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ECONOMICS AND RESEARCH DEPARTMENT

No. 56

Viet Nam: Foreign Direct Investment and Postcrisis Regional Integration

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September 2004

Asian Development Bank

http://www.adb.org/Economics

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September 2004
ISSN 1655-5252

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FOREWORD

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CONTENTS

Abstract		vii
I.	Introduction	1
II.	Recent Trends and Developments in FDI in Viet Nam	1
III.	The Impact of FDI	9
IV.	Policy Regimes, Business Environment, and Trade-related Issues	15
V.	Regional Integration and Specialization Analyses	19
VI.	Conclusions	23
	References	24

ABSTRACT

Since Viet Nam started its transition from a centrally planned economy to a socialist-oriented market economy, many reforms have been implemented. The Foreign Investment Law signaled an important step toward Viet Nam's integration in the regional and international economic systems. The relatively low amount of foreign investment relative to other countries in East and Southeast Asia made more evident the necessity of a new set of reforms in order to compete with Asian neighbors, and principally with People's Republic of China, in the attraction of foreign direct investment. Even if foreign capital contributed in many important ways to the growth that Viet Nam has achieved since *doi moi* started, its impact in other areas was limited because of different problems affecting the Vietnamese economic system. This evidence underlines the need for reforms in the private sector, financial and banking sector, state-owned enterprises, and trade policy. Accession to the ASEAN Free Trade Area represents an important event and a new scenario where Viet Nam will compete and cooperate with its partners. It calls for a serious analysis of the changes occurring in comparative advantages of the Southeast Asian economies after the economic crises and of the role that Viet Nam can play in the regional production network.

I. INTRODUCTION

Since the introduction of *doi moi* (renovation) economic reforms in 1986, Viet Nam's economy has been among the fastest growing economies in the region. Its economic structure reflected an increasing share of industry and services while the share of agriculture declined. Viet Nam has been successful in poverty reduction strategies and has been able to ensure rapid growth with relative equity. Among the factors that led to this success, foreign direct investment (FDI) has played a crucial role, providing Viet Nam's economy with its relatively scarce factor, capital, and representing an extremely important instrument for integration in the world economy, especially at the regional level.

This paper attempts to analyze the recent developments in FDI flows to Viet Nam, particularly its impact on Viet Nam's economy and the economic, political, and institutional weaknesses that must be faced in order to ensure a future capacity to receive more foreign capital and to build a system able to realize more of the potential benefits of foreign direct investment. Particular attention has been given to the regional dimension of these issues because of the great historical importance of regional partners for Viet Nam, especially before the Asian crisis, and because of the ASEAN Free Trade Area's (AFTA) accession path that represents an important stage in Viet Nam's further integration in regional production networks.

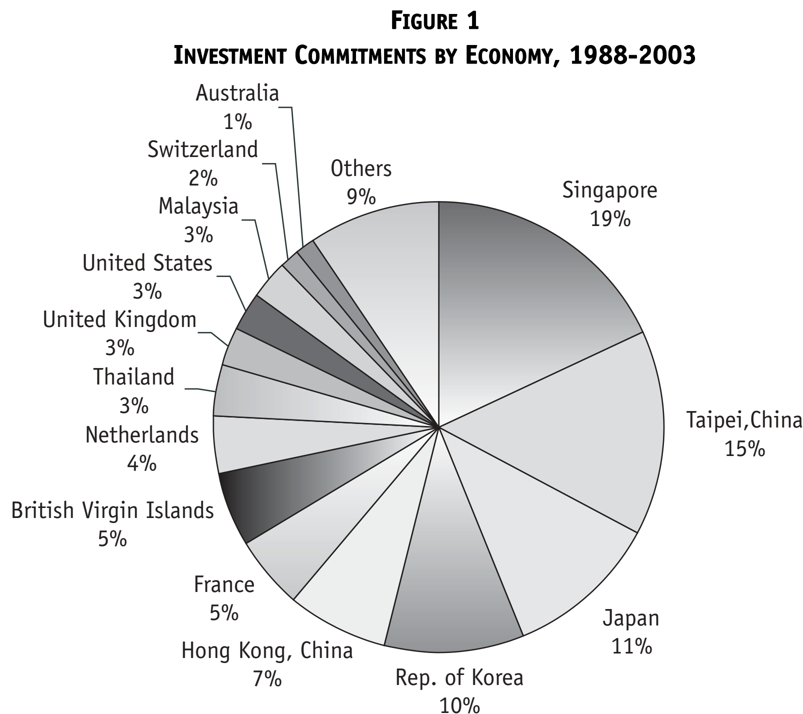
This paper is organized as follows: Section II discusses FDI developments and trends, drawing particular attention to the effects of the Asian crisis on capital flows. Section III considers the impact of FDI on different aspects of Viet Nam's economic development. Section IV examines different aspects of the business environment, policy regimes and trade-related issues, and their effects on Viet Nam's FDI inflows and impacts. Section V discusses AFTA and Viet Nam's accession schedule, and tries to contribute to a better understanding of the changes occurring in the regional comparative advantages of ASEAN economies with production specialization. The last section provides conclusions underlining the altered postcrisis opportunities as threats for Viet Nam's development, and the consequent policy recommendations regarding FDI-related issues.

II. RECENT TRENDS AND DEVELOPMENTS IN FDI IN VIET NAM

Attracting foreign investment has been an integral part of the Vietnamese reform process since the late 1980s. Since the Law on Foreign Investment (LFI) was approved in 1988 there has been a substantial inflow. According to the Ministry of Planning and Investment, from that time to the end of 2003, the Vietnamese economy attracted total investment capital of about US$40.8 billion in terms of commitments, while the total realized capital was US$24.6 billion.

Up to the end of 2003, investors from 64 countries and territories had invested in Viet Nam, but Asian economies accounted for the major part of these capital flows. Singapore is the principal foreign investor with 288 projects and $7370 million of registered capital; followed by Taipei,China (1,086 projects and $5998 million); Japan (418 projects and $4480 million); Republic of Korea (henceforth Korea) (662 projects and $4161 million); and Hong Kong, China (288 projects and $2975 million). These top five investor economies account for 61 percent of total FDI commitments in the period 1988-2003. Countries of the Association of Southeast Asian Nations account for 25 percent of the total investment, mostly because of Singapore's capital. However after the signing in July 2000 of the US-Viet Nam Bilateral Trade Agreement, investment from countries such as France, Netherlands, and United States has been increasing. Meanwhile, FDI from the United Kingdom is principally connected to investments of the 1990s in the oil and gas sector (Figure 1).

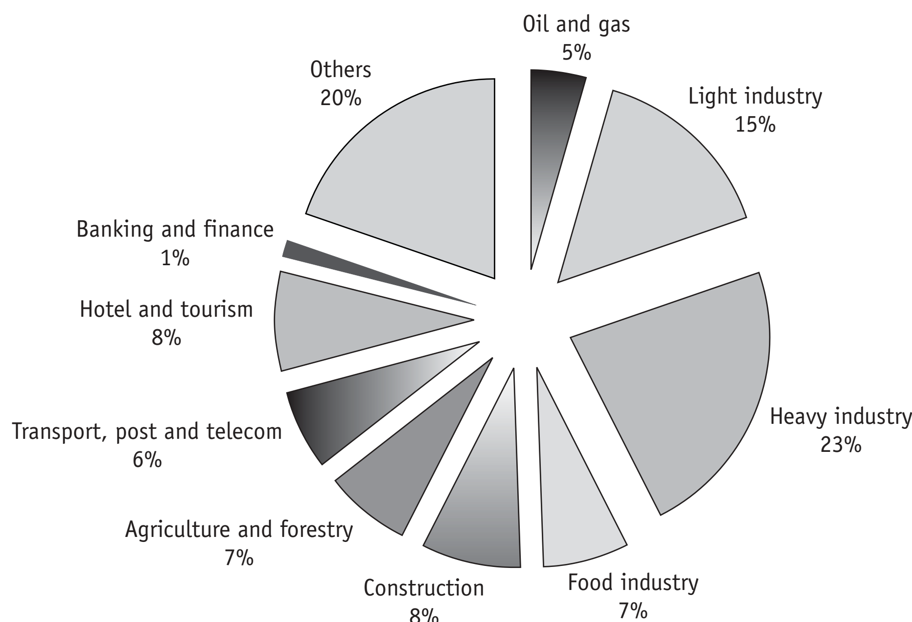
Figure 1
Investment Commitments by Economy, 1988-2003



