FROM LOW-INCOME TO
INDUSTRIALIZED
VIETNAM IN THE NEXT DECADE AND BEYOND
FROM LOW-INCOME TO INDUSTRIALIZED

VIETNAM

IN THE NEXT DECADE AND BEYOND

(Editors)
Kee-Cheok Cheong
Pham Minh Duc
Nguyen Thang

Hanoi - 2010
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FOREWORD

Vietnam has entered a new development phase with the objective of becoming an industrialized country by 2020. The current growth model, on which Vietnam has relied on for more than 20 years since the reign of Doi Moi has led to rapid economic growth – almost ten-fold in per-capita income, and reduction of the poverty rate from 58 percent in 1993 to 14.5 percent in 2008. Vietnam recently crossed the per capita income threshold to become a lower middle income country.

With increased competitive pressures in a rapidly evolving global environment, Vietnam has to confront a new set of challenges, possibly requiring a different set of solutions from those currently applied. Vietnam may have to adopt a new model of economic growth. This new model must permit Vietnam to achieve the broad-based progress needed to move up the value chain in production and exports. For this to happen, Vietnam must move beyond getting economic policies right to strengthen its human capital base and modernize its economic and social institutions. The new model will also require the combined efforts of the country’s many stakeholders in the development process, from the government bureaucracy to private sector institutions, mass organizations and people at large for the country to unleash all its development potential to avoid the middle income trap. For this reason, Vietnam’s leaders have launched a comprehensive consultative process that will bring forth stakeholder inputs to the Strategy.

The Vietnam Academy of Social Sciences (VASS) has been entrusted with the important task of coordinating the analytical
inputs from the research community both within and outside Vietnam. In contributing to this effort, the World Bank has provided technical assistance to support the generation of substantive research-based evidence and stimulate the formulation of strategic ideas.

This volume is a product of this process. It deals with a number of key challenges which Vietnam confronts and will confront and must overcome to achieve its long-term goal. Its authors, and the many unnamed contributors from VASS, other Vietnamese government agencies, the World Bank, and researchers both inside and outside Vietnam have had productive discussions on various drafts of the papers in the volume to improve their quality. It is hoped that the substance of this volume will not only contribute to the process of formulating the government’s Strategy but also be a useful guide to researchers working on, as well as those with a keen interest in Vietnam’s development.

Prof. Do Hoai Nam
President of Vietnam Academy of Social Sciences
PREFACE

This volume consists of a report and several technical working papers that were inputs to the Vietnamese Government’s finalization of its National Socio-economic Development Strategy 2011–2020. These documents are the products of a collaborative program between the Vietnam Academy of Social Sciences (VASS) and the World Bank, and supported by the World Bank’s Technical Assistance Program initiated in fall 2009 (World Bank, 2009b).

The papers here do not cover all aspects of this development strategy. Given time and resource constraints, the program was designed earlier on to focus on specific themes with attention devoted primarily to issues that are just emerging and in need of greater elaboration or were contentious. This meant that major themes about which a fair degree of consensus had been achieved and on which the government was already taking action have been omitted or received only cursory attention.

Although each paper bears the names of its authors, it reflects a significant degree of cross-fertilization across themes and individuals, including many from both organizations as well as other organizations not named. We are grateful to all of them. We are particularly indebted to Prof. Do Hoai Nam (President, VASS), who provided overall guidance, Ms. Victoria Kwakwa (Country Director, World Bank in Vietnam), Vikram Nehru (Director and Chief Economist, EASPR, World Bank), Martin Rama (Acting Director and Chief Economist, South Asia, World Bank) and Deepak Mishra (Lead Economist, World Bank in Vietnam). Other contributors (from the World Bank) include Christian Bodewig,
Austin Kilroy, Deepak Mishra, Martin Rama, and Dean Cira. Substantive comments were received from Mr. Truong Dinh Tuyen (Former Minister of Trade of Vietnam), and Steven Jaffee, Toomas Palu, and Daniel Mont from the World Bank. The excellent editorial work of Ibrahim Ndoma is duly acknowledged.

We also express our gratitude to Prime Minister Nguyen Tan Dung who participated in the Program’s Senior Policy Seminar (SPS), to Deputy Prime Minister Nguyen Sinh Hung who attended and guided discussion in the Inception Workshop, and to Mr. Justin Lin, Vice President and Chief Economist of the World Bank, who made a presentation and contributed to substantive discussions in the SPS.

The Editors

Disclaimer - The views expressed in the papers that make up the chapters of this volume are the personal views of the authors and are not those of the organizations to which these authors belong.
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<td>ADB</td>
<td>Asian Development Bank</td>
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<tr>
<td>AFTA</td>
<td>ASEAN Free Trade Area</td>
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<td>ASEAN</td>
<td>Association of Southeast Asian Nations</td>
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<td>APEC</td>
<td>Asia-Pacific Economic Cooperation</td>
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<td>BTA</td>
<td>Bilateral Trade Agreement</td>
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<td>CAFTA</td>
<td>China – ASEAN Free Trade Area</td>
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<td>CIP</td>
<td>Competitive Industrial Performance</td>
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<td>CNY</td>
<td>Chinese Yuan</td>
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<td>ECD</td>
<td>Early Childhood Development</td>
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<td>ESCWA</td>
<td>Economic and Social Commission for West Africa</td>
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<td>EIU</td>
<td>Economist Intelligence Unit</td>
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<td>ELG</td>
<td>Export-led Growth</td>
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<td>ER</td>
<td>Exchange Rate</td>
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<td>ETDZs</td>
<td>Economic and Technological Development Zones</td>
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<td>EXIMBANK</td>
<td>Export and Import Bank</td>
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<td>FDI</td>
<td>Foreign Direct Investment</td>
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<td>FEZs</td>
<td>Free Economic Zones</td>
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<td>FTA</td>
<td>Free Trade Area</td>
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<td>GSO</td>
<td>General Statistics Office</td>
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<td>GSP</td>
<td>General System of Preferences</td>
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<tr>
<td>HCMC</td>
<td>Ho Chi Minh City</td>
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<tr>
<td>IFC</td>
<td>International Finance Corporation</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>LEG</td>
<td>Large Economic Group</td>
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<td>MNCs</td>
<td>Multinational Corporations</td>
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<td>MPI</td>
<td>Ministry of Planning and Investment</td>
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<td>NER</td>
<td>Nominal Exchange Rate</td>
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<td>NEG</td>
<td>New Economic Geography</td>
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<td>NIE</td>
<td>Newly Industrialized Economy</td>
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<td>NSDS</td>
<td>National Socio-economic Development Strategy</td>
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<td>NTT</td>
<td>New Trade Theory</td>
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<td>Acronym</td>
<td>Description</td>
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<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
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<tr>
<td>OER</td>
<td>Official Exchange Rate</td>
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<tr>
<td>PIIGS</td>
<td>Portugal, Ireland, Italy, Greece, Spain</td>
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<tr>
<td>RCA</td>
<td>Revealed Comparative Advantage</td>
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<tr>
<td>RER</td>
<td>Real Exchange Rate</td>
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<tr>
<td>REER</td>
<td>Real Effective Exchange Rate</td>
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<td>R&amp;D</td>
<td>Research and Development</td>
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<tr>
<td>RTA</td>
<td>Regional Trade Agreement</td>
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<td>SBV</td>
<td>State Bank of Vietnam</td>
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<td>SEZs</td>
<td>Special Economic Zones</td>
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<td>SOE</td>
<td>State-owned Enterprise</td>
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<td>STI</td>
<td>Science, Technology and Innovation</td>
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<tr>
<td>TFP</td>
<td>Total Factor Productivity</td>
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<td>UNCTAD</td>
<td>United Nations Conference on Trade and Development</td>
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<td>UNIDO</td>
<td>United Nations Industrial Development Organization</td>
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<tr>
<td>USD</td>
<td>United States Dollar</td>
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<tr>
<td>VAT</td>
<td>Value-added Tax</td>
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<td>VDR</td>
<td>Vietnam Development Report</td>
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<td>VND</td>
<td>Vietnamese Dong</td>
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<td>WB</td>
<td>World Bank</td>
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<td>WCO</td>
<td>World Customs Organization</td>
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<td>WEPZA</td>
<td>World Export Processing Zones Association</td>
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<td>WTO</td>
<td>World Trade Organization</td>
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1.1 Vietnam Achieves Middle-Income Status: The Context

Since the launch of economic reforms under *Doi Moi* in the late 1980s, Vietnam has made major strides in its socio-economic development. GDP per capita has increased more than 10 times, from under US$100 in 1990 to about US$1,200 in 2010. In the process, the proportion of the population living in poverty has fallen from 58 percent in 1993 to 12.3 percent in 2009. Macroeconomic aggregates reflect this growth. Total investment has increased almost tenfold since 1995, while exports increased about 24 times, to US$57 billion, in the two decades between 1990 and 2009. This impressive growth performance has enabled Vietnam, among the poorest countries in Asia when its economic transformation began, to achieve the status of a (low) middle-income country.

However, the growth momentum built up under *Doi Moi* is in danger of losing steam. This is because of a confluence of both domestic and external factors, the latter gaining importance with Vietnam’s greater integration into the global economy. Domestically, the limits of existing reforms are being reached while externally, the global environment has seen major changes.¹

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¹ In recent years, although there remains optimism about Vietnam’s economy (e.g. Qiao, 2008), increasing concern has been expressed about the sustainability of the Vietnam miracle (see, for instance, Overland 2008, Pincus, 2009, Tsuboi, 2007).
1.1.1 The Changed Domestic Context

Domestically, early liberalization reforms that helped overcome preexisting inefficiencies resulting from constraints to efficient resource allocation and free up resources so that they can be more productively deployed have just about run their course. As Vietnam attains the status of a middle-income country, new challenges are emerging to confront the existing model of growth. Hence, a new development approach is needed if Vietnam is to realize its goal of becoming a developed country by 2020. The task of further reform now has to confront structural deficiencies and rigidities in the economy that need to be subdued. This does not mean abandonment of initiatives to promote growth, but it means shifting from an emphasis on growth exclusively at the extensive margin to one that also improves the quality of growth. Thus, Vietnam must address challenges that include moving beyond poverty reduction to improving human well-being through quality healthcare and education, creating sufficient productive employment for a young and growing labor force with rising expectations, developing flexible and responsive state institutions and strengthening governance to support a larger role for private enterprise, and deepening the human resource base to meet the needs of a rapidly changing economic environment increasingly driven by technology. Overcoming these challenges will be essential to raise the population’s incomes and savings to finance and sustain higher levels of development. The new domestic environment is examined in greater detail in Section 1.2.

