

## MAIN REPORT

# Introduction

(Preliminary draft for internal discussion)

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[This is a preliminary draft for “Introduction” of our Main Report. Ideas contained below are proposed to form our main conclusions. All research members of the NEU-JICA project should carefully examine them. Any comments or suggestions should be communicated to Chuong or Ohno as soon as possible. This draft will be revised as many times as necessary.]

### 1. Background

How to achieve industrialization while vigorously pursuing trade and investment liberalization is a big question for all developing countries including Vietnam. Following doi moi reform in the late 1980s, Vietnam drastically opened its economy in the early 1990s. Since then, the integration process has proceeded rapidly.

In the last ten years, Vietnam experienced large inflows of FDI and ODA, entry into ASEAN and APEC, ongoing negotiations for WTO accession, the Asian crisis and its aftermath, and accelerating competition in trade and FDI attraction with its neighbors, especially China. These external factors stimulated growth as well as forced changes on the Vietnamese economy and society.

From early on, Vietnamese policy makers and business leaders were largely aware of the opportunities and risks of international integration. They understood that integration was essential for systemic reforms and economic development, but serious preparations were needed to meet this challenge effectively. The importance of having realistic and consistent policies for development has been emphasized. The Vietnamese government also knows that, in principle, extreme policies such as big bang liberalization or reversion to control are impractical and undesirable. It recognizes that market and government must be combined properly.

Up to now, however, the Vietnamese government and business community have not presented sufficiently concrete industrial strategies suitable for the age of integration, nor has the identification of candidate industries for promotion (or downsizing) been made. Meanwhile, the AFTA deadline of 2006 is approaching and WTO accession talks and tariffication of non-tariff barriers are continuing. Without a clear industrial vision, industrial policy cannot be designed effectively and coherent tariff structure cannot be proposed to WTO. The lack of a predictable industrial vision greatly increases uncertainty associated with

business plans of both domestic and foreign enterprises.

Vietnam is willing to integrate, but preparations remain incomplete. The joint research project by National Economic University and Japan International Cooperation Agency was organized in Summer 2000 to produce real-sector studies that could help overcome this problem. In this project, Vietnamese and Japanese researchers join hands to produce intellectual inputs for policy makers, which are concrete, realistic and suitable for Vietnam's particular situation. This book is an interim report of our ongoing joint research effort.<sup>1</sup>

## 2. Methodology

Economic theory is useful and necessary as general guidelines, but not concrete enough to answer the urgent and practical questions that the Vietnamese industries actually face. Theory must be supplemented by in-depth and up-to-date studies of domestic industries as well as global market trends.

In the global aid community today, poverty reduction is considered to be the primary goal as well as the most effective means of development. In addition, improvement of the development process—strengthening partnership, transparency, accountability, ownership, empowerment, etc—is regarded as high priority. We support these ideas, but we think they are not enough. In addition to fight against poverty and procedural reforms, we believe policy makers should pay much more attention to the real-sector issues, analyzing them deeply and realistically with the help of Vietnamese and foreign experts. Without thorough understanding of Vietnam's industrial position in the context of global competition, no realistic industrial strategy can be designed or implemented. Without industrial strength, poverty reduction is very difficult to achieve. Growth orientation may be a bit old-fashioned in the global aid community, but it is crucial for Vietnam.

Basic trade theory (comparative advantage) is shared by all economists. Our researchers are also highly proficient in latest trade and investment theories. But policy implementation requires more than just a model or a regression. As we try to propose viable policy options, primary emphasis is placed on gathering concrete facts and discussing actual problems, rather than general advice or additional theoretical modeling. We try to stay away from preconceived conclusions not firmly based on local facts.

