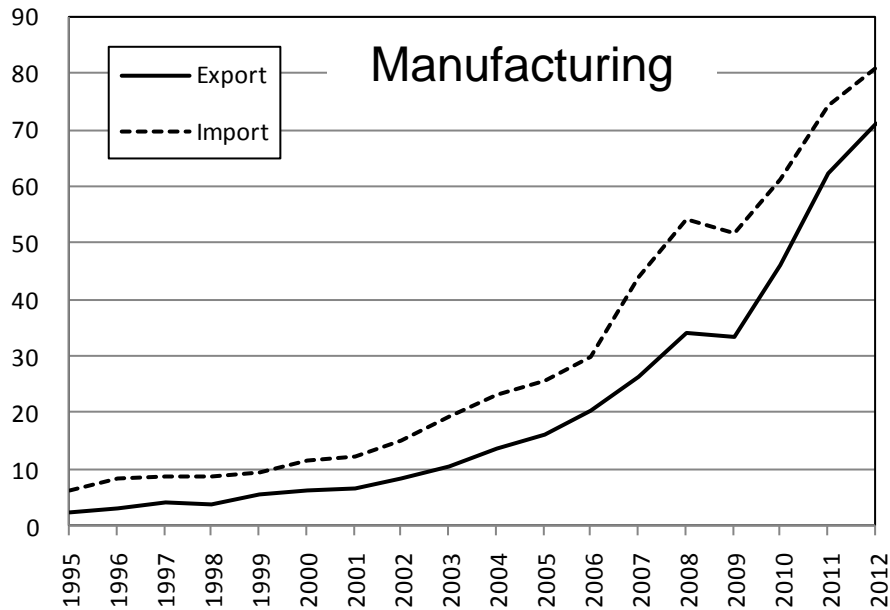
Export structure seems industrializing, but...

Net Export: FDI vs. Domestic Sector



- FDI is a net exporter while the domestic sector is a net importer.
- Import surge in 2008 was due to consumption & construction boom, not manufacturing inputs (no output surge in 2008).