1.1.2 The Changed External Context

Externally, Vietnam’s integration into the world economy, with its accession to the world trade organization (WTO) in 2007 was a major milestone that brought competition to the country’s doorstep and hence, restricts the country of the luxury of modernizing at its own pace. Globalization in trade and finance is pitting Vietnam’s exports against those of other nations, many in the region, and intensifying competition for foreign investment. Geographically at Vietnam’s doorsteps is China, a member of the WTO since 2001,
with its huge population base, rising incomes, a skilled labor force complemented by growing technology capability that has not only earned it a reputation as a formidable competitor, initially as a manufacturing base for low-tech products but increasingly of high-tech products as well. Although a late starter, India is opening its economy and looking east. The growth of both giants will have major consequences for Vietnam’s economy.

The urgency of these long-term structural changes has been heightened by developments over the past decade that began with the Asian Financial Crisis (1997-1998) and ended with the even more severe Global Financial Crisis that began in 2008 and is only now beginning to subside. The Asian Crisis, from which Vietnam emerged relatively unscathed even as its ASEAN neighbors were savaged, contributed to a rearrangement of the competitive landscape in Southeast Asia, partly through reallocation of foreign investment flows, with Vietnam a beneficiary of this redistribution.\(^1\) More importantly, it set the stage for the emergence of Asia’s giants, China and India, which was part and parcel of a global shift in the balance of economic power from West to East. The Asian Financial Crisis also precipitated another manifestation of this power shift – the accumulation of foreign reserves by East Asian nations, China as well as those most severely impacted by the Crisis, as a precaution against future crises. The result has been for East Asia to possess over half the world’s external reserves.

The Global Crisis of 2008 has not only accelerated these trends but also put in place a new international dynamic that has particular relevance for Vietnam. For the first time in modern history, Asia’s giants, China and India are leading Asia’s recovery ahead of the battered Western economies, forcing critics of the ‘decoupling’ thesis, seemingly vindicated when Asian financial

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1. The World Bank’s World Development Indicators balance of payments data show Vietnam’s net foreign direct investment to be US$9.6 billion in 2008, equivalent to 11 percent of its GDP, compared to just US$1.3 billion, or 4 percent of GDP, in 2000. Indonesia has also seen net foreign direct investment inflows almost as large (US$9.3 billion), although as a much smaller proportion of its GDP (2 percent).
markets crashed and exports diminished, to reconsider their triumphalism. After years of underperformance, Indonesia is set to take its place as an emerging giant. The soundness of Asian financial sectors, thanks to reforms undertaken during the Asian Financial Crisis, which stands in sharp contrast to the economic devastation of their Western counterparts. In the medium term, new giants, China and India and emerging Indonesia, together with Japan, still a formidable economy, will account for over half the world’s output. This shift in global economic power is nowhere better reflected than by the current focus on the G20 rather than the G7 or G8.

At center stage is China, which, although scarred by the Global Financial Crisis, has, through massive fiscal spending, been able to maintain its 8 percent growth rate in 2009. Furthermore, its external reserves, at US$2.4 trillion are by far the world’s largest, and it is the U.S.’ largest creditor. In the midst of calls for ‘rebalancing’, China’s export momentum has not been significantly diminished, only redirected, from the U.S. and Europe, towards Latin America and Africa. It has boosted consumption, with the government’s recent (June 2010) support for higher wages as part of this effort. It is the source of a new global dynamic which would have occurred even without the Global Financial Crisis – the heightened demand for natural resources and primary commodities worldwide, with the consequent upward pressure on their prices.

Heightened demand for commodities from China and India to fuel their growth will elevate commodity prices over the medium term, with Vietnam’s primary exports benefiting from this boom. However, greater commodity price volatility also affects Vietnam’s imports of inputs, including raw materials, to fuel its export machine. Commodity price fluctuations translate into corresponding fluctuations in trade balances, and ultimately in

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1. China’s announced fiscal package of 4 trillion yuan (US$586 billion), or the equivalent of 14 percent of its GDP, in November 2008. In value terms, it is second only to the fiscal package of the US, but as a percent of GDP it is far larger.
Vietnam’s macroeconomy, given the country’s growing dependence on trade.

Efforts to exit the Global Financial Crisis and to prevent a repeat will likely lead to new and tighter regulations on international finance, although the final shape of the regulatory package remains to be seen. Even as tighter regulatory legislation is making its way through the US Congress, disagreements across the Atlantic remain, and European countries are themselves at odds over some regulatory provisions proposed. American and European financial institutions are doing their best to have regulations pulled back or watered down, forgetting that they were responsible for the global meltdown in the first place.\(^1\) The more recent Greek debacle will also add to calls to lower tolerance for debt. Asian countries which had already learnt these lessons from the Asian Financial Crisis should not be too worried by these developments. However, in Vietnam, where credit growth has been persistently high, the lessons of the Global Crisis need to be taken seriously.

Vietnam will need to deploy as many policy instruments as there are at its disposal to meet the challenges from these changed circumstances. However, WTO accession in 2007 has altered policy levers, mainly in the direction of voiding many options policy-makers used to have before WTO. Specifically, Vietnam has committed to financial liberalization, leaving it with limited time to reform and strengthen its institutions. The extent and nature of state support for state-owned enterprises (SOEs) will also need to be consistent with WTO rules, which ensure a level playing field between the state and private sectors. Export incentives, e.g. export subsidies for textiles, will likewise have to be proscribed. There will also be pressure to make progress in reforms to move Vietnam towards a full market economy. Being labeled a ‘non-market economy’ renders the country vulnerable in trade disputes and exposes it to trade sanctions. Thus, at the very time when more and more effective economic management is needed, fewer

\(^1\) Wolf (2010) found the Basel III agreement, hammered out in fall 2010, decidedly underwhelming.
instruments are available. Section 1.3 closely examines this new external environment.

**1.2 The New Domestic Environment**

Vietnam’s objective is not to just become a middle-income country. Attaining the status of a middle-income country is just the stepping stone for the country to actualize (higher-income) its stated goal of becoming an industrialized country by 2020. What is the domestic environment the country faces as it pursues this objective?

**1.2.1 Avoiding the Middle-Income Trap**

Clearly, for Vietnam as for any other country, advancing to high-income status requires sustained growth of income. But this advance is far from guaranteed. Many countries that had shown early potential for growth or had reached middle income status were locked into low growth trajectories and hence unable to elevate themselves into high income countries. Gill and Kharas (2007) referred to this as ‘the Middle-Income Trap’. While the phenomenon is basically an empirical one, theories had been developed to explain why it can and have occurred. A general explanation of why such a trap exists for middle-income countries arises from the increasing complexity of their economies which makes management difficult while at the same time, their institutions have not yet the capacity to cope. Major factors explaining such failure include economic crises that resulted from economic mismanagement, low human capital, a low level of technological capability, environmental degradation, high income inequality and poverty. This risk is heightened in East Asia, including Vietnam, where rapid economic growth has outpaced institutional deepening which takes time. East Asia is a victim of its own success.

Asia is rich with examples both of success and of failure. For example, South Korea, on one hand, with rising technological capacity supported by human capital depth, export-driven growth, and a major role played by industrial policy, broke out of the trap,
was in danger of falling back into it during the Asian Financial Crisis, but reemerged as an even more robust economy after that Crisis ended, thanks to major economic and institutional reforms (Figure 1.1). On the other hand, the Philippines, characterized by low savings and investment and weak fiscal management combining to produce fiscal and external deficits, and with institutions infected by pervasive corruption, was trapped in a low growth trajectory even while it was only a lower middle income country. These weaknesses had their roots in the capture of the state by powerful vested interests. Intermediate examples of countries that might face a middle income trap are Malaysia and Thailand. Malaysia, halfway up the middle-income group, is seeing its progression to high income retarded by low private investment and a shortage of human capital. Thailand, a little lower than Malaysia along the income scale, is facing the same constraints, but also rising income disparities that culminated in the March 2010 street protests in Bangkok.

1.2.2 Ingredients for Sustained Economic Growth

Moving from middle- to high-income constitutes a major challenge. This is on account of the increasing complexity of an economy as its income advances and the need to change growth strategies. To achieve sustained increase in national income, a country must successfully transform itself structurally through successful transition in three areas. They are transitions:

- From output expansion via the use of more factors of production to that based on productivity increase. This shifts emphasis away from an emphasis on the quantity of productive resources to the quality of these resources;

- From diversification of output to specialization based on technological upgrading. This means moving away from producing an ever expanding range of products to a more narrowly specialized range of products and services based on raising productivity and strengthening technological capability. In the process, some sectors may have to be left to decline;
• From the ‘rule of man’ to the rule of law. This means a civil society that abides, not just by sheer weight of political power (‘rule of man’), or by the threat of legal penalties (‘rule by law’) but by collective recognition of a common good (‘rule of law’), to rules and regulations governing its behavior.

Figure 1.1: Escaping the Middle-Income Trap - Examples of Successes and Failures

Source: Kharas (2007).

Lessons of transition can be drawn from both successes and failures. As South Korea’s case shows, for success to be sustained, attainment of the above transitions needs to be accompanied by adaptability when conditions change. This will require complementary roles played by the state and market, supported by strong institutions backed by strong political will and decisive leadership. The lessons of failure are equally important. The middle-income trap does not set in only when countries reach the high end of the middle-income range. Countries can be stuck in a low-growth trajectory even at low levels of income. As the case
of the Philippines shows, this can occur even when countries have high growth potential. Also, being stuck in the ‘trap’ can give no assurance that a country will remain middle-income. Deterioration, both in relative and absolute terms, can be rapid and sizable. The above examples also showcase specific factors that put countries into the ‘trap’. These include the destructive role of interest groups in the Philippines, the dominant economic role played by Bangkok at the expense of the countryside, and the upper classes against the lower, that led to the rupture manifested by the recent political turmoil, and the shortage of human capital that condemned Malaysia to heavy reliance on foreign labor while those educated seek greener pastures elsewhere through emigration.\footnote{Recognition of this problem, as well as other structural deficiencies, has led the Malaysian government to commission a study that culminated in an unprece- edentedly frank assessment of Malaysia’s plight. See NEAC (2010).}

Viewing it from the Vietnamese context, the above country experiences need to be examined in relation to their relevance, given the specific circumstances applicable to each country. While they offer broad lessons, Vietnam also needs to deal with risks unique to its economic situation. Over the short-term, Vietnam had to contend with problems arising from its WTO accession, \textit{viz.} large inflows of capital that led to asset bubbles in 2007 and early 2008, not helped by its persistent addiction to credit expansion. A longer-term risk is that the demographic dividend Vietnam is reaping, in the form of a large proportion of young people of working age who could save and a low dependency ratio, together with a slow pace of urbanization, will eventually come to an end. For these reasons, it is none too soon to adapt and endogenize lessons learned from other countries in developing a new model for growth if it were to achieve its ambitious objective of becoming a developed economy by 2020.