We spend much time visiting managers, merchants, markets, factories, trade villages, officials and foreign investors. We rely heavily on questionnaires and interviews. Technical experts often accompany us to advise on the way to consolidate or upgrade production facilities. International trading companies help us to evaluate the domestic market as well as

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<sup>1</sup> For more details of the NEU-JICA project, visit our website: <http://www.neujica.org.vn>.

the marketability of Vietnamese products. We find interaction of experts from various backgrounds extremely stimulating and fruitful. Policy dialog with key officials responsible for Vietnam's industrial policy is an integral part of our project. When prior theoretical knowledge is combined with intensive examination of specific industries, policy recommendations for Vietnam's particular problems can be generated and meaningful preparations for international integration can be made.

### 3. Toward truly joint research

We would like to avoid one-way flow of advice from foreigners to Vietnamese. Our project aims to be truly mutual and cooperative.

NEU and JICA researchers conduct research as equal academic partners. Both sides share the responsibility for the quality of output, from project design to final dissemination. We conduct joint research trips and discuss the contents of main papers intensively and repeatedly. Vietnamese and Japanese research styles differ, which adds to the complexity of our project. Compared with the unilateral approach, this is much more time consuming. But we believe this is the right way to do research internationally. Our project is part of the ongoing and never-ending research on Vietnam's industrialization. Much more has to be done in the future. We consider the very process of this cooperative research to be important, apart from whatever tentative conclusions we reach.

### 4. Shifting global environment

Vietnam must simultaneously achieve economic development, systemic transition and international integration. External influences including foreign competition, trade, FDI, ODA, global recession and regional crisis are reshaping Vietnam's economy and society today. The need to integrate positively is widely recognized among Vietnamese officials and business leaders, but the country's capability to cope with foreign competition is underdeveloped in both public and private sectors. Technological and institutional gaps are still large, and it is not easy for Vietnamese industries to compete with China, NIEs or developed countries without protection.

Nevertheless, there is no way but forward. Vietnam must integrate, and discussion should now focus on the concrete method and sequencing of integration. As a first step, the global market into which Vietnam is integrating must be studied very carefully. Among many factors, those that have significant bearings on Vietnam must be recognized.

First, integration pressure has intensified recently. Not just developed and middle-income countries but also very latecomer countries are required to liberalize domestic economies and adopt "international best practice." The main reason for this trend is the

dominance of the US economy after the collapse of USSR.

Second, the Asian crisis forced rethinking of development strategies in the region. While the immediate crisis impact is over (except perhaps Indonesia), NIEs and ASEAN began to re-examine their policies in the aftermath. Rethinking is taking a complex form. Trade and FDI liberalization is partly accelerated but partly slowed down. Some countries are willing to accept American standards while others are more careful. Financial sector reforms are emphasized while real-sector weaknesses are also recognized.

Third, China is emerging as a global factory. In the last few years, China overcame weak domestic demand and is now attracting a large amount of FDI and strengthening its export competitiveness. In Southern China, concentration of foreign producers and their parts suppliers is generating a virtuous circle. Although China also faces the problem of industrial restructuring and SOE reform as it enters WTO, it will certainly remain the most formidable competitor for Vietnamese producers in both domestic and overseas markets.

Fourth, Japan's external economic policies are changing. Japan is the largest trading partner and ODA provider for Vietnam. However, recent shifts in Japanese policies are not very favorable for Vietnam. They include reduction of ODA due to fiscal crisis (although how much will be cut for Vietnam is uncertain) and rising protection for domestic producers including the recent imposition of safeguards on goods mainly imported from China (Vietnam's garments and towels are also potential targets).

Fifth, the US economy is likely to have more influence on Vietnam in the future. During much of the 1990s, the US economy was buoyant thanks to IT revolution and asset inflation. Now the tide has turned and Asia's export-oriented economies (especially IT equipment producers) are hit hard. With the bilateral trade agreement, Vietnam is about to link more heavily with the US when the world is entering into recession. [Also discuss EU]

## 5. The need for an industrial blueprint

Vietnam needs to move strongly toward a full-fledged market economy as a long-term goal, but we do not believe activation of full market forces at this low stage of development will necessarily yield good results. Rapid external opening without due preparation as well as bold economic liberalization without necessary policies and institutions should be avoided. Market-oriented measures must be introduced with proper speed and sequencing. The way to mix market and government should be balanced and flexible. The government should not replace markets but enhance its development and mend its weaknesses.