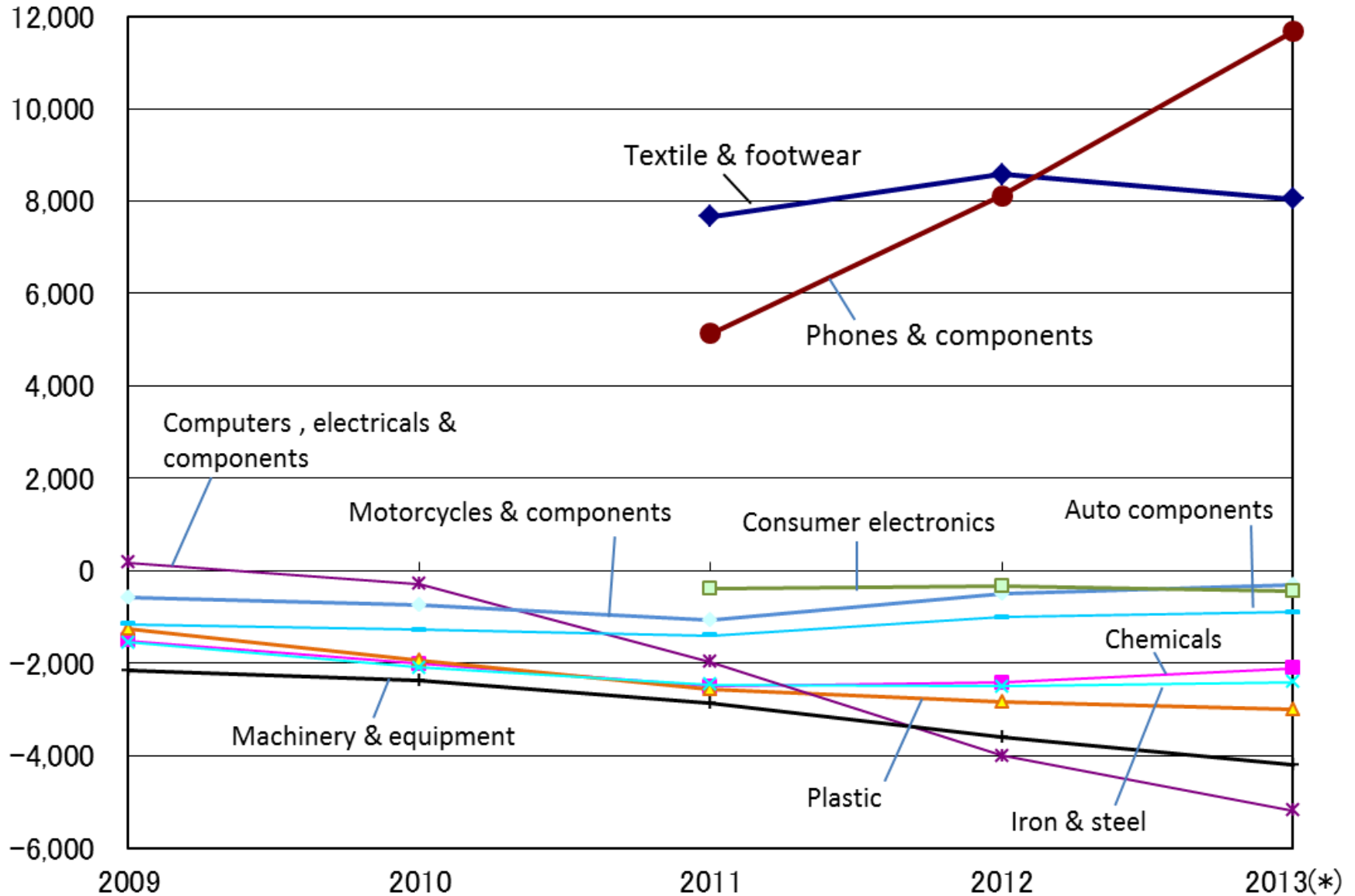
Export & Import for Selected Sectors



Net Export by Product

(USING VIETNAM CUSTOMS DATA)

USD million



4. Stagnant Global Ranking

- Vietnam ranks low to medium in economic ranking.
- No improving trend is visible in recent years.

	Global Competitiveness Ranking, World Economic Forum	Ease of Doing Business, World Bank	Index of Economic Freedom, Economic Freedom of the World
No. of countries	144	See below	154
2006	77	99/155	99
2007	68	104/175	105
2008	70	91/178	107
2009	75	92/181	93
2010	59	93/183	102
2011	65	78/183	122
2012	75	98/183	...
2013	70	99/185	...

World Bank's Doing Business Ranking

	2006	2007	2008	2009	2010	2011	2012	2013	2014
Singapore	2	1	1	1	1	1	1	1	1
Hong Kong	7	5	4	4	3	2	2	2	2
Malaysia	21	25	24	20	23	21	18	12	6
Korea	27	23	30	23	19	16	8	8	7
Taiwan	35	47	50	61	46	33	25	16	16
Thailand	20	18	15	13	12	19	17	18	18
Mauritius	23	32	27	24	17	20	23	19	20
Japan	10	11	12	12	15	18	20	24	27
Rwanda	139	158	150	139	67	58	45	52	32
Tunisia	58	80	88	73	69	55	46	50	51
Morocco	102	115	129	128	128	114	94	97	87
China	91	93	83	83	89	79	91	91	96
Vietnam	99	104	91	92	93	78	98	99	99
Philippines	113	126	133	140	144	148	136	138	108
Indonesia	115	135	123	129	122	121	129	128	120
Ethiopia	101	97	102	116	107	104	111	127	125
Egypt	141	165	126	114	106	94	110	109	128
Bangladesh	65	88	107	110	119	107	122	129	130
India	116	134	120	122	133	134	132	132	134
Cambodia	133	143	145	135	145	147	138	133	137
Myanmar	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	182
Total number of countries & areas	155	175	178	181	183	183	183	185	189



Source: World Bank Doing Business Report 2006-2014. The survey was initiated in 2004 and began to be published in 2006.

5. Growth-caused Problems

- Vietnam now faces income & asset gaps, inflation, stock & land bubbles, congestion, environment damage, corruption...
- Land price in Hanoi is equivalent to Tokyo suburbs, but Vietnam's per capita income is only 1/30th of Japan's.