1.2.3 Major Risks
Dealing with these challenges is a daunting task. Even worse off, Vietnam has to confront several major risks, not all of which are of domestic origin. These risks arise from:
• The increasing complexity in economic structure as the economy develops, so that actions taken or developments occurring in one part of the economy increasingly affect other parts. Continued reliance on strategies that worked in the past may do more harm than good given this changed structure.

• A more hostile environment for loans, especially concessional, thanks to the economic climate as a result of the Global Financial Crisis, with the US showing anemic growth and a huge public debt overhang, and the sovereign debt problems in Greece and the other PIIGS that rocked the Eurozone. In the U.S. itself, legislation to overhaul the financial regulation system, the failure of which led to the Global Crisis, had been passed in July 2010, while Europe is also moving in this direction (Hall, Peel and Tait, 2010).

• The onset of major economic crises, so far two in a decade, which can derail growth for a long time. Such crises have exposed the weaknesses of the economy; adversely affect the most vulnerable among the population, and damaged prospects for long-term growth. They can also lead to realignment in economic competitiveness among nations, with those that are structurally vulnerable or poorly managed losing out.

1.2.4 Where is Vietnam Now?

As the healthy inflow of foreign direct investment (FDI) shows, Vietnam is still competitive as a low wage manufacturer. That China, long the leader in this mode of production, has decided to reduce its dependence on low cost manufacturing and move up the production value chain, and that some multinational corporations (MNCs) are keen to diversify their production facilities out of, but remain geographically close to, China has helped entrench Vietnam’s competitive advantage in this area. It is also competitive in primary production, its oil and coal finding ready markets in
China and elsewhere (Ha Thi Hong Van and Do Tien Sam 2009). It is a high-yield producer of natural rubber. Vietnam is now the world’s second largest exporter of coffee, having become the second largest producer, after Brazil, in the 1990s (see Nguyen Quang Huy, 2010).

These strengths, together with the fact that Vietnam has just arrived at middle-income status, means the middle-income trap poses no immediate threat to the country at this time. However, assuming the country continues its healthy rate of growth, it could reach the danger zone in a decade, sooner if growth is more rapid than projected. Even this breathing space cannot be guaranteed; the income level of the Philippines (at just above US$2,000 per capita in 1975, as shown in Figure 1) illustrates just how close Vietnam can be to this danger zone. Even if the decade of breathing space exists, measures needed to ensure sustained long-term growth can have a long gestation period before fruition. It is therefore entirely appropriate to begin strategizing how best the middle-income trap can be avoided. Vietnam should take heed of another country’s example, Malaysia, in the middle of the middle-income category, which, when confronted with this trap, finds itself unable to respond quickly because its human resource base is not up to the task (see NEAC, 2010).

1.3 The New Global Environment

Although much discussion on current issues is about the Global Crisis and its aftermath, this Crisis is but a product of the new global environment facing all countries and parts of the world. Even without this Crisis, there are a number of challenges and risks posed by this environment which Vietnam, and all other economies plugged into the world economy, must confront and manage.

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1. In recent years, Vietnam has benefited from expanding output as well as rising rubber prices, thanks to growing demand. See Vietnam Business News (2010).
1.3.1 Volatility of Capital Flows

Arguably the most serious challenge, starkly revealed by the evolution and impact of the Global Financial Crisis, is the potentially destabilizing impact of capital flows. Already evident during the Asian Financial Crisis of 1997-1998 when portfolio capital flight sank Indonesia, Malaysia, South Korea and Thailand, while testing Hong Kong, Singapore and Taiwan, this challenge has become even more daunting with the growing importance of the financial sector in the global economy. Although there are persuasive arguments in favor of capital flows, the risks from abetting such flows are also substantial. Large speculative flows in search of yield invariably find their way into assets perceived to yield the expected returns, driving up asset prices in the process. When for whatever reason investors decide to exit, herd instinct makes for sudden and sharp reversals that can decimate stock markets and disrupt financial stability. At the same time, the exit of capital affects the exchange rate, as occurred at the onset of the Asian Financial Crisis, affecting the trade competitiveness of countries’ whose exchange rates were affected. Given the size of the global financial sector, which is now a multiple of that of the real sector and the close links between both, any financial crisis quickly develops into a global economic crisis, with damaging consequences for individual countries, big or small.

This challenge can be met if the psychology of the market can be managed, but it is easier said than done. Panics and manias are as much part and parcel of the deepest and most sophisticated stock markets in the world as of the smallest and least developed. Strong economic fundamentals also cannot guarantee rational decision-making by investors. The strength of Asia’s financial sectors was no match for the panic that set in on Asian markets when those in New York and London collapsed in the last quarter of 2008. Still, suggested measures, like building up foreign reserves, strengthening capital reserve requirements of financial institutions, liberalizing outflows, and shifting public sector deposits to the central bank, have been suggested to deal with surging inflows while prudential regulation, robust governance, flexible exchange
rates and the use of anti-cyclical fiscal policy would help manage these flows. To the extent possible, regional coordination has also been recommended, while even the controversial capital controls are no longer off the discussion table.¹

1.3.2 Regional Opportunities and Challenges

A second challenge comes from the realignment of economic power within Asia itself. This realignment has been occurring over the past decade, but had been accelerated by the Asian Financial Crisis of 1997-1998 and the current Global Financial Crisis. The extent to which these crises affect countries depends on how dependent countries are on external markets and the size of their domestic economies. By these criteria alone, China and India would have considerable advantages over other Asian countries. Through the above crises, both economies recorded not only positive but stellar growth.² Two years after the beginning of the Global Financial Crisis, China, more globalized than India, is leading Asia’s recovery, while both countries are contributing to global growth in a way that the US and Europe have been unable to.

The rise of China and India is reshaping intra-Asian trade, especially with China’s relentless search for energy and raw materials to fuel its growth, as well as its role as an anchor for regional supply chains. China, the largest exporter in the world, has become the largest trading partner for Japan and South Korea, replacing the US in both cases. Its growing prowess in technology exports is also seeing greater competition in this area.³ At the same time, regional

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1. In the context of the 2008 Global Financial Crisis, the IMF, a staunch opponent of capital controls during the Asian Financial Crisis, now believes that “Controls on foreign capital into emerging economies can be part of the policy options available to governments to counter the potential negative economic and financial effects of sudden surges in capital.” See Ostry et al. (2010).

2. In 2008, China recorded growth of GDP of 9 percent while India grew by 6 percent.

3. Although much criticized for its lack of respect for intellectual property rights, China has developed, and continues to strengthen, its domestic technological capacity. In terms of peer-reviewed scientific papers in academic journals, China is only second to the U.S. See Pomfret (2010).
economic relationships are being reshaped. For instance, not only has China come to play a lead role in APEC, it has been a proponent of the ASEAN Plus Three (APT) concept and the driving force for the establishment of the China ASEAN Free Trade Area (CAFTA).\(^1\) India, recognizing the growing importance of East Asia, has also begun to engage ASEAN and want APT to be ASEAN Plus Four. This focus on ASEAN has given the organization a new dynamism with respect to Southeast Asia, although the fact that ASEAN is made up of two tiers of more and less developed nations, has made the task of arriving at a consensus, an ‘ASEAN way’, more challenging. Complicating these regional arrangements is an increasingly dense web of bilateral agreements, some of these with countries outside the region, of which the Vietnam-US Agreement is just one example.

The changing dynamics of East Asian trade is also partly a reflection of changes in FDI flows. These flows are the result of multinational corporations taking advantage of a new pattern of competitiveness, driven increasingly by technology. Those countries which enjoyed early-mover advantage in FDI, Malaysia and Thailand, are losing their edge. Vietnam and Indonesia are the areas generating great FDI interest on the strength of their low cost advantage, especially as China, the top destination for FDI, is attempting to move out of low cost manufacturing and up the product value chain. The key to future competitiveness is technology, and inability to develop local technology capacity is a major reason for Malaysia and Thailand losing out in attracting FDI. The experience of these countries, together with what China is doing, should inform Vietnam as to what needs to be done to move out of low cost production as it must to avoid being caught in the Middle Income Trap.

These developments, especially those related to China, present major opportunities and threats to the rest of Asia, and in particular

\(^1\) China’s latest agreement with Taiwan, the Economic Cooperation Framework, signed on June 29, 2010, will also have implications for regional trade, and for a proposed China-Japan-South Korea Free Trade Agreement now under discussion. See Asahi Shimbun (2010).
Vietnam. A major opportunity is to meet the heightened demand for energy and primary commodities and benefit from their rising prices this heightened demand engendered.\footnote{China is the largest consumer in the world for a number of raw materials. In 2002, China became the world’s largest consumer of copper and natural rubber and it is now one of the largest consumers of alumina, zinc and nickel (Heinrich Boll Stiftung, 2008). China is Vietnam’s largest consumer of natural rubber.} This will lead to both higher export revenues and foreign direct investment. Another is to leverage whatever comparative advantage exists, e.g. Vietnam’s lower-cost skilled labor, or its potential as an alternative production platform to China, also to attract FDI. A third is to attract FDI from these emerging giants, especially with China, sitting on its huge stockpile of external reserves, keen to invest overseas as part of its ‘Going Out’ strategy.

There are also challenges. In a world of shifting competitive advantage, China and India may well prove to be formidable competitors, even to the more advanced Asian countries, without giving up its low cost base, thanks to their very considerable economies of scale. Their enterprises may also be less concerned with international environmental standards and working conditions norms, the potential harm being aggravated by their operations in extractive and other environmentally damaging activities. That more established global corporations are less willing to invest in these activities, coupled with Chinese companies’ readiness to invest heavily, gives Chinese companies especially considerable leverage.