In a low-income country with underdeveloped markets like Vietnam, there should be a coherent and concrete national development strategy encompassing trade, FDI, SOE reform, SMEs, banking, securities markets, exchange rate, budget, money, etc. in order to provide policy consistency and private-sector guidance. The primary goal should be real-sector

development while financial-sector concerns are also important but secondary in supporting the primary goal. It should not be vice versa.

Laissez-faire policy does not work if markets and the private sector are underdeveloped. Even developed markets often exhibit high instability, let alone undeveloped ones. In Vietnam, the cycle of boom and bust, accompanied by over-investment and over-capacity, is visible in many industries. Domestic mistakes are multiplied when the country is globally integrated. The question is not whether government should intervene in market activities but how and when it should do so. The skillfulness of intervention will determine the success or failure of Vietnam's industrialization and modernization.

In Vietnam the government and ministries already have five-year plans, ten-year strategies, and other strategies for specific industries. The quality of these strategies is far from satisfactory. Currently, most industrial strategies remain no more than hopeful quantitative plans for future output and investment. What is lacking is evaluation of such plans in the context of fierce global competition. Realistic strategies must be firmly based on the analyses of market trends, technological changes and cost comparison in the world economy. Few of the present strategies can lead industries into the age of integration.

Vietnam should formulate a comprehensive and concrete long-term development strategy for the entire economy. In addition, each key industry should have a concrete and realistic development strategy, with limited and temporary protection if necessary, consistent with the overall national strategy. All economic policies including trade, FDI, SOEs, SMEs, banking, rural development, etc. should be integrated under a coherent industrial vision.

## 6. Different policies for different industries

Vietnam cannot promote all industries. Therefore prioritization is necessary. Different types of industries should be distinguished since they require different types of policies. Export promotion and import substitution are not necessarily mutually exclusive. They can proceed in parallel.

Given Vietnam's initial conditions, exports of labor- and skill-intensive products should be the first priority. Following that, conditional support for carefully selected import-substitution industries should be the second priority. As to the IT industry, official targets are too ambitious and should be deflated.

First priority: garment and footwear, electronics, and food processing: These three are the industries with clear dynamic comparative advantages. If successfully supported, they will surely be the main export base by 2020 [projections of export, output and labor structure up to 2020 will be attempted in Chapter 1]. These industries are already growing quantitatively, but their growth may stall and technology transfer may be hindered if wrong policies are taken. By contrast, good policies can accelerate their growth and make them

firmly rooted in Vietnam's own skills and management.

For the development of these industries, FDI is crucial. Under the fierce global competition, Vietnam by itself cannot compete effectively in these industries. This does not however mean that Vietnam will forever be the supplier of cheap labor force. Over time, Vietnam's strength in technology, design and marketing can be improved. But that will require proper sequencing of policies.

For export-oriented labor- and skill-intensive industries, the proper sequencing should be (i) accumulation of assembly-type FDI as much as possible ("agglomeration"); (ii) invitation of supporting industries which supply parts to these assemblers; and (iii) gradual absorption of technology and management skills by the Vietnamese. In short, industrial base must be first broadened, then deepened, and finally improved. The reverse order will not work. China has emerged thanks to the successful execution of steps (i) and (ii). In Southern China, assemblers and parts suppliers are mutually reinforcing to produce an expansionary virtuous circle. But even in China, technology transfer takes much time.