Land Prices in Hanoi and Tokyo, 2012

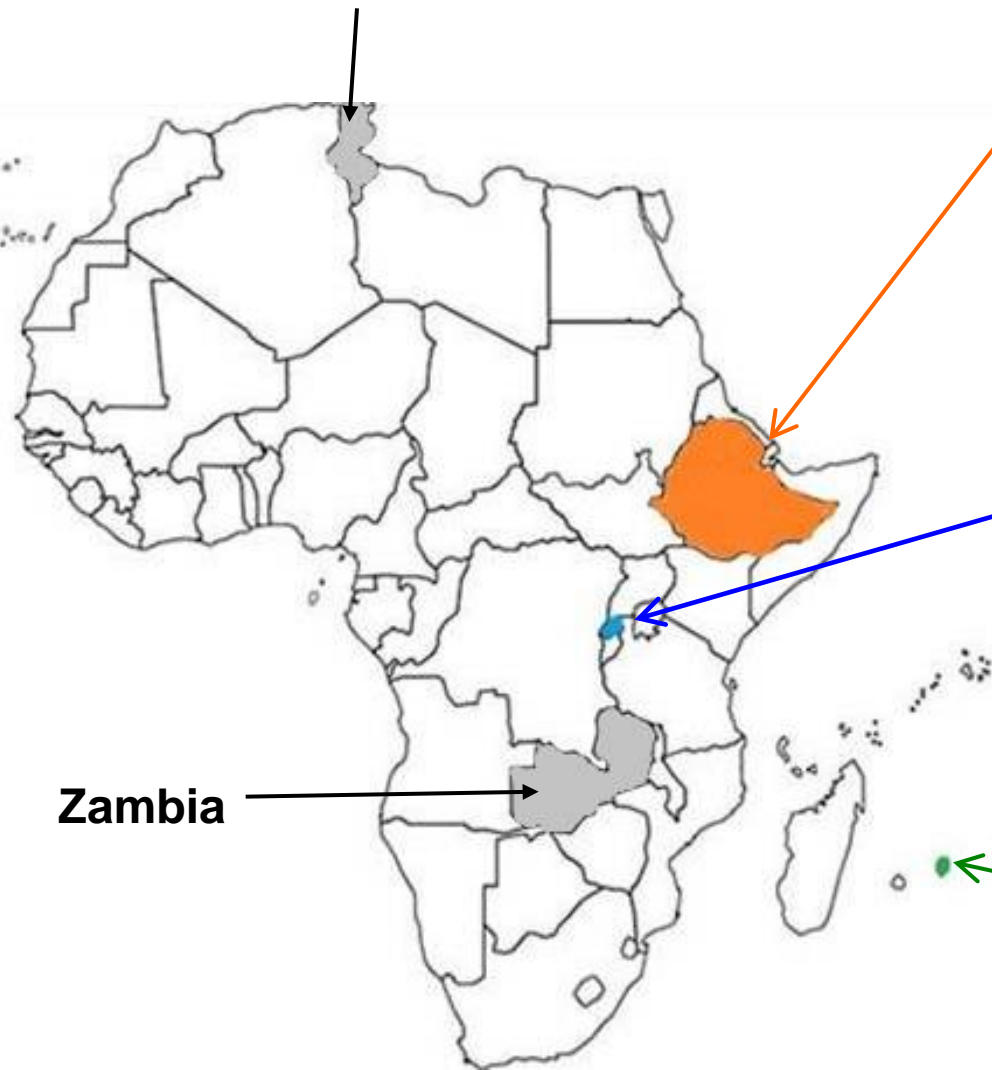
Hanoi		Tokyo		
Location	USD/m ²	Location	USD/m ²	Remark
Pho Co	38,406	Ginza (Chuo-ku)	240,244	Commercial/CBD
Ba Dinh	5,425	Kabukicho (Shinjuku-ku)	54,268	Commercial/CBD
Dong Da	3,217	Hongo (Bunkyo-ku)	18,171	Academic/residential
Hai Ba Trung	3,505	Shirokanedai (Minato-ku)	12,683	Uptown residential
Tay Ho	2,496	Iidabashi (Chiyoda-ku)	11,951	Commercial/residential
Cau Giay	4,993	Yutenji (Meguro-ku)	7,500	Uptown residential
Hoang Mai	2,256	Toyochō (Koto-ku)	5,293	Residential
Long Bien	2,400	Zenpukuji (Suginami-ku)	5,183	Residential
H. Dong Anh	576	Akebonocho (Tachikawa City)	3,659	Residential
H. Gia Lam	816	Asahigaoka (Hino City)	2,512	Residential

Sources: Mua & Ban Newspaper (Nov.12, 2012), Ministry of Land, Infrastructure, Transport & Tourism (July 2012).