1.3.3 The Aftermath of Crisis

The legacy of the Global Financial Crisis also poses particular risks for Asia’s recovery. Although Asia is recovering well, the developed world is experiencing much more fragile growth that can be derailed by a number of factors. Regional or national crises, such as in Dubai, and Greece, that threaten to engulf weaker European states, have sent shockwaves through financial markets worldwide, raising risk premiums and hence borrowing costs.
Although these crises were of magnitudes that could be contained, the issues have as much political as economic ramifications. This seems also the case with the debate on global imbalances and their moderation, with deficit countries (mainly the US) blaming the surplus countries (mainly Asian, especially China) for their plight and demanding that these surpluses be reduced. Such rebalancing, even if agreed to by the surplus countries, will take time. A third area of tension, and related to the second, is over exchange rates, with China being accused of keeping its currency artificially depressed to boost its exports. That a bilateral exchange rate, even an important one, is just one of many factors affecting a country’s current account balance seems to have been forgotten in this politically charged debate.

These debates, if not tempered with common sense, can lead to countries retreating into protectionism and competitive devaluations, the very actions that deepened the Great Depression. In the early part of the Global Financial Crisis, this possibility was only forestalled by the convening of the G20 and agreement reached for collective concerted action. However, protectionism did increase. Data from the World Bank-sponsored Global Antidumping Database showed a substantial increase in new trade barriers – in the form of WTO-compliant measures, such as antidumping, global safeguards and countervailing duties – towards the end of 2009 (Bown, 2010).

A last area of uncertainty is how to deal with the unprecedented levels of public debt that had been the direct result of the fiscal stimuli to stem the tide of recession. While this coordinated stimulus effort has been generally successful, there is no agreement on when and how this debt can be unwound. This disagreement was on show at the G20 summit in Toronto in June 2010, with the US arguing for continued fiscal laxity but Europe arguing for fiscal tightening. Either course of action can lead the world economy back into recession. Continued fiscal spending could lead eventually to unsustainable levels of debt, culminating in a debt crisis. Fiscal tightening before recovery has gained traction.
can plunge the global economy back into recession, as occurred in Japan in 1996.

1.3.4 Vietnam’s Accession to the WTO

Vietnam’s accession to the WTO in early 2007 is an important milestone in the country’s integration process. Some commentators see the start of a new round of reforms that would lead to far reaching changes in the policy and business environment, with major implications for Vietnam’s economic growth and poverty reduction. The changes that take place are beyond-, on- and behind-the-border. The beyond-the-border changes include Vietnam’s greater access to foreign markets, including from the removal of quotas on Vietnam’s garment exports, and from the dispute settlement mechanisms available to WTO’s members. The on-the-border changes include lowered barriers to trade in the form of reduced import tariffs and the dismantling of numerous non-tariff barriers. The behind-the-border changes include the opening up of services and distribution sectors and legal and institutional reforms as required by Vietnam’s commitments under WTO accession. These will help Vietnam accelerate the process of transition to a market economy, with salutary consequences for economic growth and poverty reduction.

However, challenges go hand in hand with opportunities. First, lowered import tariffs, from the pre-accession average rate of 17.4 percent to a final upper-bound of 13.4 percent, and the dismantling of non-tariff barriers to trade will mean greater competition from foreign firms, particularly from countries within the region, where a wide range of similar products are made. As already indicated, the most potent competitor is China, which joined the WTO in 2001, and against the goods of which Vietnam can no longer discriminate once a member of WTO. But the rise of Indonesia in particular and efforts by other ASEAN countries to strengthen their competitiveness will put increased competitive pressure on Vietnam’s goods for export.

With regard to external financial liberalization, international experiences suggest that having strong regulatory and supervisory
structures are critical for a country to maximize benefits and minimize costs associated with this process. The high degree of volatility and pro-cyclical nature of international capital flows have had destabilizing effects on countries where regulatory frameworks for short-term capital are inadequate. Macroeconomic instability in Vietnam that prevailed in the first three years of the country’s accession to the WTO can be partially attributed to the lack of appropriate mechanisms to manage large investment inflows. This exacerbated the country’s inherent structural problems related to low efficiency of public sector investment, the presence of critical bottlenecks to growth such as weak infrastructures and inadequate human capital, and large and persistent budget and growing trade deficits. The large inflows of portfolio investments in 2007 and 2008, together with the existence of the chronic problem of “dollarization”, caused huge difficulties for monetary and exchange rate policies. Inappropriate policy responses undertaken then resulted in high inflation and bubbles in stock and real estate markets, and large macro imbalances, which panicked market participants into a mini-crisis in the middle of 2008. Therefore, proper monitoring and management of foreign investment, with special attention to short-term speculative funds, and more broadly, keeping financial liberalization at the right pace should be seen as an important part of Vietnam’s integration strategy in the new global context.

Within the country, the hitherto protected financial sector, consisting primarily of banks, will be opened to foreign competition according to an agreed-to schedule. The length of time envisaged by this schedule may not be long enough for government reforms to strengthen Vietnamese institutions adequately to face such competition. And should Vietnam’s large number of banks resort to unsound competitive practices, the improving but still imperfect regulatory mechanisms and institutions may not be up to the task to prevent a financial crisis from developing.

Likewise, the national treatment principle means that domestic enterprises have to compete with foreign firms on an
equal footing, without being able to rely on the Government’s targeted support as they used to. Other WTO commitments mean the Government of Vietnam now has to use only WTO-consistent instruments to strengthen the competitiveness of domestic firms, promote exports and encourage investment into certain sectors or regions.

Thus, upon the country’s accession to the WTO, a number of policy levers previously available to the Government, as well as some industrial policy tools used extensively by East Asian countries in the early stages of their socio-economic development can no longer be deployed. Specifically, the need to comply with trade-related investment measures upon accession means that preferential state credit and import tariffs contingent upon localization ratios ceased to exist as soon as Vietnam became a WTO member. Nor can the Government provide subsidies in the form of export performance-linked investment incentives beyond the five-year phase-out period. Special treatment for SOEs in general and state trading enterprises in particular, which was quite common in the pre-accession period, is also no longer possible. Furthermore, Vietnam is among a few WTO members who still suffer from the unjust and arbitrarily determined “non-market economy” status. This considerable disadvantage would possibly continue until 2018 unless Vietnam’s efforts to exit this status earlier come to fruition. But until then, trading partners can, without difficulty, take antidumping actions with devastating effects on Vietnamese firms, workers and households. Thus, Vietnam is highly vulnerable to global protectionism, which tends to rise in the challenging times of global economic downturn and in the post-crisis period.

These challenges pose several major risks for the Vietnamese economy. The first, and one that is faced by all transition economies, is that being labeled as a ‘non-market economy’ (NME) exposes Vietnam to all kinds of trade allegations on the grounds that prices, particularly production costs, are not market determined. Since the WTO was to promote trade among market
economies, the NME concept was applied to transition economies, including Vietnam and China, as part of the accession package. This designation, however, could be waived; ASEAN countries considered Vietnam a market economy, but the US, EU and Japan continue to designate Vietnam as an NME (Nguyen Son et al. 2007). Under a NME status, Vietnam’s production costs could be compared unfavorably with those of an arbitrarily-chosen third country, giving a convenient excuse for the US, EU and Japan to impose anti-dumping penalties and countervailing duties that are permitted under WTO rules.¹

A second risk consists of asset bubbles that can be formed by a combination of factors. They include:

- unchecked credit growth, abetted by persistent reliance on credit to fuel growth;
- a poor regulatory framework that is unable to manage external capital inflow and channel it to productive use;
- the power of state-owned enterprises with preferential access to credit; and
- very imperfect real estate markets.

Asset bubbles have occurred in Vietnam’s recent history, but the risk is heightened by liberalization of capital flows attendant on WTO accession.

Asset bubbles are symptomatic of a third risk, namely, the government’s loss of control over the economy. With economic management rendered that much more challenging by the increasing complexity of the economy, the inability to exercise direct administrative tools on account of the need to be WTO-compliant will make this task even more difficult.

¹. As of 2009, nearly 30 anti-dumping cases had been filed against Vietnamese exports, the majority of them by the country’s major trading partners, the U.S., E.U. and Canada. Products targeted included catfish, shrimps and footwear (Le Thi Thuy Van and Tong, 2009, pp. 1-2).
1.4 Implications for Vietnam’s Development Strategy

1.4.1 The Need to Change Strategy

Vietnam’s current growth strategy, while hitherto successful in bringing about rapid growth for over two decades, has serious vulnerabilities, especially in the context of the new domestic and global environment.

First, its growth has been built around credit expansion that cannot be sustained over any period of time. Excessive credit expansion, which produced domestic crises arising from asset price bubbles and financial instability, is directly linked to over-borrowing from state-owned enterprises (SOEs) that receive preferential treatment and are not subject to financial discipline. It is also linked to the emergence of private banks that, thanks to lax regulation, competed through aggressive lending using dubious instruments that heightened credit risk. The large current account deficit from capital and intermediate goods imports that required financing has added to the demand for credit. Although this has been partly met by FDI, reliance on portfolio capital was on the rise, bringing with it the risk of sudden reversals, with pressures on the exchange rate the result.

In late 2007 and early 2008, Vietnam’s economy overheated from excessive credit expansion combined with a large influx of foreign capital.¹ This credit expansion, together with rising world energy and food prices fueled inflation. Although the government’s stabilization policy proved ultimately successful, this had costs for the economy, with interest rate hikes bringing hardships to firms, and costs also borne by domestic banks. At the same time, fiscal intervention had left the government with a growing debt burden, much of which would require external financing. At a minimum, stabilization diverted the government’s attention from promoting sustainable growth. Continued reliance on credit expansion to drive growth will certainly lead to a repeat of this episode or worse, with damaging consequences for long-term growth. Massive inflow of

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¹ Credit growth reached a record 53.9 percent in 2007.
capital and aggressive credit expansion mated to a fixed nominal exchange rate was the recipe for the Asian Financial Crisis of 1997-1998. China’s sterilization of capital inflows that resulted in the buildup of massive reserves, although also not without problems in the long-run, should be seen as that country’s attempt to hold down inflation.