Source: http://www.vneconomy.com.vn/eng/article_to_print.php?id=040105165613

During these years Viet Nam's economy was able to attract foreign investment in all sectors. The oil and gas sector was where FDI was most focused during the first half of the 1990s, and up to the end it absorbed 8 percent of the total FDI in Viet Nam. The industrial sector accounted for the most important share of the capital inflows over the full decade: heavy industry for 21 percent, light industry for 13 percent, and food industry for 6 percent of the total registered capital. Another important role in attracting FDI was played by real estate services, which absorbed the highest amount of FDI within the tertiary sector. The share of agriculture, forestry, and fisheries was only a small part of the total, though it is slowly increasing (Figure 2). All 61 provinces of Viet Nam have attracted FDI but investors have so far located their investments mostly in urban areas where they can take advantage of more developed infrastructure. Ho Chi Minh City and Hanoi accounted for 26 and 19 percent, respectively, of the total FDI absorbed by Viet Nam in 1988-2003. Apart from these two principal Vietnamese cities, other areas attracted high amounts of FDI,

Figure 2
FDI Commitments by Sector 1988-2003



Source: http://www.asemconnectvietnam.gov.vn/asemvn/asps/news.asp?idnews=5931&tuan=23

especially in the southeast. The provinces of Dong Nai, Binh Duong, and Ba Ria–Vung Tau absorbed another 29 percent of total FDI, far more than the other principal northern provinces of Hai Phong, Lam Dong, and Hai Duong, which absorbed just 7 percent. Central Viet Nam attracted only a very modest amount of FDI, mostly in Quang Ngai province. From these data a dualistic result is evident: 74 percent of the total amount of FDI absorbed by Viet Nam in the last 15 years was invested in only five of the 61 regions composing the Vietnamese state (Table 1).

To attract investment with limited infrastructure, Viet Nam has developed a system of industrial zones. Up to the end of 2002, 76 industrial zones have been built in different areas of the country.

Table 1
FDI by Province, 1988-2003

PROVINCE	COMMITMENTS ($M)	PERCENT
Ho Chi Minh City	10755	26.36
Hanoi	7563	18.54
Dong Nai	6504	15.94
Binh Duong	3378	8.28
Ba Ria-Vung Tau	2065	5.06
Quang Ngai	1872	4.59
Hai Phong	1477	3.62
Lam Dong	869	2.13
Long An	541	1.33
Hai Duong	526	1.29
Others	5244	12.86
Total	40795	100.00

Source: http://www.vneconomy.com.vn/eng/article_to_print.php?id=040105160446

Among them 17 zones have been developed by joint ventures (JVs) and one by a 100 percent foreign-owned enterprise. The other 52 zones are Vietnamese-owned industrial zones. These zones have attracted a high proportion of the total FDI in the country: 1,202 projects have been approved for an amount of $9.4 billion, representing about 25 percent of the FDI that flowed into Viet Nam up to 2002.

Viet Nam's LFI considers three forms of investment: business corporate contract (BCC), JV, and 100 percent foreign-invested company. The LFI establishes that for investments in the sectors of oil and telecommunications, the BCC form must be applied. Joint ventures are required for a wide range of sectors such as transportation, tourism, culture, port construction, airport terminals, and explosives production. For projects regarding investment in the construction of infrastructure, such as water and electricity supply, the law requires build-operate-transfer contracts to be signed with the authorized state agency. Up to the beginning of 2002, just six projects for a total amount of $1.2 billion had been for this kind of contract. Meanwhile, BCC projects accounted for about 11 percent of total inflows and for a minimal portion of the number of approved projects. The projects under 100 percent foreign-owned enterprises account for 61 percent of licensed projects and 33 percent of committed capital, while JVs account for 34 percent of licensed projects and 53 percent of committed capital. But the tendency is for an increasing prominence of 100 percent foreign-owned projects. Two motivations can explain this trend: the first is that after a period of investigating and understanding the Vietnamese market, reliance on domestic counterparts is becoming comparatively less important. Second, foreign investors increasingly prefer the wholly owned form after learning about the difficulties of operating with domestic counterparts. Furthermore, about 98 percent of JVs have been made with Vietnamese state-owned enterprises (SOEs) (Doanh 2002). This happened because these links permitted the foreign investors to benefit from the SOEs' preferential treatment and because of the weakness of Viet Nam's domestic private sector. The inefficiencies that foreign investors had to face in carrying out projects with their local counterparts have contributed to the growth of interest in 100 percent foreign-invested companies (Table 2).

TABLE 2
FDI BY FORM OF INVESTMENT, 1988-2001

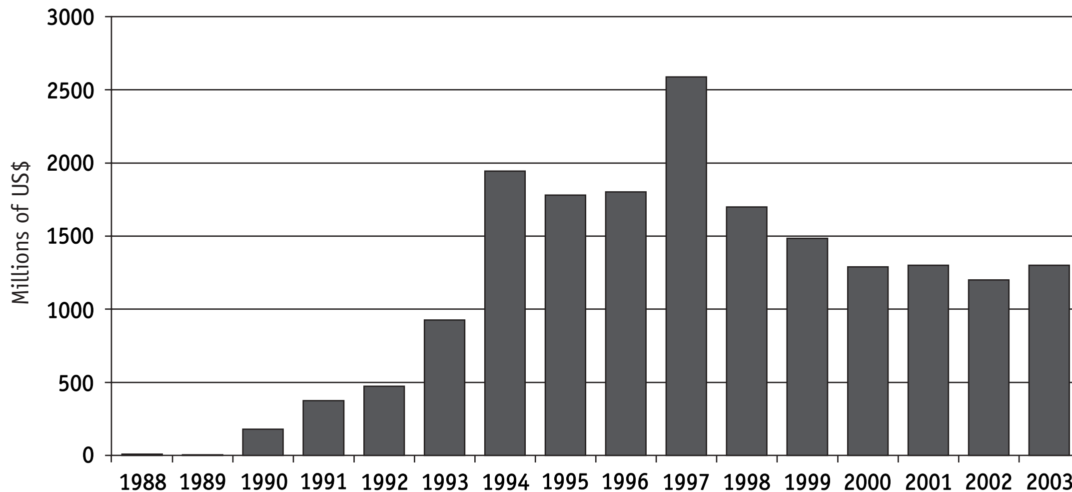
FORM OF INVESTMENT	NUMBER OF PROJECTS	COMMITMENTS ($M)
Joint Ventures	1043	20167
100% foreign-owned project	1858	12414
Business cooperation contracts	139	4052
Build-operate-transfer projects	6	1228
Total commitments	3046	37861

Source: Bui (2004).

Since 2001, the role of the *Viet Kieu* (Overseas Vietnamese) has been slowly increasing. That year, the state officially committed to protect their legitimate interests, encouraging them to keep close links with their native land. In reality, things are still difficult and the capital flow from over 2.6 million overseas Vietnamese is not comparable to the important resources People's Republic of China has received from Hong Kong, China; Taipei,China; and other Chinese sources. More

important is the role played by remittances in recent years. In 2001 the remittance flow was over $2 billion, and in 2002 it reached $2.4 billion, mostly to the Ho Chi Minh City area (EIU 2003a). In 2003, the Committee of Overseas Vietnamese said remittances peaked at $2.7 billion, 60 percent of which went to Ho Chi Minh City. Between 1988 and 2003, the total amount of foreign capital inflows in Viet Nam was about $18.4 billion (Figure 3) (UNCTAD 2004).

FIGURE 3
FDI IN VIET NAM, 1988-2003



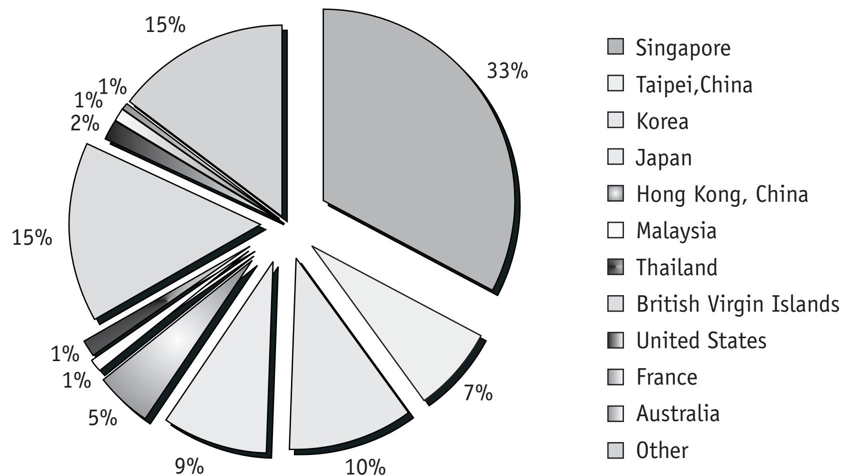
Source: UNCTAD (2004).