International Comparison of Policy Quality

- GRIPS Development Forum & Vietnam Development Forum have visited Asia and Africa to compare policy quality.
- **Asia**—Japan, Vietnam, Singapore, Taiwan, Korea, Malaysia, Thailand, Indonesia, India, (Bangladesh)
- **Africa**—Ethiopia, Rwanda, Mauritius, Mozambique, Zambia, Tanzania, Ghana, Uganda
- We evaluate the **quality of industrial policy** by examining policy formulation, implementation and impact. Good performance due to private effort, foreign assistance or sheer luck is not counted as “good policy.”
- Asia is not always superior to Africa. Some African countries have far better industrial policy than Vietnam (Mauritius, Rwanda, Ethiopia; ... maybe Tunisia & Zambia also).

Tunisia



Ethiopia

Population – 94 million
Per capita income – \$470
Unskilled wage – \$50/month
Main exports – coffee, sesame, roses, garment, shoes
Beginning to attract Turkish, Indian & Chinese manuf. FDI; policy learning from Japan

Rwanda

Population – 12 million
Per capita income – \$620
Unskilled wage - \$75/mo.
Main exports – coffee, tea
ICT drive, no corruption, clean streets, targeting Singapore

Zambia

Mauritius

Population – 1.3 million
Per capita income – \$9,210
Unskilled wage - \$300-400/mo.
Main exports – garment, sugar
A small island nation with very competent government

Note: World Bank data for population and income (2013).

Overview of Selected Asian Economies

	Per capita income (WB, 2013)	World Bank income classification	History of industrialization (approximately)	Industrial policy quality (GDF evaluation)
Singapore	\$54,040	High	Five decades	Excellent
Taiwan	\$20,930	High	Six decades	Very high
Malaysia	\$10,400	Upper middle	Six decades	High
Thailand	\$5,370	Upper middle	5.5 decades	Moderate & spotty
Indonesia	\$3,580	Lower middle	Five decades	Poor
Vietnam	\$1,730	Lower middle	Two decades	Poor
India	\$1,570	Lower middle	Two decades	Poor
Ethiopia	\$500	Low	One decade	Improving...

Note: Taiwan's income is from IMF. India's industrialization history counts post-planning years only.

Income Performance vs. Quality of Industrial Policy

Very good
Good
Fair
Fail

	Per capita income (WB, 2013, USD)	Ease of Doing Business ranking (WB, 2013, among 189 countries)	Industrial policy assessment by GDF (industrial human resource & enterprise support)							
			Overall	Human resource	Supporting industries	Manufacturing SMEs	Export promotion	FDI policy	Industrial parks	Productivity & innovation
Singapore	\$54,040	1	A+							
Taiwan	\$20,930	16	A		NA			NA		
Malaysia	\$10,400	6	B							
Thailand	\$5,370	18	B-							
Indonesia	\$3,580	120	D							
Vietnam	\$1,730	99	D							
India	\$1,570	134	D							

Note: Policy assessment excludes results of external factors, private effort or foreign support.

Business Environment

	WB Ease of Doing Business Ranking 2013	Remark
Singapore	1	World's top business location since 2007.
Taiwan	16	Reliable environment with low corporate income tax (17%); No investment incentives except for R&D.
Malaysia	6	MIDA provides good services & support.
Thailand	18	Board of Investment supports investors well; policies are reasonably stable & predictable.
Rwanda	32	Good national image creation based on ICT. Excellent one-stop service copied from Singapore.
Indonesia	120	Laws & regulations are unpredictable, unclear & without stakeholder consultation
Vietnam	99	Improving slowly since mid 1990s, but irregularities still abound.
India	134	FDI deregulation & industrial zones underway. Generally very difficult business climate.
Ethiopia	125	Government's commitment & policy effort are laudable, but many business barriers remain.

Note: World Bank's Ease of Doing Business ranking among 189 countries and areas benchmarked to June 2013.

FDI, SME & Industrial Zone Policies

Partial summary of assessment by GRIPS Development Forum based on site visits and interviews with officials, private sector, researchers, zone operators and tenant firms

	FDI policy	Manufacturing SME promotion & linkage	Industrial zones
Singapore	Highly strategic based on individual deals	Productivity support for targeted segments	State-owned & strategic; overseas expansion
Taiwan	(No longer important; outward bound)	Highly developed and effective	World model state-owned science parks & EPZs
Malaysia	High-tech orientation	Well-coordinated but results to be seen	Reasonably good
Thailand	Shifting to high-tech orientation	Generally weak except auto part suppliers	Many private IZs (AMATA...); modest state-management
Indonesia	Restrictive & unfriendly; nationalistic	Many scattered policies but ineffective; clusters	Left to private sector
Vietnam	Irregular though slowly improving	Almost none despite JICA/JETRO support	Many state, provincial, private IZs but many are plan only
India	Restrictive; only slowly opening	Almost none at policy level	State-managed; very hard land procurement
Ethiopia	Improving...	Generally weak except textile, leather, kaizen...	Initial zones under construction