Second, Vietnam’s economy is still dependent on natural resource extraction and primary commodity production. While benefiting from high commodity prices, reliance on these products exposes the economy to international price fluctuations and, unless carefully regulated, it is injurious to the environment in the long-run. Likewise, its food and agricultural exports are based upon extensive (and potentially not sustainable) utilization of natural resources and generally feature low levels of value addition. Its manufacturing sector is characterized by industries that employ cheap labor, with low value-added per unit of output. There is little innovation embodied in any of these activities, preventing Vietnam’s industries from participating productively in the international supply chains from which China and its Southeast Asian neighbors had reaped so much benefit (Phan Minh Ngoc, 2008). Low technological capability is the result of Vietnam’s low human capital stock, itself the product of an education system much in need of reform.¹ These issues are addressed in Section 6.4.

Third, a lack of dynamism in industry can be blamed in large part on the dominance of state enterprises, which receive preferential treatment from government and in any case face little competition from a very small and underdeveloped private sector. Their poor efficiency, lack of dynamism and innovation cannot be remedied by the formation of large economic groups without major reform to address inefficiency and poor productivity through, at a minimum, effective regulation and leveling the playing field.

¹ Vallely and Wilkinson (2008, p. 1) noted: “It is difficult to overstate the seriousness of the education challenges confronting Vietnam in higher education... Without urgent and fundamental reform to the higher education system, Vietnam will fail to realize its enormous potential.”
Indeed, these large groups heighten the risk of moral hazard and that greater concentration of power among their management would create even more powerful vested interest groups capable of capturing the state. These groups will be discussed at greater length in Section 7.3.

Fourth, even without the above vulnerabilities, Vietnam’s continued growth is coming up against infrastructural constraints. The existing woefully inadequate trade-related physical infrastructure, logistics and facilitation processes, have produced bottlenecks that raise the manufacturers’ cost, hampers commerce, and harms the country’s competitiveness overall. As Vietnam continues its transition to a market economy through integration into the world economy, the role of trade logistics becomes increasingly important. Unfortunately Vietnam is weak in all key areas. Transport infrastructure, be it road, railway, inland waterway, port, or airfreight, are underdeveloped both quantitatively and qualitatively, with actual implementation of upgrading activities falling far short of planned. The logistics industry is underdeveloped; operators lack modern equipment and operational models, while information and communication technologies are far below global norms. Vietnam’s border management system is slow, unresponsive, and inconsistent, hampered by opaque and often inconsistent regulations and implementation plagued by pervasive corruption. Unfortunately, what is bad news for Vietnam is good news for its neighbors, especially those, like Singapore, with highly developed trade facilitation infrastructure able to handle cargo volumes that Vietnam cannot or only at high cost. Section 6.2 examines these issues and proposes solutions in greater detail.

Deficiencies in transport infrastructure are just part of the sorry state of public infrastructure in Vietnam, for which huge investment needs must be met if Vietnam is to continue registering high growth. Another area in which infrastructural upgrading

1. For instance, in road transport, compared to the planned 196,852 million ton persons planned for 2008, the actual was only 443 million.
is needed is urban development. Vietnam is urbanizing rapidly, and cities now generate about 70 percent of the country’s output. While much of this output is from large urban centers, medium-sized cities are growing in importance. These trends present many challenges for policy-makers. The many challenges include land and planning, urban poverty, weak institutions and urban management capacity, and environmental degradation. Specific areas that need attention include the following:

- An urban strategy is needed since urban issues, especially the high land prices which pose risks to the credit system, has come to the fore.

- Given the considerable resources required for urban development, where these resources will come from would also have to be ascertained.

- Also needing clarification is what should be the balance between short-term and long-term needs, given that short-term fixes, although urgently needed, were potentially more expensive over the long-term.

- In terms of the mode of management, a choice of models needs to be made. Should cities compete, as was the case in China, or should they be managed as a portfolio?

Section 6.3 provides a comprehensive and detailed discussion on this issue.

1.4.2 Setting Priorities for Breakthrough Interventions

Dealing with the existing deficiencies requires the government to set priorities so as to achieve breakthrough interventions. These priorities may be summarized as follows:

- *Avoiding crises*, and effectively managing them to the extent they cannot be avoided, as is the case with crises of external origin, both immediate and in the long-run, is necessary for a country to sustain a high growth rate. International experiences show that crises, whether
home-grown or having an external source, may push affected countries down to a lower growth trajectory, and because investors and the public have long memories about the suffering inflicted upon them, it normally takes years to restore investor confidence and for investment to recover. At the same time, other countries better able to deal with crises may vault ahead of Vietnam, given the growing interconnectedness among nations in the world economy. This subject is discussed in greater detail in Section 5.

- Given the growth constraints Vietnam now faces, a priority should be to diminish these constraints to realize gains in total factor productivity. This can be achieved by modernizing policies and raising the effectiveness of investments in human capital and skills formation, by providing much needed physical infrastructure, in addition to coping with the rapid urbanization process, and by promoting exports and FDI, and by the exercise of appropriate industrial policy. Section 6 is devoted to breakthrough interventions to raise productivity.

- Above all, there is need to improve governance if Vietnam is to succeed in shifting to a new growth model. A level playing field for both public and private sectors, rules-based decision-making and good enforcement, transparency and predictability, the presence of consensus building institutions to protect national interests against the negative influence of powerful interest groups etc. would be key components of a model of modern governance that Vietnam needs to put in place in the next decade for achieving its ambitious objectives. This is the subject of Section 7.

These breakthrough interventions and the specific policies and measures associated with these interventions are discussed next.
1.5 Breakthrough Intervention 1: Avoiding Crises

1.5.1 Managing Short-term Risks

Even before crises can be avoided over the long-term, Vietnam has to manage short-term vulnerabilities so that these will not trigger crises in the domestic economy that have long-term consequences.\(^1\) These vulnerabilities have been exacerbated by Vietnam’s integration into the global economy.\(^2\)

*Vietnam’s financial system is susceptible to moral hazard.* Because SOEs and banks have an implicit government guarantee, they have no qualms about over-borrowing, but when this lands them in trouble, it is the government that must bail them out using public funds. This is tantamount to privatization of profits and socialization of losses or an incentive to borrow excessively. Over-borrowing then heightens the danger of a looming debt crisis that will have a major and lasting impact on economic growth. Ready access to credit also gives SOEs an unfair advantage over the private sector, stunting the latter’s growth. Without effective competition from the private sector, SOEs will be able to disregard market signals, continue to operate at low efficiency, and, ultimately bring on a credit crisis.

A proposed agenda to mitigate this form of risk would see strengthening the domestic financial sector through better regulation and supervision and establishment of clear credit policies mandating financial discipline for SOEs as a primary area of reform. While this reform is being implemented, control of external capital, especially portfolio capital, as a source of financing the current account deficit, should be left in place as a first stage.

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1. Vietnam’s ranking in the Global Competitive Index has been pulled down by concerns about its macroeconomic management. Its Global Competitiveness rank fell from 68 in 2007 to 75 in 2009, thanks to the even steeper fall in its ranking for macroeconomic stability from 51 to 112 over the same period (WEF, various years). Vietnam regained some lost ground in the 2010 rankings.

2. The onset of the Global Financial Crisis in 2008 has heightened awareness of Vietnam’s vulnerabilities, both in the immediate future and medium-term. See for instance (Pincus, 2008).
Once a strong financial sector materializes, the second stage can then see relaxation of capital controls.

*Fixing the financial sector should be accompanied by complementary macroeconomic policy measures.* One is to target inflation and the budget deficit in the short-run instead of the current government focus on growth. Controlling inflation is needed to relieve pressure on the pegged exchange rate. A case can also be made for a more flexible exchange rate. Better management of the macroeconomy, especially in terms of keeping fiscal and current account deficits manageable, would also be a key requirement for longer-term reform. There is also a pressing need to rebuild external reserves and to curtail public debt that has risen to uncomfortable levels as the Global Financial Crisis begins to wane. These measures should help restore policy flexibility, essential in times of volatility, but currently compromised by excessive levels of credit, high public debt and low external reserves. The current approach of driving growth at the expense of economic stability not only limits this flexibility but also creates problems that require constant fire-fighting by the government, and, in the end, also compromises long-term growth.

### 1.5.2 Strategic Planning to Avoid the Middle-Income Trap

Even as sound short-term economic management is put in place, the magnitude of the challenges facing Vietnam's long-term growth underlines the importance of strategic planning if Vietnam were to even come close to achieving its goal by 2020 and avoid the middle income trap. This task requires:

- The clear articulation of strategies that translate into realistic targets, duly prioritized in recognition of resource constraints as well as the limited number of policy instruments available.
- Ensuring these strategies are consistent with the overall objectives of sustained growth with distribution.
- Linking targets to not only strategies but also policies and measures that will be put in place to achieve these targets.
• Making explicit complementarities and trade-offs between policies and their outcomes, especially in relation to the risks involved.

• Explicitly recognizing that institutions and their governance are as central to achieving objectives as having the right policies and their implementation. For this reason, building institutional capacity should be part of the strategic plan.

• Recognizing the environment, a part of which is outside policy-makers’ control, under which strategies and policies are to be implemented.

• Incorporating dialogue mechanisms to ensure all stakeholders can have an impact of addressing development challenges.

Vietnam should consider abandoning the strategic planning style retained from the time of the centrally controlled economy, namely to pair socio-economic development directions with quantitative targets for key economic sectors to produce specific estimates of resource allocations. If this approach continues to be applied to forthcoming five-year plans, there is a real risk of these plans placing undue emphasis on subjectively determined quantitative projections and targets rather than on appropriate policy options that take into account the likely external environment and the country’s comparative and competitive advantages.

In addition to the above, ensuring maximum policy efficacy requires policy as well as institutional coordination to ensure that specific policies do not contradict one another in intent and impact. Institutional mechanisms must be streamlined, or to the extent these do not exist, established, to facilitate greater interaction, including the sharing of information, between policy-making bodies.

1.5.3 Macroeconomic Management for Sustained Growth

Prudent macroeconomic management supported by coherent macroeconomic and financial policies is obviously a key component
of the strategy, as it helps Vietnam to avoid crises as a necessary condition for sustaining the high-growth trajectory. There are a number of priority areas that Vietnam should focus on to ensure macroeconomic stability.

• Managing asset bubbles should be given special attention, as it would help to avoid instability in the banking system, and excessive consumption due to the wealth effect of inflated assets, with negative impacts on Vietnam’s long-term growth through lowered rates of domestic savings.

• Ensuring greater predictability in macro management and avoiding “policy shock” as has been repeatedly seen in Vietnam in recent years should be considered as a priority, as this would help to reduce the high cost of an inflation-growth tradeoff in the short-run, which Vietnam has been struggling with in recent years of high inflation. More important, it would contribute towards creating an enabling environment for long-term high-quality investment, which is critical to addressing bottlenecks to growth and raising the country’s productive capacities.