Analyzing the data, we can divide the FDI flows into three periods. Prior to 1994 the oil and gas sector was the focus of FDI in Viet Nam, permitting growth in crude oil exports, which represented the leading component of export growth until 1996. Since 1994, foreign investment expanded to a range of new sectors, first real estate and then different industrial activities. The latter in particular received capital flows from East Asian countries that were facing the boom preceding the 1997/1998 crisis as they sought new locations for their export production to face the rising cost of their local workforce. Foreign investment flowing into Viet Nam during these years played a very important role, not only in providing finance but also in facilitating export market access, introducing new ideas and processes, elevating skills and know-how, and proposing models that have been copied by domestic investors (Figure 4).

After 1997 Viet Nam's economy experienced a sharp decline in FDI disbursements. This is commonly supposed to be caused principally by the slowing reform process. In supporting the relevance of the environment for foreign investment as predominant over the impact of the Asian crisis, two arguments are often underlined: that the decline in implementation of investment commitments started before 1997, so the regional crisis made evident problems existing prior to the crisis; and that after 1999, investments returned to Korea, Malaysia, and Thailand but not to Viet Nam.

Masina (2002) argues that the causal nexus between the slowing pace of doi moi and the decline in FDI flows has probably been overestimated. Considering the data on FDI commitments

FIGURE 4
FDI COMMITMENTS BY ORIGIN IN 1996



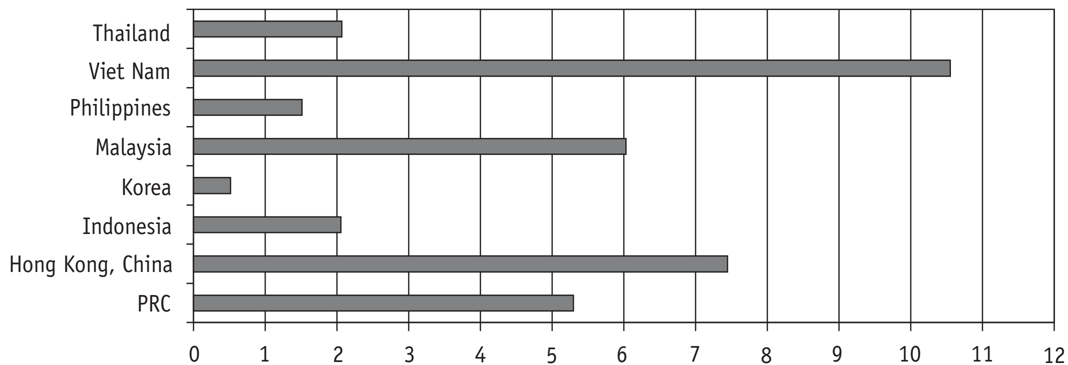
Source: IMF (2002).

by sector it is evident that there was an element of speculative FDI in real estate, as it dropped from $2.7 billion in 1995 and $3.3 billion in 1996 to $338 million in 1997. Subtracting these values from the total FDI commitments in Viet Nam during the period 1995-1997 we can see that the decline in FDI is entirely attributable to the real estate sector. In fact, the subtotals for the three years are respectively $4.0 billion, $4.4 billion, and $4.1 billion. During the 1990s the real estate sector was largely speculative and dominated by East Asian financial groups. The slowdown of commitments of FDI in 1997 was the result of the bubble's deflation in that sector. Moreover, analyzing the series regarding FDI disbursements in Viet Nam in 1995-1996, and considering the elevated instability of investments in the oil and gas sector because of the large size of this kind of project, the total disbursement after subtracting the values of the real estate and oil and gas sectors shows an increasing trend from $1.2 billion in 1995 to $1.7 billion in 1997. This confirms that before the crisis there was no evidence of a decline in FDI in Viet Nam.

One element characterizing the precrisis period is that Viet Nam attracted higher FDI than much larger Asian economies, which suggests the presence of overinvestments or catch-up investments that could have characterized this economy in the years before the crisis. This involved not only real estate and the construction sector but also heavy industry as a result of optimism about Viet Nam's domestic market based on relatively little documented information. Comparing different Asian countries in 1997, Viet Nam appears as an economy with an excessively high FDI as a percentage of gross domestic product (GDP), raising suspicion that before 1997 there was overinvestment in Vietnamese productive sectors (Figure 5).

This explanation of the FDI slowdown after 1997 is only partial. The contraction of foreign investment was also due to the financial crisis and the investment downturn that Asian economies in general had to face after 1997, which is a main explanation of the sharp decline in Viet Nam from 1998 onward. However, the crisis increased pressure to improve the investment climate for Viet Nam to compete as a leading production location in the context of diminished flows of investment funds.

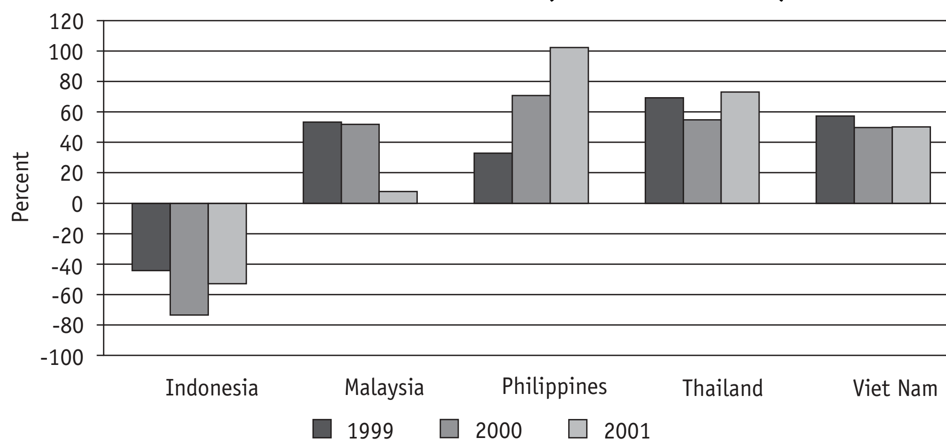
FIGURE 5
FDI AS PERCENTAGE OF GDP IN 1997



Source: Calculated from UNCTAD and World Bank data.

It is only partially true that after 1999 investment has returned to other Asian countries more than to Viet Nam. Considering the maximum amount of FDI flows to selected Asian countries before the bubble burst, in the period 1999-2001, only the Philippines was able to attract an amount of investments higher than the peak its economy had achieved before the crisis. Malaysia in 1999 and 2000 showed a rise, about 50 percent, similar to Viet Nam's, but in 2001 it registered a sharp drop after Kuala Lumpur, by imposing controls on short-term capital flows, moved in a rather different direction from that favored by international financial institutions. Indonesia also showed a sharp decrease of FDI inflows after 1999, heavily affected by the volatile political and security situation. Thailand was able to rapidly restore its investment attraction capability, but overall it is not clear that capital returned to the area in general, and Viet Nam represents an exception (Figure 6).

FIGURE 6
FDI INFLOWS IN SELECTED ASIAN COUNTRIES 1999-2001
AS PERCENTAGE OF MAXIMUM (FDI 1996; FDI 1998)

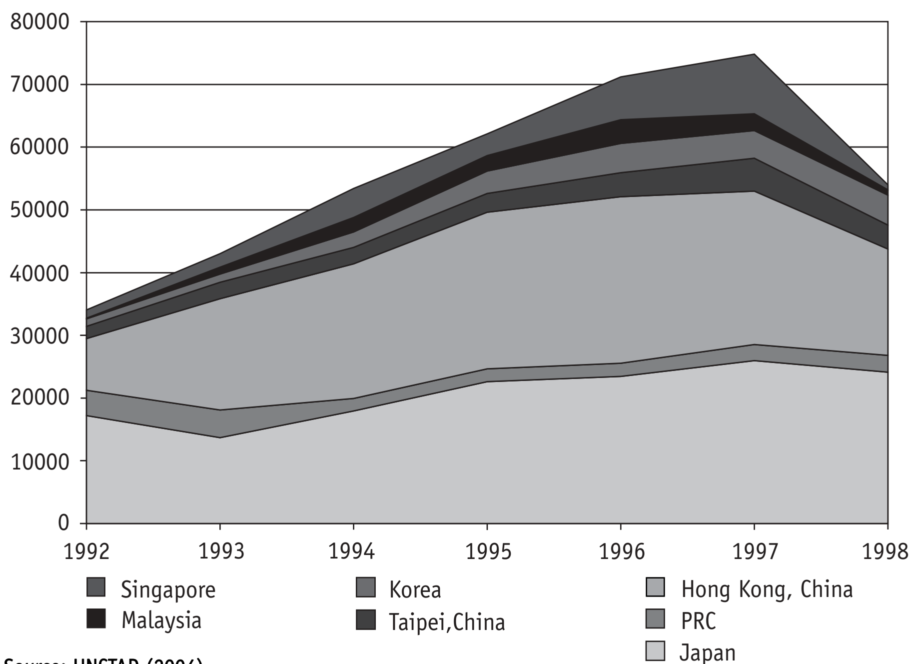


Source: Calculated from UNCTAD data.