Indonesia (pc income \$3,580)



- A large population (250 million) and strong domestic demand attract FDI that produce cars & consumer goods. However, Indonesia is **not an export base** for manufactured products.
- From 2000 to 2010, manufacturing share fell from 27.7% of GDP to 24.8%, and from 57.1% of export to 37.5% (WB data).
- **Economic nationalism** is on the rise. FDI policy is becoming more restrictive instead of opening up.
- Planning (BAPPENAS) and investor service (BKPM) are good, but the **Ministry of Industry** is weak and sub-divided. SME & TVET policies are fragmented. No support exists for industrial zones, supporting industries, productivity or innovation.
- **Decentralization** makes it difficult for central government to execute industrial policy nationwide.
- Jakarta suffers from **severe traffic jam** and port & airport congestion (Japan is offering to build infrastructure).

Jakarta's traffic



Ministry of Industry



BKPM (investor service)



BAPPENAS (planning)



Strong consumer demand

Vietnam (pc income \$1,730)



- After Doi Moi & integration, Vietnam grew fast and reached lower middle income around 2008. But domestic value creation is stagnant. There are signs of an approaching middle income trap.
 - Vietnam lacks both will & capacity to promote industrialization compared with high performers in Asia and Africa.
 - TVET, SME and supporting industry policies are still weak. Export, FDI and industrial parks are not effectively supported. Policies for productivity, kaizen, and innovation are virtually nonexistent.
 - If nothing changes, it is certain that Vietnam will be caught in a middle income trap. It is already starting.
- ➔ Is Vietnam following Indonesia with a few decades lag???**



Vincom Royal City



New Highway (HCM-Dong Nai)



Lotte Center



Industrial University of HCMC



Industrial park



Human-robot collaboration



Rwanda (pc income \$620)



- The 1994 genocide killed 1/10 of population and devastated the nation. The economy began to recover from around 2002.
- Strong and serious **President Paul Kagame** (since 2000) runs a developmental state promoting high-value services (ICT, telecom, finance, tourism, etc.), **benchmarking Singapore**.
- There is **no corruption**, and all ministers and technocrats are competent and hard working. Everyone must make an annual pledge and results are monitored (performance contract).
- Streets are **clean & safe**. Plastic bags are prohibited. Everyone must clean streets on last Saturday of each month.
- One-stop investor service is efficient (Singapore model). Rwanda now has an image of ICT-based **African Miracle**. However, policy implementation and impact are still weak.



Kigali (capital) is a hill town.



ICT incubation center



Government strictly regulates motorbike taxis



New convention Center for conference industry



Everyone must pick up rubbish



Ethiopia (pc income \$470)



- Industrial effort began around 2002. Ethiopia wants to learn industrialization from **East Asia**, not the West. It studied from Taiwan, Korea, Germany, Italy & UNIDO. Since 2008, it has regular policy dialogues with Japan (GRIPS-JICA).
- Ethiopia's vision: to attain middle income and become **Africa's leading nation in light manufacturing** by 2025. It also wants to become the Kaizen Center of Africa.
- The will to industrialize is very strong. Policy drafting and execution are very fast. **National Kaizen Fever** is going on.
- **Textile, Leather & Kaizen Institutes** were established to help industries. Japan and India are assisting. China is building roads, railroads, telecom, etc.
- India, Turkey & China are relocating their garment & footwear factories to Ethiopia. From these three countries, over 1,500 FDI firms have registered, with about 500 in operation.

Ayka—a Turkish garment maker, vertically integrated, employing 7,000 workers & expanding to 12,000



FDI activities



Eastern Industrial Zone developed by China

State-run & World Bank-supported industrial zone



Local Firms (JICA-supported kaizen introduced)