• Avoiding moral hazard, which has been rising in the SOE sector and in the banking system in recent years in Vietnam, is a priority reform area. Moral hazard compounds and entrenches the existing serious problems of low efficiency in the SOE sector, while increasing the vulnerability of the banking sector to shocks, with the result that the already rising public debt may get even worse.

• Although not unrelated, it is important to differentiate between internal and external risk factors in order to come up with the right mix of policy responses and reforms. Thus, to make the economy more resilient to external risks, it is important to determine the right pace of financial liberalization and to introduce instruments of hedging against commodity price and exchange rate.
risks. On the domestic front, it is critical to deal with risks at their sources – inherent structural problems as mentioned above such as inefficiency in the SOE sector, moral hazards in the SOE sector and banking system, large savings and investment gaps and the associated large budget and current account deficits.

- Restoring room for maneuver by improving fiscal position and building up State Bank of Vietnam’s foreign reserves in good times is very important, as it would give the Government adequate policy space for responses to shocks, and more importantly, work towards raising investor’s and public confidence and improving market sentiment, which in turn contribute to minimizing vulnerability to systemic shocks.

1.5.4 Deepening Structural Reforms

Beyond macroeconomic management, structural reforms are essential for the successful transition of the Vietnamese economy to a market economy and for sustained long-term growth. This reform agenda has had, and will continue, to confront vested interests that resist change. However, for reform to succeed, it is crucial that a consistent message stressing a level playing field for both public and private sectors be reflected in all key documents, including legal, and, above all, the constitution. In the long run, a mechanism for checks and balances at national level is vital for an effective monitoring and early warning system to control damages that may result from the weak performance of the SOE sector. Given the huge discretionary benefits that are expected to come from being a large economic group (LEG), it is likely that large corporations will seek every opportunity to be ranked as an LEG.¹ At a minimum, this check and balance mechanism should lead to a set of strategic criteria for an LEG established and operated. For such entities, corporate finance status, in particular corporate debt

¹ The issue of SOEs and large economic groups will be discussed in detail in Section 7.2.
liabilities and delinquencies, should be transparently monitored through this mechanism so that timely decisions can be taken (see Section 7.3). Until such a mechanism can be established, regular external audits of selected large corporations, especially those that are put under special supervision, would help provide early warning signals for policy action. In the medium term, the institutional capacity of agencies involved in SOE reform, including those that manage state assets and capital in, and monitor credit growth of, SOEs should be systematically strengthened. In the immediate future, state ownership rights should be removed from ministries and regulatory entities, and systemic risks contained by preventing LEGs from controlling financial institutions.

Transforming the State Bank of Vietnam (SBV) into a modern central bank should be the center-piece of the banking sector reform agenda. Radical changes in the legal framework to ensure the central bank functions effectively to regulate monetary policy and supervise the banking system should go hand in hand with the separation of SBV from credit-related functions and the governance of the state-owned commercials banks. The decisions to be made regarding the future of the central bank of Vietnam and Vietnamese financial system will raise more than technical issues. Different vested interests are likely to be affected and the balance of policy priorities altered by these related decisions, which may ultimately involve politics. Just as with SOE reform, success will have to rely heavily on strong political will and decisive leadership.

1.6 Breakthrough Interventions 2: Raising Productivity

As already indicated, the move from middle-income to high-income status requires a transition from diversification to specialization. The rationale for this transition is increasing productivity. Hence, the second breakthrough intervention must be to put in place measures that can bring this about. Given Vietnam’s growing dependence on exports despite the many calls for ‘rebalancing’, the focus should be on how to adopt an export strategy that can support productivity increase.
1.6.1 Realigning Export Strategy

In line with the shift in the global balance of power, Asia is increasing its share of trade, both in terms of exports and imports. An important reason for this realignment is the rise of China, an export powerhouse that is also increasing its imports of raw materials and fuels to drive its rapid growth. Vietnam, China’s immediate neighbor and with labor costs lower than China’s, stands to gain from China’s rising import demand and as a supplier of products to Asia’s rising middle class. China’s strategy of developing its inland provinces of Guangxi and Yunnan will see significant expansion of transit trade across Vietnam’s border with China. However, as already discussed, Vietnam is hampered by its poor trade infrastructure, both physical and procedural. At the same time, there is now fierce competition in low-tech exports in which Vietnam specializes.

Although successful in Vietnam, and in practically all Southeast Asian countries and China, serious analysis of the role that exports should play in Vietnam’s development has yet to be undertaken. This role includes the acquisition of foreign exchange, provision of employment opportunities, facilitation of technology upgrading, and, in Vietnam’s transition economy context, strengthening of the institutional framework, and fostering greater competitiveness. Considering these roles should lead to determining the appropriate policies that can effectively support these roles, the resources that are needed and how the resources would be obtained. This is particularly cogent in light of the Global Financial Crisis, which has damaged Asia’s export prospects because of recession in its traditional export markets in the West that will take time to dissipate.

Even without the Global Financial Crisis, Vietnam’s heavy reliance on commodity exports poses medium- and long-term risks. While the country has benefited from high demand for her commodities, especially by a soaring China, it is exposed to price fluctuations that are characteristic of primary commodities. Such fluctuations are then transmitted to the domestic economy, adding
to the macroeconomic stabilization burden of government. For crops like rice and rubber, extreme weather conditions can also bring about sharp falls in output and hence exports. But the impact of extreme weather go beyond diminishing export revenues, disrupting livelihoods, damaging assets, and forcing government to divert much needed resources for development to relief and rehabilitation.

Pending such a thorough analysis, a shift away from exports is not advised for the coming decade, given the still considerable potential in this strategy that Vietnam has yet to realize and the lack of a viable alternative strategy that can contribute equally to Vietnam’s growth. Instead, the export strategy should be adjusted to overcome its current deficiencies and capture this unrealized potential. This adjustment should include:

- Reviewing export promotion incentives and their implementation, with a particular focus on export financing. These incentives would need to be integrated with industrial and investment policies.

- Ensuring that trade and exchange rate policies are in line with the export promotion strategy, at the same time recognizing that some policies, such as deliberate undervaluing of exchange rates, have other adverse consequences that need to be taken into account.

- Refining the strategy to focus on the potential and particular needs of specific products, or at least product groups, with a view to enhancing value-addition of exports and encouraging technology upgrading (see below).

- Promoting more sustainable practices (and associated certifications) for natural resource-based export commodities, supported by regulation and effective enforcement.

- Designing initiatives to promote technology transfer from, and upgrading local technological capacity
through, exports and hence increase the value-added per unit of exports.

- Strengthening trade facilitation through provision of better transport infrastructure and administrative processes to enhance Vietnam’s export competitiveness (see Section 6.2).

- Generating employment, but simultaneously upgrading skills, so that the objectives of increasing value-added and shifting away from existing labor-intensive, low productivity exports can be met. Given that this process may take time, since poverty alleviation may have to rely on labor intensive production in the short-term, carefully planning and phasing will be vital.

### 1.6.2 Strengthening Trade Facilitation

Trade facilitation and logistics as a key component of export promotion is receiving increasing attention. Poor trade facilitation is a binding constraint on export flow, no matter what products are exported. The medium-term future export reality for Vietnam has the following characteristics:

- Continuation of ‘maquila type’ flows (i.e. made up of exports with high import content).

- Growth in trade with China, mainly via surface transport, including across land borders.

- Potential for Vietnam’s ports to act as gateways to China’s inland southern provinces, Cambodia and Laos.

- Rising importance of the cold chain for high-value agricultural products.

- Growing share of high-value products in total exports that are shipped by air.

- The above activities to be conducted within the framework of regional agreements like AFTA, and now (since January 2010) CAFTA.
The government’s existing plans, especially related to the transportation sector, include trade facilitation and logistics components to deal with the above medium-term scenario. Some of the projects also have, rightly, a regional focus, although some analysts believe there is a bias towards hardware components in these plans and insufficient thought has been given to relate plans to resource availability.

Given that the expected trends outlined above will:

- generate new demands, quantitative and qualitative, on Vietnam’s three trade hubs, particularly in manufactured and agricultural products, and
- lead to the more rapid expansion of inter-regional compared to intra-regional flows, trade logistics and facilitation initiatives using multiple policy levers.

These should revolve around four major policy priorities:

- Continue investment in infrastructure, with priorities for specific projects based on sound economic analysis.
- Promote rationalization and modernization of regulations and innovation in service provision, with emphasis on quality.
- Enhance customs and border management procedures to increase efficiency and reduce corruption.
- Work towards becoming an international gateway for inland neighboring countries.

Detailed analysis of Vietnam’s trade facilitation practices and the necessary measures to strengthen them is given in Pham Minh Duc et al. (2010).

1.6.3 Dealing with Urbanization Issues

Urbanization has special relevance for achieving many of the long-term strategic objectives set out in this chapter.¹ Global

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¹ Deputy Prime Minister Nguyen Sinh Hung, speaking at Vietnam National
evidence\(^1\) indicates that the rural-to-urban transformation is a critical part of increasing economic productivity, and thus of generating growth and lifting workers out of poverty. But there are potential dangers too: the process of urbanization, if badly-managed, can lead to congestion, pollution, and other costs that lock-in costs and inefficiencies for future generations.

How relevant are these insights for Vietnam? And moreover, in the context of finite financial resources, how should Vietnam’s policy and investment decisions be prioritized? A collaborative study by VASS, several government departments and the World Bank should provide an analytic base for policy choices in the urban sector and across all sectors that contribute to a successful path of urbanization. In the interim, several interventions appear to have priority.

- **Understanding Urban Evolution.** The process of urbanization depends not only on urban policies but also on the interaction of rural areas with urban areas. For example, Vietnam may be able to improve the efficiency of its urbanization process by investing in basic services for rural areas, so that potential migrants are pulled towards cities in search of better livelihoods, and not pushed from rural areas due to lack of public services and public goods. But rigorous diagnostic analysis is required in order to determine whether this is really the case. This question, and other crucial dilemmas about urbanization paths, can be addressed by assembling accurate measures of the speed of rural-urban land conversion, inequalities in the provision of basic services, changes in urban density, the distribution of industries.