The more positive trend registered in Korea and Thailand is clearly connected to acquisitions of local corporations after these countries liberalized their markets in connection with conditions to receive loans from the International Monetary Fund (IMF). In fact, conventional "greenfield" FDI, where new production capacity is created, actually sharply declined during that period. After the crisis, cross-border mergers and acquisitions (M&A) were the main engine of FDI flows. Mergers and acquisitions drove the corporate and bank restructuring process in affected countries. All affected countries benefited from increased M&A activity to varying degrees. Much of the FDI inflows received by Korea and Thailand after the crisis were associated with M&A activity. Viet Nam did not feel the need to speed up the pace of reforms because, even though regionally well integrated, the economy exhibited a degree of resilience toward the East Asian crisis and proved quite successful in maintaining macroeconomic stability. The slow pace of reforms may have provided a countercyclical element of stability in a period of international economical instability (van Arkadie and Mallon 2003). Consequently M&A, even after 1999, played a marginal role in FDI inflows to Viet Nam, in contrast to most other countries in the region. Viet Nam's current business legislation is not very conducive to the establishment of strong M&A activity: foreign investors may only acquire up to 30 percent of total shares in a local company in Viet Nam if the company operates within one of the 35 approved business sectors, and must get the approval of the prime minister's office before doing so.

According to the IMF (2002), between 1988 and 1998 about two thirds of the disbursed and committed FDI in Viet Nam was from Hong Kong, China; Japan; Korea; Malaysia; Singapore; Taipei,China; and Thailand. The crisis strongly reduced and changed the investment outflows from these countries, and this consequently caused the heavy decrease in total FDI to Viet Nam (Figure 7). The decline of FDI inflows to Viet Nam in 1998 was mainly the result of a general regional trend, but does not mean that national deficiencies regarding the environment for investment did not play a role in generating discontent among investors. Once the regional perspective

Figure 7
FDI Outflows from Selected Asian Countries (million US $)



Source: UNCTAD (2004).

deteriorated and the total investment absorbed by the regional economies registered a sharp decline, the difficulties of doing business in Viet Nam also assumed more visibility as a reason for dissatisfaction among foreign investors. Thus, an improvement of the investment climate through important reforms is necessary for Viet Nam's economy to restore economic growth but, at the same time, a serious analysis of changing comparative advantage in East Asia and of the changing regional productive systems in the postcrisis environment is needed to identify appropriate policies and medium and long-term strategies.

III. THE IMPACT OF FDI

International capital flows represent a potentially effective instrument to increase world output and welfare. Foreign direct investment in particular, because of its stability compared to other forms of capital flows, either private or public, can be very important in achieving higher levels of economic development. Many countries have adopted strategies to attract as much FDI as possible, believing in its capacity to integrate the host country into the world economy through assets provided by transnational corporations, such as capital, technology, and skills.

Before discussing new scenarios and opportunities that Viet Nam is going to face in coming times, an analysis of the impact of the large amounts of inward FDI that the Vietnamese economy has absorbed since the promulgation of the first LFI in December 1987 is warranted. After having reviewed the effects of FDI on the Vietnamese economy and welfare, it is possible to formulate a critical view of the policies carried out in recent years and to suggest hypotheses for future reforms aimed at creating a better environment for a more incisive impact of FDI on development, growth, and poverty reduction.

We have seen the high amount of inward FDI that has been registered in Viet Nam since implementation of liberalization and open policy reforms. The role of foreign investment as a capital source was relevant throughout the 1990s, financing the country's fast growth. Before the crisis considerably reduced foreign investment flows, FDI's contribution to total investment was obviously greater than in most recent years, with a peak of 30.4 percent in 1995. After the decline of 1998, the percentage of total Vietnamese investment constituted by FDI stabilized at around 18 percent (Figure 8).

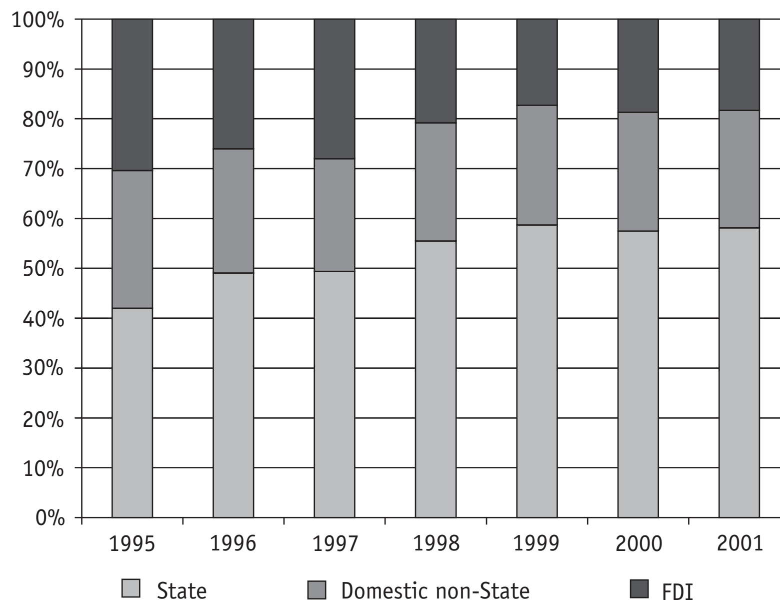
While its contribution to total investment reached its highest levels on the eve of the Asian crisis, the contribution of FDI to GDP, exports, and total output has been characterized by a growing trend since the beginning of the 1990s. The contribution to GDP has doubled during the late 1990s from 6.3 percent in 1995 to 13.3 percent in 2000 (Table 3).

Table 3
FDI Contribution to GDP and Export (percent)

YEAR	CONTRIBUTION TO GDP	CONTRIBUTION TO EXPORT
1995	6.3	8.1
1996	7.4	10.8
1997	9.0	19.5
1998	10.0	21.2
1999	12.3	22.4
2000	13.3	23.2

Source: MPI data.

FIGURE 8
INVESTMENT BY OWNERSHIP (PERCENT)



Source: GSO (2002).

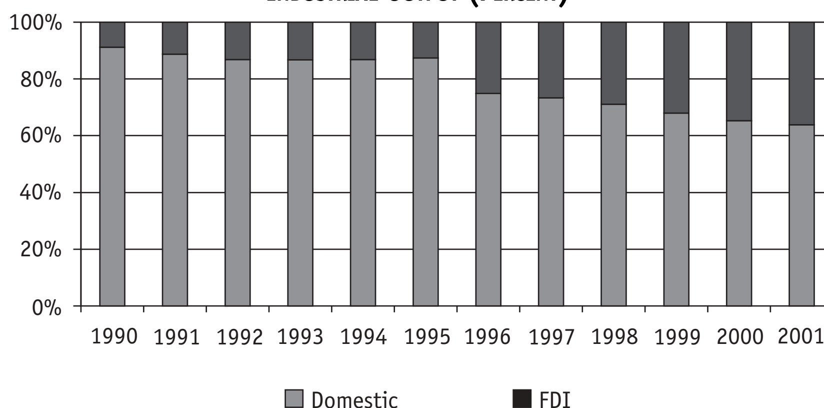
Foreign direct investment also played an important role for export growth, especially after the crisis. From 1996 to 1997, the foreign-invested sector's contribution to exports registered a growth rate higher than 80 percent, accounting for about 20 percent of exports. In 2000 it accounted for 23.2 percent of total exports and this value has increased during the last two years. Transnational corporations investing in Viet Nam during the last decade provided export market access; moreover, FDI has served as a catalyst for other domestic exporters. During 2002 the contribution of FDI to total exports was particularly relevant in some key industries such as footwear; textile and garments; and electronics, computers, and supplies. It accounted for 82 percent of the latter, 42 percent of footwear exports, and 25 percent of textile and garments exports (Bui 2004).