In Vietnam, first signs of agglomeration are visible in garment and electronics. However, official policies remain inappropriate. The biggest problem is local contents requirement that not only violates WTO but goes against the proper sequencing described above. Attempts to increase value-added will fail if FDI agglomeration is insufficient. Since foreign parts suppliers are unlikely to invest in markets where demand is small, assemblers will be forced to (i) ask for high import protection, (ii) continue to use expensive imported parts, or (iii) exit from Vietnam. Local contents requirements should be removed, and all export-oriented FDI should be welcomed regardless of value-added contents and under a low and neutral trade protection. For their promotion, neither high protection, generous incentives, nor huge public investment is required (Vietnam may already be giving too much incentives to FDI). What is important is removal of policy uncertainties and irregularities to ensure a stable and predictable business environment for all investors, domestic or foreign.

Second priority: heavy material industries including steel, cement, paper, chemicals, etc. For these import-substituting industries, official support should be given conditionally and with caution. There is no guarantee that they will survive the age of integration, and probably many of them will disappear. The ultimate verdict must be given by market forces. But the government can help in three ways: (i) helping them formulate a proper strategy; (ii) providing limited support and protection; and (iii) amelioration of transitional pain if they fail.

These industries should be supported for limited time and amounts only, with budget expenditure and import protection if necessary, provided that they have a realistic and concrete long-term development strategy. Realistic here means being able to compete in an integrated world without permanent protection or social cost. In order to assess such potentiality, a large amount of technical, financial, marketing and managerial information

needs to be collected on the industry as well as relevant global trends.

In supporting weak industries, one perennial problem is political capture by interest groups. All too often, inefficient industries are protected permanently at the cost of the national economy under an intense political pressure. There should be a mechanism to prevent this. Decisions to protect must be made openly and by operational criteria. The amount and length of protection must be properly calculated. The sunset clause—to terminate protection after a pre-specified period—must be pre-announced and adhered to. There should be no extension of protection whether the promotion succeeds or fails.

Be more realistic about the IT industry: The Vietnamese government designates software as a high priority industry. Establishment of a high-tech park is also envisioned. We understand the need to upgrade Vietnam's technology in the age of IT. However, given the current level of economic development, IT is unlikely to be among the leading industries of Vietnam in the foreseeable future. This does not mean that Vietnam should ignore IT. But investment in and expectations of IT should be balanced with other needs of the national economy.

The meaning of IT should be clarified in Vietnam. IT has many dimensions including internet and mobile phone use, software production, computer literacy of general public, production of IT devices, use of IT to improve business efficiency, etc. Vietnam should identify which aspect is most crucial for the country. Some IT uses may spread without official intervention. Others may not deserve public support. At any rate, IT policy should be integrated in the context of a broader development strategy. With a clearer focus, the IT industry may be supported with properly targeted budgeting, training and education.

## 7. Integration risk management

Global integration entails both opportunities and risks. With greater external exposure, global shocks are transmitted to the national economy. Furthermore, domestic problems may be amplified. In the Asian crisis, domestic banking problems led to huge foreign overborrowing and subsequent macroeconomic collapse. Economic management must take these new risks into account.<sup>2</sup>

One of the most serious risks is the worsening of boom-and-bust cycles. In any economy, firms over-invest in good times and suffer from over-capacity in bad times. But these cycles may become more pronounced under integration. First, FDI may reinforce these trends rather than dampen them. Second, global price swings may trigger large domestic

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<sup>2</sup> In the Asian crisis, the most severely hit economies were financially open. Since Vietnam still remains financially insulated, external financial disturbances (such as speculative attacks, asset bubbles and interest rate fluctuations) are unlikely to be transmitted from abroad. But real-sector shocks are possible as discussed in the text.

over-investment.<sup>3</sup> Third, the possibility of foreign borrowing may accelerate over-investment. When the private sector (including FDI) exhibits unsubstantiated exuberance, government may slow it down through warning signals as well as some form of taxation and penalty. It may even wish to coordinate public and private investment more directly.