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Urban Conference, November 6th-7th, 2009, observed that ‘Vietnam will have only one chance to get urbanization right. If we fail at urbanization, we will fail at industrialization and modernization’.

across Vietnam (including in industrial clusters and special economic zones), decentralization reforms, and the geographic distribution of poverty. These measures need to be benchmarked against comparator countries at various stages of development in order to identify key policy areas.

- **Land Markets, Planning, and Housing.** Land markets and urban planning are critical factors in helping urban economies to function efficiently and equitably. While labor and capital can move geographically in search of the highest returns to their use, land is fixed in location and must therefore be able to adapt to different uses, as determined by market demand for land uses and intensity of land development. In terms of tangible policies, this means paying attention to (i) rural-urban transformation: the process by which rural land is converted to urban uses and basic infrastructure (roads and water mains) is installed; (ii) markets & prices: the efficiency with which land and housing markets are functioning in cities; and (iii) land planning & management: the impact of government planning and regulations on urban form, function, and prices. Policy decisions on these issues should be based on analytical work that measures current performance and the impacts of current policies, and benchmarks them across Vietnamese cities and against other countries.

- **Financing Infrastructure Service.** Universal access to basic services (water, sanitation, education, and healthcare) is a foundation for long-term economic growth and inclusive development. How can policies be prioritized to best meet this objective? How should capital expenditures be financed, and which financing instruments can best achieve intergenerational equity of finance? Answers to these questions require understanding of (i) how much access to basic services, and the costs of service provision,
differs across Vietnam; (ii) how service provision varies according to differences in local *financing*; and (iii) how *devolution and inter-jurisdictional coordination* have affected access to services in Vietnam. These key pieces of information provide an analytic base for making investment choices and institutional reforms.

- **Connecting the Urban Portfolio.** Transport infrastructure and logistics are key components of national economic success: they join parts of the urban system together, link urban and rural markets, increase the geographical range (and thus size) of product markets, and facilitate the sharing of information and technology. Investments in transport infrastructure should be made by taking into account global, regional, domestic, and local connectivity, in the context of a consideration of long-term trade and development potential. Government investment decisions should be guided by thorough analysis which lays a solid foundation to facilitate a national consensus on which types of investments, and in what locations, would be most cost-effective and of the highest priority.

The choice of these thematic areas is guided by the paradigm that government interventions to foster economic development are most effective when basic services and land institutions are in good shape, and once economic activity is already able to allocate itself across the country according to market interactions of supply and demand. This means ensuring that institutions are in place before committing to infrastructure investments, and that both institutions and infrastructure should precede government interventions in spatial economic planning (World Bank, 2009). Government interventions and regulations should aim to compensate for the externalities of urbanization.

### 1.6.4 Strengthening the Human Capital Base

None of the above initiatives can be guaranteed success without attention being paid to strengthening human resources.
Innovation capacity, human capital and Vietnam’s ability to produce higher order skills and competencies are central to its long-term knowledge-based economic growth and development prospects. They are at the heart of the earlier mentioned three transitions needed to move from middle- to high-income. Education and skills are also key tools to reduce poverty and promote inclusive growth.

Despite Vietnam’s impressive achievements in terms of near-universal primary enrolments and rapid expansion of secondary and tertiary education over the past decade,1 its current low human resource base is insufficient to support the country’s long-term strategy of avoiding the middle income trap and sustaining high rates of growth. Sustained efforts at promoting human capital and innovation will be required. This implies a triple challenge of (i) addressing inequities in education outcomes, (ii) promoting quality and learning outcomes across the entire education system with the aim of producing more and better-skilled labor market entrants, and (iii) improving the national innovation system. Already there are signs of increasing skills shortage, especially in larger, foreign owned and exporting firms (Enterprise survey 2005 and 2009).

Addressing Inequities

Vietnam still faces inequitable outcomes in education at all levels, and there is evidence of increasing inequalities in education attainment. While the poorest households and ethnic minorities have been the main beneficiaries of increasing access to primary and lower secondary education over the last two decades, household survey data show persistent, or even increasing, gaps in secondary attendance and completion rates between poor and non-poor, rural and urban areas, and Kinh and Chinese and ethnic minorities. In addition to outcomes, there are also inequities in inputs, including in instruction time, student-teacher ratios, quality of teachers and teaching materials across the country. Unless the sources and

1. Public spending on education and training has also risen dramatically from 3 percent of GDP in 2003 to 5.9 percent in 2008, and there has also been significant private spending.
drivers of inequality in education are strategically addressed, there is a risk that the gap in education attainment will grow. A focus on two priority policy directions is needed:

- **Early Intervention for Greater Life Chances:** Investments into Early Childhood Development (ECD) have a significant impact on subsequent educational outcomes and yield greater returns than later investments (Caneiro and Heckman, 2003). ECD interventions that aim at developing the cognitive, motor, behavioral and language skills of 0-5 year-old children promote greater equality of starting conditions when they enter primary education, while high-quality childcare particularly benefits the most disadvantaged children. Further development of integrated early childhood education and development interventions, linking nutrition, health, education and good parenting, and focusing on effective support mechanisms for disadvantaged children in education such as designated ethnic minority teaching assistants in preschools are thus a promising policy direction for Vietnam.

- **Comprehensive Policies to Overcome Educational Disadvantage at Preschool, Primary and Secondary Level:** This requires a combination of tools for disadvantaged schools, including (i) fee exemptions and financial incentives for children from poor households to attend and complete school, (ii) ensuring minimum quality of teachers, infrastructure, and materials, (iii) incentives for good teachers to work in challenging schools and rewards for improvement in learning outcomes, (iv) a strategic policy to train and use more ethnic minority teachers and teaching assistants, (v) appropriate pedagogical practices, and (vi) full-day schooling for disadvantaged children.

*Promoting Quality Learning Outcomes*

To meet Vietnam’s rising demand for a well-trained and adaptable workforce; the country’s education system will need
to deliver both a larger quantity and better quality of skills. This means the need to impart complex competencies, not just technical skills. A fundamental re-orientation of the system – from a focus on inputs to outcomes – will be necessary.

Delivering better quality skills will require a change in the way the education system is managed. Promoting human capital and skills development and innovation will not necessarily require more public resources for education and research, but better use of resources and a shift of focus from inputs to outcomes. Reform directions include:

- **Changing the Governance of the Education System**: More decision-making power for all education institutions, but making them accountable locally for ensuring better learning outcomes is needed. The role of the state would be one of steering, facilitating and monitoring, and not managing, the system. Also needed is a clearer vision on the role of private providers and an environment conducive to their development and performance.

- **Directing Financing towards Better Quality and Ensuring Greater Efficiency**: Allocating education financing based on the number of students, rather than current inputs, ensures greater efficiency of spending. This can be complemented by including in the financing mechanism incentives for performance or to promote equity.

- **Improving Information on Learning Outcomes and System Efficiency**: The above reforms require improvement of the information management in the education system, with better quality and disaggregated information on education-specific indicators, learning outcomes and financing to enable informed decisions by parents and students and for the central and provincial authorities to effectively steer the system. Policymakers would also benefit from better information on skills and labor market outcomes through graduate tracer surveys and skill modules in firm surveys.
**Improving Innovation**

Despite improvements in recent years, Vietnam is still ranking low in regional and global indices of innovation capacity.\(^1\) Financing for science, technology and innovation (STI) remains, at about 0.5 percent of GDP, lower than in most other middle-income countries in the region. Moreover, financing is heavily dominated by State budget funds and generally inefficiently allocated. Linkages between research institutions and enterprises are weak, particularly for the many public institutes which make up the majority of institutions in the system. Most research institutions do not have sufficient technological capacity or resources to undertake effective research, and the human resource base for STI is still insufficient. Vietnam will require a fundamental reorientation of the policy framework for innovation to take place.

**Strengthening the national innovation system** involves efforts to promote greater capacity of science and technology managers at the central and provincial levels as well as of R&D institutions. Supporting higher demand for innovation and technological upgrading from the private sector is a key strategic direction for innovation policy. A diversification of funding for R&D and promotion of partnerships between the enterprise sector and R&D institutions go hand in hand in promoting greater relevance of research, as does support to intermediary organizations that provide support in management and technical training, business development and IT.

First steps in these reform directions have been made, especially in higher education and science and technology, but sustained attention to their completion and implementation will be necessary. Moreover, increasing attention to general and vocational secondary education will be required, since the majority of labor market entrants graduate from secondary education and below.

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1. In the most recent World Bank’s Knowledge Economy Index (KEI), which focuses on the use of knowledge as an engine of growth, Vietnam ranks 100 out of 146 countries overall and 115 on the innovation index.
Education reforms take time to plan and execute, and require a generation to yield results, suggesting there is little time to waste.

1.6.5 Poverty Reduction

Vietnam can look back to impressive achievements in poverty reduction. Broad-based economic growth has brought improvements of well-being of almost its entire people. The General Statistics Office has estimated that the poverty rate fell from 58% in 1993 to 14.5% in 2008. Other social indicators such as access to basic social services and infrastructures (education, health, electricity, road, water and sanitation etc.) also confirm this very positive trend.

Looking forward, however, Vietnam is likely to face numerous challenges. First, although all groups of the population benefited from rapid economic growth, the degree of their participation in the development process has varied, resulting in the currently large disparities in well-being, asset ownership in broad terms (access to land; basic social services and educational attainments) and poverty reduction across different segments of the society, most notably between rural vs. urban dwellers, inhabitants in different geographic regions and from different ethnic groups (see for instance, IDS, 2008). Disparities are even starker within groups. Thus, although the country as the whole is off the list of the poor countries, segments of the population have not yet left the poverty trap for good. This implies that as compared to 20 years ago when the tide lifted all boats, nowadays much more sophisticated and nuanced policies are required in order to avoid the so called “inequality traps”

Second, as the group of hard-core poor become progressively smaller, further reduction in poverty will not only be more costly in terms of investments and/or economic growth. In other words, if Vietnam cannot improve considerably the efficiency of its social investment, it would require a higher rate of economic growth with associated larger investment requirements. Hence, to sustain fast poverty reduction, it is critical for Vietnam to not
only increase efficiency of investment, both economic and social, but also improve the pro-poor pattern of economic growth. The latter can be partially achieved by raising efficiency and effectiveness of social expenditures and institutions,\(^1\) promoting labour-intensive sectors and small and medium term enterprises in order to create more jobs and incomes for low skilled workers, and at the same time, improve working conditions and worker safety. However, as indicated earlier, skill training of workers will be needed to shift away from labor-intensive production over the medium-term.