Foreign direct investment also contributed to state revenue. Between 1997 and 2000 foreign-invested enterprises accounted on average for 5.7 percent of the state budget. If oil and gas revenues were included, FDI's contribution would account for over 20 percent (IMF 2002).

During the early 1990s, industrial output from foreign-invested enterprises accounted for less than 10 percent of total output, but increased decisively after 1995. In 2000 it accounted for about 35 percent of total industrial output, and was still achieving a growth rate higher than the state sector's. Before 1995, when foreign investment was concentrated in hydrocarbons, about 42 percent of the output of foreign-invested enterprises was in the mining sector. This percentage decreased during the following years, reaching 32 percent in 2000 as a consequence of the development of other sectors as targets of FDI (Figure 9).

In exploring the effects of FDI on Viet Nam's economy, spatial issues cannot be ignored (Figure 10). Even if during the doi moi process relevant results were achieved in poverty reduction, and

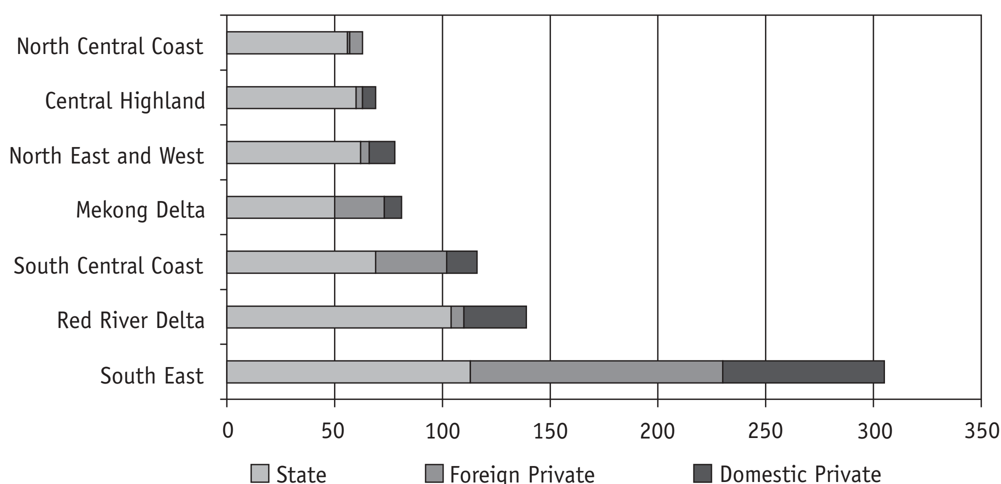
Figure 9
Industrial Output (Percent)



Sources: GSO (2002 and 2000).

even if its growth path was differentiated from other fast growing economies by a significant level of equity, Viet Nam still remains a country affected by a large amount of poverty. Furthermore, from a demographic point of view, Viet Nam is still a mainly rural country with an urban population of only about 25 percent (UNDP 2002). Considering the fact that 74 percent of total inward FDI

Figure 10
Regional Trend in per Capita Investments



Notes: State investment is for 2000; foreign investment is realized FDI in 2002; domestic private investment in 2001.
Source: Dapice (2003, Table 8).

absorbed by the Vietnamese economy reaches just five provinces representing less than 15 percent of the total population of Viet Nam, this means that FDI for the other 56 provinces—with 85 percent of the Vietnamese population—accounts for less than 30 percent of the total amount.

Only a few provinces have been able to attract high amounts of foreign direct investment. The reasons differ: first of all many investors want to be close to major markets and cities. But other criteria can influence the destination of FDI inflows, such as presence of raw materials or tourist attractions. In general, most investors prefer to locate their activities close to where others already are. For most Vietnamese regions, and for the totality of the poorest regions of Viet Nam, most investment and growth came from the state sector. In Northern Central Coast and in Central Highlands, state investment accounts for more than 85 percent of total investment; and 79 percent in the Northeast and West, showing that state sector reform represents a key issue on the path of doi moi. State investment is allocated according to economic and political criteria and has constituted until now an important instrument to balance the regional distribution of foreign direct investment. However, there is a limit to how much infrastructure can justifiably be built without subsequent productive investments. So it is possible that even state investment will be aimed toward fewer and more efficient state enterprises, mostly located where growth is fast and there is a clear need for infrastructure.

Despite impressive and rapid growth of the domestic private sector, the initial low base of the sector leaves it only accounting for a small share of total output and employment. Nevertheless, as shown in Figure 8, the state share of total investment registered an increase between 1995 and 2001, passing from 42 to 58.1 percent, while the domestic private sector's share decreased from 27.6 to 23.6 percent. The explanation of this trend is not certain. It can be the result of undercounting of domestic private investment by small enterprises and households especially in rural areas. However, data reveal the Vietnamese government's tendency to be more sympathetic to FDI than to domestic private investment, throughout the whole final decade of the last century, with a regime that was not encouraging to formal private business activity. The logical result was that unregistered firms carried on a great part of domestic private activities (van Arkadie and Mallon 2003).

In a study by Dapice (2003), the geographical concentration of FDI and private domestic investment are compared. The results indicate that FDI is much more concentrated than domestic private investment among the provinces. About 40 percent of all Vietnamese provinces experienced domestic private investment (of at least $10 per capita), compared to only 10 to 15 percent for foreign direct investment. Furthermore, differently from FDI, domestic private investment covers a much wider range of situations. In fact, even in some very poor regions there are provinces that were able to enjoy domestic private investment. These results imply that most provinces should focus more on creating favorable conditions for domestic private investors, and less on attracting foreign direct investment.

In analyzing FDI's impact on Viet Nam's economy, another aspect of relevance is that FDI did not create as much employment as expected. Despite their shares of GDP, total investment, and exports, foreign-invested enterprises in 2000 accounted for only 2 percent of the total number of people of working age in the labor force, according to Viet Nam's General Statistical Office. Other studies report even lower shares. For example, McCarty and Diep (2003) report estimates of FDI's share of total employment between 1991 and 2000 at 0.6 percent. In terms of contribution to total employment up to 2000, foreign-invested enterprises accounted for 6.4 percent of total labor

in industry and construction; 0.2 percent in agriculture, forestry, and aquaculture; and 0.4 percent in service sectors (Figure 11).

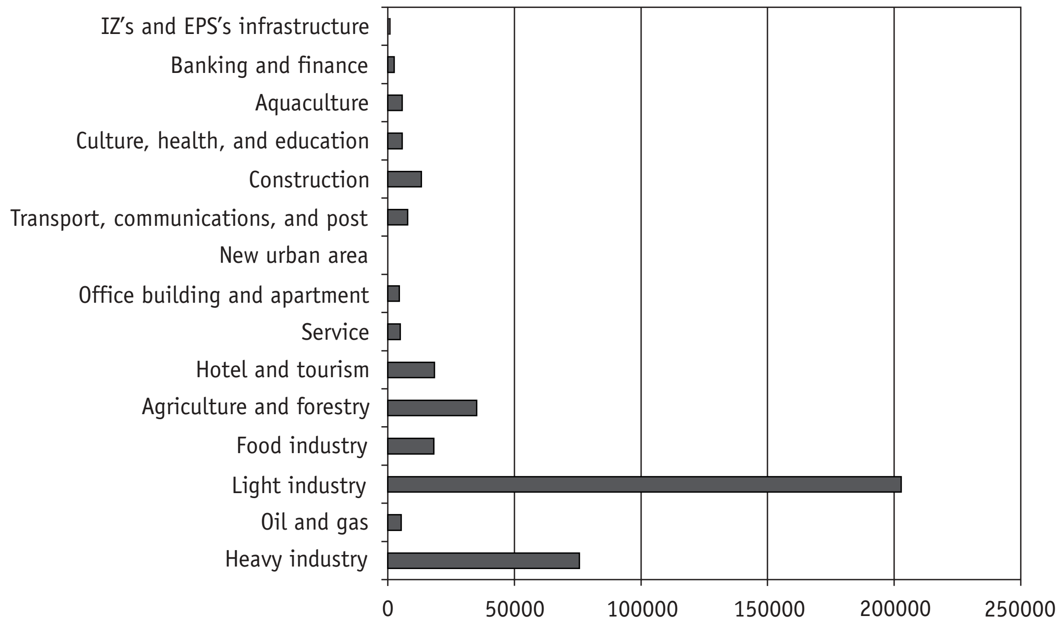
Figure 11
Direct Jobs Created by FDI Sector

Source: Bui (2004).