Another serious integration risk is the adverse impact of global price fluctuations and recessions. Even with restrained investment, global economic cycles will become a major source of disturbance beyond the control of the national government. Primary commodities and electronic goods—which are key export items for Vietnam—both exhibit large price fluctuations.

The Dutch disease may also affect the Vietnamese economy. Traditionally, the Dutch disease is a situation where the manufacturing sector is suppressed due to the rapid growth of an extractive sector (oil, natural gas, minerals, etc). This occurs through overvaluation of the exchange rate caused by large inflows of foreign exchange earnings.<sup>4</sup> But more generally, the Dutch disease may occur when too much FDI or ODA is received relative to absorptive capacity, or when primary commodity prices surge. At present, Vietnam's FDI and ODA do not seem to crowd out other domestic investments; rather, they play a catalytic role in stimulating more investment in a labor-abundant economy. But government may still wish to monitor the possibility of the Dutch disease in Vietnam's development process.

## 8. WTO entry strategy

The realistic target for WTO accession may be around 2005-06, if not later. Vietnam should prepare the following so as to join WTO with as much benefits and with "ownership."

First, long-term development strategies for the macroeconomy as well as for individual industries must be established (see above) in order to use trade liberalization in a most conducive way to Vietnam's development. WTO must be one key factor in the broad development framework and entry negotiations should be conducted from this perspective. If it is desirable for some industries to delay trade liberalization beyond what WTO (or AFTA) normally permits, realistic promotion plans accompanied by a pre-committed sunset clause should be presented. (But whether WTO will accept such exceptions is not certain.)

Second, market access and systemic convergence are often required of new entry members, but negotiations for them should be done carefully and case by case. From a theoretical viewpoint, the case for accepting these conditions immediately is not strong.

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<sup>3</sup> For example, when international coffee prices rose, Vietnamese coffee supply responded very strongly. Now that their prices have plunged, the domestic producers are forced to scale down.

<sup>4</sup> More theoretically, the Dutch disease is associated with a shift in the relative price of tradables to nontradables as well as the movement of domestic resources (such as labor) away from the non-extractive tradable sector.



Third, WTO does not always treat newcomers fairly. An applicant's position vis-à-vis existing members is very weak, and some large countries use this opportunity to their commercial advantage by prying open newcomers' markets as a precondition for entry. Moreover, WTO regularly imposes bolder and faster trade liberalization on new LDC members compared with existing LDC members in similar stages of development. Vietnam should distinguish WTO's legitimate requirements and inconsistencies. If unfair treatment of latecomers is detected, Vietnam may choose to appeal internationally in cooperation with countries saddled with similar disadvantages.

## 9. Capacity building through actual industrial promotion

Requirements for successful integration are many, but Vietnam's domestic capability is at present limited. Both government and business leaders are ill-prepared for integration. There is a clear need to improve their capability but the question is how to achieve it. We have two suggestions.

First, the best way to learn is to do it actually. Instead of arguing general merits and demerits of industrial policy forever, Vietnam should now start to formulate sharply focused measures suitable for the age of integration for a few selected industries. At first, information may be lacking and foreign assistance may be needed. Coordination within government may take time and mistakes will be made along the way. However, the hands-on approach is the only way to internalize operational policy skill. One successful case will give much pride and confidence to the nation. Even mistakes can be good lessons. Rather than endless conferences and seminars, there should be a taskforce to design and implement actual policies.

Second, in order to execute this learning-by-doing strategy, official administration should be reformed. At present, economic policymaking is too diffused and incoherent. For WTO negotiations, SOE reform and others, too many ministries and organs are involved; as a result, no one takes the responsibility or leadership. We propose to create an elite policy team directly under Prime Minister to design and coordinate all key economic policies (relevant ministries may actually execute them). The best young people from various ministries and academia should be assembled. The team should be given full authority and confidence of Prime Minister. Such a team existed in many NIEs to implement their development policies.

[END]