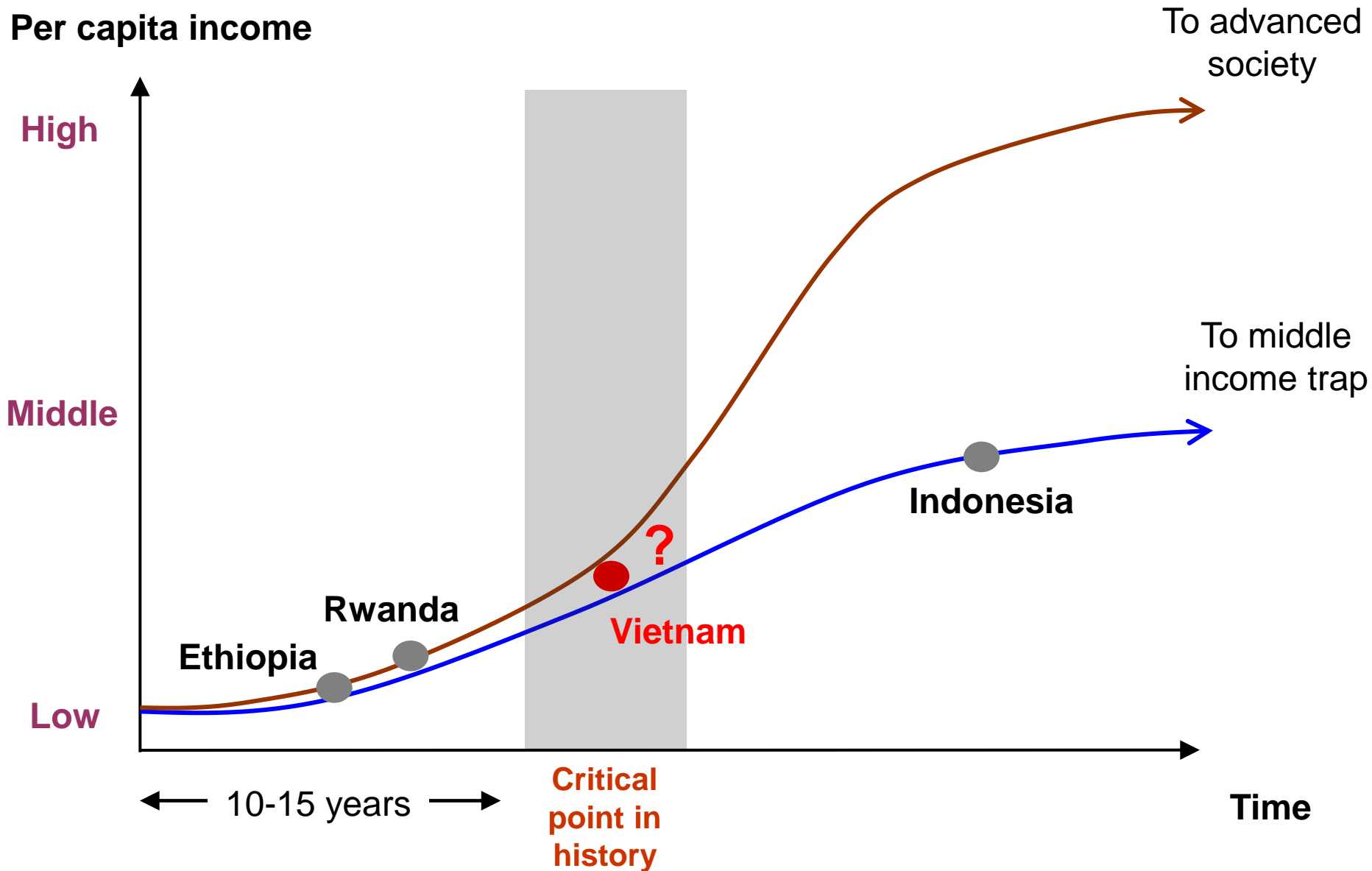
Tire factory



PVC pipe factory



A Critical Moment for Vietnam



A Proposed Policy Structure for Industrialization

Vision: Vietnam is a fully industrialized country by 2020

Targets for 2020 and beyond

- Manufacturing value-added per head
- Net manufacturing export
- Champion products with high domestic value-added
- Sufficient number of engineers (both quality & quantity)

Policy areas (for FDI-linked technology transfer):

1. Strategic attraction of FDI

- General improvement of business climate
- Strategic marketing (bring targeted FDI by negotiation)
- One-stop service
- Hard & soft infrastructure
- Industrial parks
- Reform investment laws, MPI/FIA...



3. Linkage policy

- Incentives & policy support for linkage
- Matching of business & JV partners
- Effective follow-up & monitoring

2. Local enterprise capacity building

- Kaizen & shindan
- Benchmarking
- Export promotion
- Handholding
- Management training
- Sector-specific QCD & TT
- Strengthening agencies & institutes incl. IPSI

Policy areas (cross-cutting):

4. Efficient logistics

- Transport infra. & systems
- Fast & reliable customs, etc.

5. Industrial HR

- TVET
- Universities
- Industry-univ. cooperation