The main reason why foreign investment does not create more employment is reflected in the low labor requirements per unit of output characterizing foreign-invested enterprises. This is fundamentally because labor productivity is higher in foreign-owned enterprises (Quynh, Nguyen, and Bui 2002), and in destination sectors since Viet Nam started attracting foreign direct investment. Regarding the first point, in all sectors, labor productivity tends to be higher among foreign-invested enterprises due to the more advanced technology to which foreign enterprises have access and that characterizes their production processes, but also because of the large amount of imported inputs utilized by foreign firms. It is estimated that in 1999 imports by foreign-invested enterprises accounted for 74 percent of the value of their turnover (Apoteker 2000) and for 1998, IMF (2002) reports a share of imports equivalent to 82 percent. Until the productive processes of foreign-invested enterprises in Viet Nam involve mostly final stages of production, rather than assembling imported parts and components, the general impact on employment will remain low. Moreover, it dramatically reduces the effect on the balance of payments due to the large share of exports from foreign-invested enterprises. The second cause that strongly affected the potential impact of FDI on employment is the large share of FDI projects that were carried out in capital-intensive industries such as cars and motorbikes, cement, and steel instead of sectors characterized by more labor-intensive production. Furthermore, FDI in agriculture played a very marginal role among the general context of inward FDI, while agriculture still accounts for about 25 percent of GDP and two thirds of employment (Figure 12).

Up to the end of 2001, industry played the major role in creating new jobs, accounting for 77 percent of total labor in the FDI sector. Agriculture, forestry, and aquaculture reached only 10 percent and the rest is attributed to services and transportation. During 2002, industry's share was 83 percent of the over 650,000 jobs created by the FDI sector while agriculture's share was 10 percent and services, 7 percent. In 2001, light industries attracted the largest share, or 50.6

FIGURE 12
EMPLOYMENT OF FDI BY SECTOR, 2001



Source: Quynh, Nguyen, and Bui (2002).

percent of the total labor generated by the FDI sector. Light sectors, according to the Project Monitoring Department of MPI's classification system, includes textiles, garments, footwear, and industries producing consumption goods—industries often characterized as more labor-intensive products than other industries.

The huge amount of inward FDI that reached Viet Nam during the last 15 years has brought not only capital but also management skills and technologies. The technologies used by FDI projects are generally of a higher level than the technologies currently in use in Viet Nam, especially in the oil and gas, telecommunication, chemical, electronics, and automobiles sectors. These new technologies are supposed to generate relevant spillover effects but, according to Tran (1999) there are indications that joint ventures and other connections between Vietnamese and foreign firms have not produced wide knowledge dissemination in either marketing or management of technical change. This could be related to the low familiarity—characterizing most Vietnamese firms—on utilizing partnership arrangements with foreign firms in order to increase technological capabilities. Moreover, the same study noted that a relevant part of the foreign firms showed insufficient determination to structure and facilitate the learning.

A further study (Tran 2002) analyzed a set of sample case studies regarding firms operating in different industries: oil and gas, telecommunications, automobiles, and information technologies. Three kinds of technological spillover effects were considered: (i) between joint ventures from foreign to Vietnamese partners, (ii) from JVs to Vietnamese organizations (institutions and firms), and (iii) direct spillovers from multinationals to Vietnamese organizations. The results of these studies confirmed that there are examples of Vietnamese enterprises learning and acquiring technological capabilities from foreign partners by the partners' participation in the global network

of production and circulation of merchandise. The main problem is that host country firms are often not ready and not organized well enough for learning and upgrading their industrial capabilities. In part this reflects the SOEs' persistently predominant role in Viet Nam's economy.

Linkages between research and development institutions and the productive sector in Viet Nam remain weak. So while FDI has had important effects on upgrading the Vietnamese economy's technology and providing technology and knowledge in different sectors, its impact is limited by the weak linkages between foreign-invested enterprises and domestic enterprises, and by the steady weakness of the local private sector. However, FDI has helped to modernize management and corporate governance, and to train a new group of young managers. According to Le (2002) some 300,000 workers have been trained or retrained, and 25,000 technicians and 6,000 managers have been trained, partially abroad. Moreover, different studies show how FDI had an important role in raising living standards of workers through higher average wages than in domestic sectors.

In summary, inward FDI in Viet Nam had important impacts on the Vietnamese economy, especially in (i) providing important financial resources that represented a significant share of total investment, (ii) financing the rapid growth that Viet Nam experienced in the last 15 years, and (iii) providing market access for its rising exports. Though the impact on employment was limited, FDI played an important role in introducing new ideas and processes, in elevating skills and know-how, and proposing models that have been copied by domestic investors whose economic background was formed in a centrally planned economy.

IV. POLICY REGIMES, BUSINESS ENVIRONMENT, AND TRADE-RELATED ISSUES

The Vietnamese National Assembly promulgated the first Law on Foreign Investment of Viet Nam in December 1987, following the historical decision taken by the Vietnamese Communist Party's Sixth Congress to introduce a new strategy of reforms. This choice signaled the formal transition from a centrally planned economy to a market economy under the slogan of doi moi. The approval of the LFI has to be considered as part of the set of reforms carried out by the Vietnamese government to realize a "socialist-oriented market economy."

Since 1987, the LFI has been amended and revised in 1990, 1992, 1996, 2000, and 2003: moving the law to suit the practice of business and closer to conformity with national treatment (STAR/CIEM 2003). In this process of progressive evolution of the rules, the regulatory system for FDI moved toward a situation characterized by fewer difficulties for foreign-invested firms to operate amid reduced risk. Pursuing this aim, different measures have been adopted: many obstacles for foreign-invested enterprises have been removed; currency balancing regulations have been relaxed; and more freedom has been ceded to change investment forms, reorganize enterprises, and transfer capital. Government procedures in FDI management have been progressively improved, the list of import tariff exemptions and reductions have been improved, and profit transmittal tax rates have been reduced. The possibility to carry forward losses has been allowed for a wider range of foreign-invested enterprises, worker recruitment has become freer, the responsibility for compensation and land clearance has shifted from the foreign partner to the Vietnamese side, and foreign-invested enterprises were allowed to mortgage their land use rights to borrow from credit organizations (Quynh et al. 2003). Consistent with the measures adopted and with the undeniable success in FDI attraction obtained since the approval of the LFI in 1997, in 2001, for the first

time, the Ninth Communist Party Congress recognized FDI as an integral and autonomous part of the national economy, incorporating it in the long-term strategy (2001-2010) for socioeconomic development.

Despite these important achievements, the regulatory framework for foreign-invested enterprises in Viet Nam remains quite restrictive. It still places many limits on the industrial sectors in which foreign industries may operate, on the structure of their investment means, and on their ability to finance their operations and their capacity to react to changes in economic circumstances (EIU 2003c).

Relevant restrictions still affect the regulations on stake and legal capital in JVs and 100 percent foreign-invested enterprises. According to the law, legal capital must be at least 30 percent of total invested capital, composed of legal capital plus loans. Joint ventures require at least 30 percent foreign equity, even if in some special cases, depending on the field of operation, technology, market, efficiency, and socioeconomic benefits of the project, it may be reduced to 20 percent of total legal capital. Foreign-invested enterprises in the motorcycle sector still have to satisfy local content requirements, and this regulatory measure was not relaxed progressively, but on the contrary during recent years has become more stringent. This kind of regulation must be viewed in the context of different policies adopted with the aim of increasing the localization rate of foreign firms' production processes such as setting of import tariffs according to the ratio of local content or import quotas for motorbike components. Moreover Viet Nam's business legislation persists in being quite restrictive of either the establishment of equity-based cross border production or relevant M&A activity: foreign investors may acquire up to 30 percent of total shares of a local company within one of the 35 approved business sectors, but must get approval from the prime minister's office before doing so. Besides these restrictions Viet Nam has many regulations to attract FDI through different kinds of incentives: taxes, tariffs, and exemption or reduction of land rent. These incentives depend on different factors such as sectors or locations (Bui 2004).

Since 2001, much has been accomplished in liberalizing the FDI regime. Many foreign-invested enterprises can now hire workers directly without the involvement of employment centers, and foreign investors can set up export-oriented enterprises through simple registration without waiting for discretionary approvals. A very important move has been the decentralization of FDI approvals and regulations to provincial levels. It opens the space for provincial policies to have impact on inward FDI flows. Further important steps cover many other aspects: tax on profit remittances, ownership of local enterprises, and management of land-use rights.

The legal system in Viet Nam is still weak: legal regulations are fast changing, unpredictable, and inconsistent in different fields: tax, foreign exchange, labor regulation, land, and jurisdiction. There are structural weaknesses in Viet Nam's legal framework. The transition from a centrally planned economy to a socialist-oriented market economy implies two kinds of challenges: first, totally new fields, never covered, have to be regulated; and second, the subjects and institutions that have to cope with this work have developed in a different context and have no experience with aspects of a market economy. This is an important reason for the weakness and contradictions still affecting Viet Nam's legal system. Moreover red tape, bureaucracy, and lack of transparency are the principal weak points of Vietnamese business environment: law enforcement is not consistent and uniform in the country, and the law's interpretation and enforcement depends too much on local agencies or on low ranking local officers (Doanh 2002).

The legal system needs to be oriented to be more accommodative of FDI (Freeman 2002). Wider issues, such as reform of state-owned enterprises, local domestic private sector development, infrastructure improvement, banking and credit system enforcement, corruption curtailment, and legal system strengthening, constitute the key political challenges to attract FDI in the coming years. Foreign direct investment reforms have to be taken out of the specific sphere of foreign investment activity and considered in the much wider context of the host country business environment, in that way also benefiting local companies.

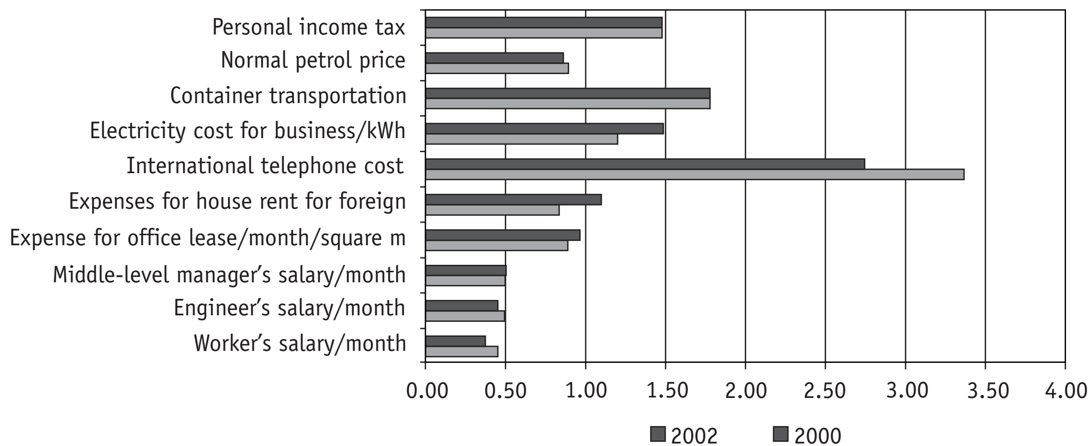
The dominance of SOEs in the industrial sector is serious because of their inefficiency (Van Arkadie and Mallon 2003). As a consequence of their losses, SOEs have to be financed either out of the government budget or through loans from the banking system, which may be not be repaid. In this way, the whole economy is affected by the SOE problem, because of the macroeconomic instability created, or because of the crowding out effect affecting more worthy borrowers in the credit market (Leung and Riedel 2001). The limited equitization of nonstrategic enterprises and the consolidation of strategic ones into large conglomerates have not resolved the problem. On the other hand, private business has been constrained in different areas by the policy regime. Masina (2002) notes that this may be related to various motivations, including political reasons: the emergence of a capitalist private sector may be perceived as a challenge to the state's authority and as a factor of political destabilization.

One area in which private business was at a distinct disadvantage was in establishing JVs with foreign investors. Foreign enterprises had an incentive to choose SOEs as partners in order to achieve administrative and bureaucratic advantages. But local firms had to face even more direct discriminatory regulations, such as that regarding the allowance conceded to SOEs but not to domestic private enterprises to contribute land use rights as equity in JVs with foreign investors (Van Arkadie and Mallon 2003). Even if the question concerning land use rights and ownership of land still remains a serious constraint for domestic private sector development, since the Enterprise Law was passed in 2000, the business environment in Viet Nam has been and is being improved step by step, enhancing confidence for investing and doing business in the country through the creation of a more level playing field. Recently, for example, Viet Nam's National Assembly unified corporate taxes: domestic and foreign enterprises will pay a unified corporate tax of 28 percent. Until 2003 domestic firms had to pay a rate of 32 percent and foreign-invested enterprises, 25 percent.

The disadvantages Viet Nam has to cope with in competing with regional neighbors for investment include other important fields. According to Doanh (2002), the high cost of doing business in Viet Nam still represents the main disincentive for foreign enterprises to invest in the country. This conclusion was based on comparison between different countries in the region in the cost of international telephone calls, Internet fees, and seaport costs, and was caused by the dual price system in Viet Nam. This analysis was conducted on the basis of data collected in 2000. Two years later there was no overall improvement, as Viet Nam's relative costs for electricity and housing rent got better but another important factor, international telephone cost, showed a rising trend. Furthermore, even if labor cost increased, Viet Nam still keeps a certain advantage in the regional context (Figures 13, 14).

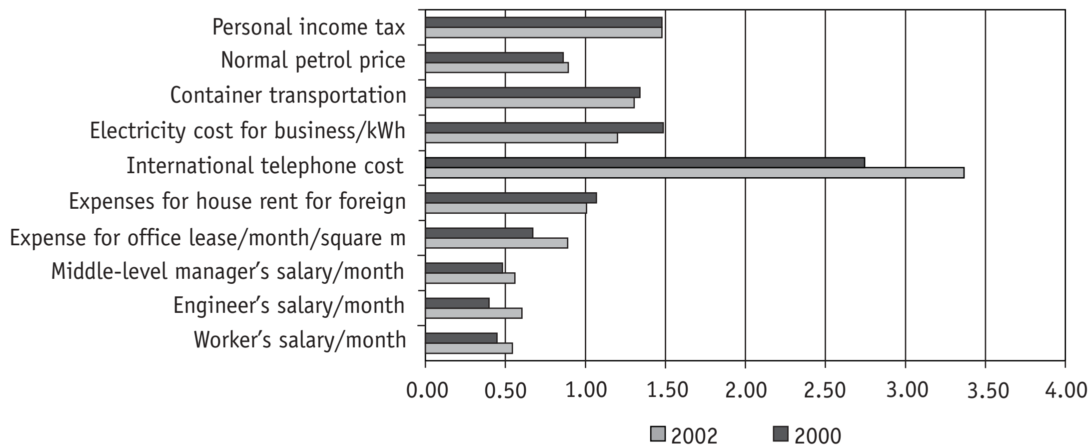
The improvement of the business environment and the achievement of lower business costs represent a fundamental challenge for the Vietnamese economy. On these variables also depends the amount of inward FDI and its impact. Instead of persisting with imposed local content requirements, to attain a higher localization of FDI, authorities could work on these issues that

Figure 13
Hanoi/Regional Average, Selected Business Costs



Source: Calculated from JETRO data.

Figure 14
Ho Chi Minh City/Regional Average, Selected Business Costs



Source: Calculated from JETRO data.

also affect the development of the domestic sector. In fact, local content requirements can be met only with difficulties because of the slow development of the local private sector. Moreover, it often results in uncompetitive products and represents a strong incentive for smuggling from People's Republic of China.

Another important factor in combating smuggling is related to trade policy issues. Several studies have underlined a bias in favor of import substitution that caused a large trade deficit in the last decade and promoted investment in sectors where Viet Nam does not have comparative advantage (CIE 1998, Kokko 1998, McCarty et al. 1998). Considering the predominance of SOEs and JVs between foreign partners and SOEs in the sectors characterized by high levels of protection, the principal aim of policy seems to differ from encouraging competitive firms. Despite the import liberalization process, Viet Nam's trade regime in 2002 still remains biased against exports, as asserted in a recent study (Martin, Rajapatirana, and Athokorala 2003): high import protection

makes production for the domestic market more profitable than for the export market, because it permits sales at prices higher than world prices and raises the costs of nontraded goods, making exports less competitive. Imported inputs for exporters in Viet Nam cost more than world prices given the tariffs on those imports.

According to a study by MUTRAP (2002a) in 2002 some capital-intensive and import-substituting sectors showed loss of competitiveness, as expected with a high level of protection. Other sectors, such as garments; seafood products; various food, fruit, and vegetable products, are highly protected but have shown robust competitiveness in the export market. According to this analysis, Viet Nam's protection shifted in nominal and effective rates after 1997, and while the average rate of protection shows a decline in domestic-oriented industries, protection rises in export-oriented manufacturing (Table 4).

These conclusions resulted from studying effective rates of protection, but as pointed out by Riedel and Parker (STAR/CIEM 2002) this kind of analysis can be misleading because of problems arising from aggregation. In fact, even within a well-defined sector like clothing there is a wide variation across firms in terms of product variety and quality, scale of operation, and technological level of production. From this evidence is derived the fact that Viet Nam has achieved rapid export growth in sectors where the profitability from selling domestically, according to the effective rate of protection, is 50 to 100 percent higher than selling to the world market.

Nevertheless even if the nominal tariff rates in Viet Nam are not significantly higher than in other East Asian countries (Table 5), the effective tariff rate, because of the dispersion across industrial sectors, appears decisively high. Considering the implementation of the AFTA road map and the reduced tariffs expected from it, domestic producers of previously protected products in the domestic market will have to face lower prices and reduced profits. So it will become even more important to carry on reforms to improve the climate for investment. A more level playing field for all investors could permit Viet Nam to compete regionally as a production platform attracting FDI and permitting local firms to enjoy the possibilities of enlarged markets and productivity improvement that can be offered by the AFTA accession.

V. REGIONAL INTEGRATION AND SPECIALIZATION ANALYSES

The ASEAN Free Trade Area was established in January 1992 to remove tariff barriers among Southeast Asian countries with a view to integrating the ASEAN economies into a single production base and creating a regional market of 500 million people. According to the Agreement on the Common Effective Preferential Tariff (CEPT), AFTA accession requires that tariff rates levied on a large range of goods traded within the region be reduced to not more than five percent. Quantitative restrictions and other nontariff barriers are to be eliminated.

Prior to AFTA there had been a loose tariff preference scheme in existence for ASEAN members but it required just a margin of preference over most-favored nation (MFN) tariff rates to be maintained. The AFTA represents an important step moving forward along the path of regional integration as it directly addresses tariff levels. The agreement is aimed at different objectives: to promote the region as a center of international trade; to face the growing strength of the two main trading blocs in the world, the European Union and the North American Free Trade Area; and

TABLE 4
SCALE OF EFFECTIVE RATES OF PROTECTION FOR SELECTED SECTORS/PRODUCTS IN VIET NAM, 2001

SCALE OF PROTECTION DESCENDING (HIGH-LOW)	MANUFACTURED PRODUCT/SECTOR
Extreme (> = 100%)	Motorcycles bicycles and parts Sugar Tea Garments Detergents, perfume Plastic products Food products Soft drinks Concrete and other cement products Processed vegetables and fruit Transport equipment Home tools and parts Other building materials
Very High (70-99%)	Glass products Confectionery goods Plastic materials Tobacco Ceramics Cement
High (50-69%)	Seafood products Paper textile Textiles
Moderate (30-49%)	Processed coffee Leather products Carpets Other manufacturing goods
Low (0-29%)	Gas Dairy products Rubber products Bricks and tiles Meat products Beverage products Vegetable oils and fats Communication equipment Electric equipment Other chemical products Accurate equipment products and meters Paint, ink, varnish General machinery

continued.

TABLE 4. *CONTINUED*.

SCALE OF PROTECTION DESCENDING (HIGH-LOW)	MANUFACTURED PRODUCT/SECTOR
Negative (=<1)	Wood products Ferrous metals and products Publishing goods Non ferrous metals and products Oils, fats Basic non organic chemicals Fertilizer and chemicals for agriculture Medicine Food products for livestock Medical tools Leather Pesticides and medicine for livestock Basic organic chemicals Printing products Specific machinery, office equipment and computers

Source: MUTRAP (2002a, Table 6.19).

finally to promote the region as an international production center and so attract an increasing share of global foreign direct investment. Even if at the beginning the principal push to regional integration by Southeast Asian nations was the will to create an entity capable of responding to the other regional trade blocs, two other important factors increasing the trend toward regionalism in Southeast Asia have been the slowing liberalization process under the World Trade Organization and the impact of the Asian crisis. Regarding the first factor, a defensive element contained in the agreement, AFTA was not conceived as an inward-looking trade pact. On the contrary it represented a form of "open regionalism", an outward-oriented and market-driven form of regional integration, aiming more to the integration of Southeast Asian markets rather than to market sharing. In the meantime the financial crisis in the region during 1997 and 1998 strengthened the international perception of the region as a single market and called for a shift of attention from supply to demand: a developed consumer base that could absorb excess production in the region. Finally, given the current difficulties of the World Trade Organization in producing another round of tariff reductions, the Southeast Asian countries have the possibility to start a process of further liberalization through greater economic integration between themselves.

The CEPT scheme is a cooperative arrangement among ASEAN countries that reduces intraregional tariffs and nontariff barriers. According to this scheme, members agreed to progressively bring down tariffs on all manufactured and agricultural products to 0-5 percent within 15 years, later reduced to 10 years. Brunei, Indonesia, Malaysia, Philippines, Singapore, and Thailand started to implement the CEPT scheme on 1 January 1993 and are expected to achieve the AFTA

goals by 2003, while Viet Nam will reduce tariffs in all manufactured goods to 0-5 percent by 2006, Laos and Myanmar by 2008, and Cambodia by 2010.

Table 5
Nominal Tariff Rates in Selected Asian Countries

COUNTRY	TARIFF MEASURE	ALL PRODUCTS
People's Republic of China	Mean	17.48
	CV	71.28
	Weighted mean	20.5
	Maximum tariff	121.6
	Minimum tariff	0
Indonesia	Mean	8.43
	CV	127.76
	Weighted mean	11.23
	Maximum tariff	170
	Minimum tariff	0
Malaysia	Mean	10.2
	CV	200.49
	Weighted mean	13.5
	Maximum tariff	300
	Minimum tariff	0
Philippines	Mean	7.6
	CV	93.82
	Weighted mean	7.51
	Maximum tariff	60
	Minimum tariff	0
Thailand	Mean	18.48
	CV	84.42
	Weighted mean	16.82
	Maximum tariff	80
	Minimum tariff	0
Viet Nam 2002	Mean	16.52
	CV	113.44
	Weighted mean	15.2
	Maximum tariff	120
	Minimum tariff	0

Source: MUTRAP (2002a, Table 6.10).

The instruments established to determine the pace and scope of liberalization comprise four lists. The Inclusion List contains the items subject to immediate tariff reduction in order to come down to the range of 0-5 percent by the prescribed deadline. The items in the Temporary Exclusion List initially are not subject to tariff reductions but are to be transferred to the Inclusion List gradually. Unprocessed agricultural goods are included in the Sensitive List and their tariffs do not need to be reduced earlier than eight years after joining the CEPT scheme; moreover, members are allowed nine years to complete this step. The General Exemption List includes goods that are not subject to tariff rate reductions, consistent with Article X of the General Agreement on Tariffs and Trade.

VI. CONCLUSIONS

Foreign direct investment has represented an extremely important source of growth for the Vietnamese economy. However, its impact on employment and its technological spillover effects have been limited. Even the imposed local content requirements have not yielded the desired results. The principal reason for these disappointing results appears to lie in the underdevelopment of the private sector and its consequent inability to take advantage of the presence of foreign firms through potential linkages.

Strengthening the private sector will involve a number of changes. It will require creation of a more level playing field between state and private firms. It will also depend on increasing access to land use rights and the capacity to use them for collateral and for equity in investment ventures. In parallel, the private banking system will need to broaden and deepen, supported by a credit culture based on assessed risk and return. In general, a more transparent and complete regulatory system will be required to establish a rule-based commercial environment.

In part, the current situation reflects the policy emphasis on continuing growth led by export of labor-intensive manufactures. The anti-import bias in the trade regime may well have distorted the kinds of flows of foreign capital in favor of capital-intensive industries anyway, especially since 1997. Meanwhile, AFTA is progressively influencing the domestic market, with greater competition and efficiency leading to lower prices and profits.

If Viet Nam continues reforms in governance, the financial sector, and its legal system, regional integration through the AFTA and ASEAN Investment Area could present the country with a much larger market in which to reveal its comparative advantage and improve its productivity.

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