Third, the share of population on the margins of poverty has not really changed. While the group just below the poverty line was larger than that just above the poverty line in 1993, the opposite is true in 2006. This implies that protecting the near poor from falling back into poverty is becoming increasingly important, and justifies the recent shift in government targeted policies and programmes to also cover the near poor.

The need for a more targeted approach is also apparent from VHLSS 02, 04 and 06 data that shed light on Vietnam’s poverty dynamics. It is estimated that approximately one third of the poor population suffers from chronic poverty during the 2002-2006 period and they therefore really need social assistance particularly, that being provided by the poverty reduction targeted programmes. The remaining two thirds experienced transitory poverty and they may need quite different types of policy interventions. Specifically, policies to enlarge income earning opportunities and to reduce vulnerability may be more critical for this group to permanently get out of poverty.

Fourth, Vietnam’s WTO accession has heightened both opportunities and vulnerability for Vietnamese households. This is because of changes at the border (reduction in import tariffs and

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\(^1\) For instance, the policy towards universal health insurance coverage can only be sustained if state management (VSS and the Ministry of Health) can do away with the adverse incentives embedded in current fee-for-service financing and strengthen governance over
removal of non-tariff barriers to trade), beyond the border (greater access to overseas markets and to the WTO’s dispute settlement mechanism) and behind the border (the opening of service sectors, distribution, changes in legal and regulatory frameworks etc.). Studies on economic and social impacts of WTO accession have found that while the net impact of the accession on economic growth and poverty reduction are expected to be positive, and that all the above mentioned three types of changes are important, the behind the border changes play the most important role in determining the final outcomes. The events taking place in Vietnam over the last three years have shown that indirect impacts of the accession have been far greater than they were thought to be during the accession process.

Indeed, the economy’s problems since WTO accession, described earlier, have heightened the vulnerability of specific groups and threaten the achievements in poverty reduction. For instance, farmers and migrant workers, who together make up the largest proportion of the population, are exposed to risks given the limited coverage of the formal social security system. According to the latest labor force survey data the agriculture and non-agricultural informal business sectors make up approximately 50 percent and 24 percent of total employment respectively in 2007. Few among these are covered by the social security system. Even in the formal business sector, which accounts for 16 percent of total employment (the remaining jobs are in the non-corporate public sector), only 51 percent of the employees are covered by the social security system in 2008, with the social security contribution rate only 7.6 percent against the statutory rate of 23 percent.1 While the existing informal safety net, including informal credit and community/family support, have worked quite well until recently, it will come under increasing stress as rising urbanization accelerates the change in family structure

1. Data on the informal sector come from the 2007 Labor Force Survey conducted by the General Statistical Office (GSO). Those for the formal sector are from the 2008 Enterprise Census. Quick assessments by VASS on the impact of the Global Crisis on Vietnamese firms has found informal social nets
towards the nuclear family. This would require strengthening of the formal social security system with a focus on broadening coverage and improving enforcement so that old persons and those affected by unforeseen circumstances are protected from falling into poverty.

Fifth, further integration into the world economy will have agglomeration effects that favor big cities located close to ports. With jobs unevenly distributed across geographic locations, geographic labour mobility should be eased to enable people from poorer provinces to better participate in the growth process. To reap the full benefits of this migration—job opportunities for migrants as well as remittances to places of origin—better access of migrants to basic social services must be ensured.\(^1\) In light of rising rural-urban migration, the proposal to issue a single social security number to every person at birth to ensure portability of social benefits across both geographic locations and programmes deserves serious consideration.

In summary, the arrival of Vietnam as a middle-income country signals the need to shift to a new phase of social development. Although income/expenditure will continue to be a central measure of people’s well-being for years to come, other dimensions of welfare, including poverty, are taking centre stage in policy fora. This in turn implies the need to have better measurement of poverty as a benchmark for policy. For instance, urban poverty as measured by income/expenditure is clearly underestimated, as critical aspects of people’s well-being such as pollution and personal security are not taken into account. Furthermore, participation, voices and representation of the poor in the policy making process will become increasingly important, as the society is becoming increasingly diverse, resulting in more conflicts of interest between various groups of population.

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1. The 2009 Urban Poverty Survey conducted by GSO in the two largest cities of Vietnam - Hanoi and Ho Chi Minh City- found that people who do not have residence registration make up over 11 percent and 20 percent of the population in these cities respectively.
1.7 Breakthrough Interventions 3: Improving Governance

1.7.1 The Need to Strengthen Governance

Governance is at the heart of all government initiatives. Vietnam ranks low in its state of governance in international comparisons, hobbled by the lack of transparency and pervasive corruption. In each of the World Bank’s Governance Indicators (voice and accountability, political stability, government effectiveness, regulatory quality, rule of law, and control of corruption), Vietnam scored below average with the singular exception of political stability. Vietnam’s rank in Transparency International’s Corruption Perception Index is 120 out of 180 nations in 2009.

These aggregate rankings notwithstanding, Vietnam has already made progress in public administration and governance reforms. The Vietnam Development Report 2010 (VDR), in analyzing developments in devolution and accountability, noted that Vietnam’s stellar growth performance is due in no small measure to “devolution in other aspects of what was once a centralized state: to provincial and lower levels of government, to administrative and service delivery units, to the courts and to elected bodies, and to the media and civil society” (p. 132). This has been accompanied by greater openness, allowing even what was once sensitive topics like corruption to become part of public discussion.

Devolution has brought particular benefits to Vietnam. “Competition among the provinces is driving them to improve their business environments. Eased entry for non-state modern institutions providers of services and greater autonomy for the management of state facilities are supporting

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1. Vietnam’s 2008 score for voice and accountability was -1.62, for political stability and absence of violence/terrorism was 0.32, for government effectiveness was -0.31, for regulatory quality was -0.53, for rule of law was -0.43, and for control of corruption was -0.76. Scores range from -2.5 to +2.5, the higher the score, the better the performance with respect to that indicator. See Kaufmann, Kraay and Mastruzzi (2009).
innovation and increasing the variety of services” (VDR, 2010, pp. i – ii).¹

But it has also posed challenges, especially in efforts to ensure accountability. The VDR noted that while downward accountability at the commune level had improved, progress at the provincial level had not kept pace. Media control, though relaxed somewhat, remained top-down and pervasive. An independent judiciary, a key ingredient of the rule of law, needs still to be fostered. Significant communication gaps in the form of confidentiality of all sorts of data and information leave markets uncertain about what actual government policies, as opposed to public statements of policies, are, let alone how they will be implemented. In addition, corruption compromises the efficacy of rules and regulations and hence accountability, raising the cost of doing business and again undermining the confidence of the business community.

In surveying Vietnam’s institutional reforms, the VDR concluded that ‘the extent of devolution has been substantial, both geographically and functionally’, and that ‘New systems of accountability are being put in place…’ However, this was often undertaken ‘with a lag and not always of the best form… in the devolved system, conflicts of interest are becoming more evident’ (p. xvi).

The quality of governance in Vietnam, already compromised by corruption, mentioned above, is also adversely impacted by the institutionally engineered uneven playing field with SOEs enjoying the upper hand in every transaction. Unless accompanied by major reform, large economic groups, which the government sponsors, will make this problem worse, not better. Greater concentration of power makes the field even less level.

Strengthening governance will be the key to the success of several ‘breakthrough innovations’ that Vietnam is putting in place to contribute to the growth momentum. Two such innovations are

¹. See also Jacobs (2008) and Kirk and Tuan (2009) on the impact of decollectivization in rural Vietnam.
free economic zones and large economic groups. Although new to Vietnam, these innovations have been tried in other countries with some success.

1.7.2 Free Economic Zones

Vietnam is considering the establishment of free economic zones (FEZs) as a potential breakthrough for the next decade. Such zones, in their many guises (e.g. city states like Singapore, special economic zones (SEZs) like Shenzhen, China, and industrial clusters like Silicon Valley, U.S.A.), have contributed to the dynamism of regions if not countries. The reasons for success have included the ability to take advantage of agglomeration economies, economies of scale and scope, and to be able to benefit from specialization.

However, since for every story of success there is a tale of failure, extreme care should be taken in the planning of FEZs if they are to be a new growth driver and a source of institutional innovation for Vietnam. Many lessons can be learned from failures as well as successes.

As an abundance of international experience can attest, FEZs that failed could have one or more of the following explanations.

- FEZs were more often than not located based on political rather than economic grounds, often reflecting the entrenched interests of the politically powerful or connected, and hence endowing them with none of the above benefits.

- Infrastructure outside the FEZs was often inadequate, leaving them, even if they were successful, as enclaves with little spillover to the rest of the region or the country.

- Failure to have a network of suppliers to support the enterprises in the established FEZs, nullifying the very reason for enterprises to locate there.

- Institutional and procedural weaknesses including
inability to provide a ‘one-stop shop’ for investors locating in FEZs, again reducing the attraction of these FEZs to investors. Given the number and range of FEZs welcoming investors with a plethora of incentives within a region, this could well cause investors tolocate elsewhere.

Reviewing the experience of China’s earliest special economic zones, arguably the most successful among FEZs, not only reveals the generic conditions needed for success but also the role of special circumstances in making success possible.¹ What were these special circumstances? They were that:

- Their proximity to Hong Kong and Taiwan, homes to an already large pool of Chinese entrepreneurs with technological know-how and capital that, with rising costs at home, were looking to relocate production to less costly locations.
- The investors, many of whom were émigré Chinese who fled China when the People Republic of China was established in 1949, were familiar with conditions in the vicinities of these SEZs.
- The bulk of the Chinese in Hong Kong, Taiwan and the Chinese diaspora in Southeast Asia originated from the provinces of Guangdong and Fujian, many of whom continued to have social ties with their places of origin.
- These two Chinese provinces had a tradition of trade and commerce that went back centuries.

These special circumstances were in addition to other favorable conditions, such as preexisting linkages with their hinterland, dense populations with a pool of skilled labor, relatively good physical infrastructure, strong institutional capacity of provincial and municipal governments to manage the SEZs, and employment of competent management with extensive autonomy.

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¹ Ota (2003) argued that China’s special economic zones have proved to be more successful than other FEZs in East Asia.
To achieve success with FEZs, Vietnam must focus on the generic success factors cited above, since the special circumstances outlined earlier cannot be replicated. The indifferent performance of the country’s high-tech industrial parks provides a home-made cautionary tale that this has not been the case so far.

1.7.3 Large Enterprise Groups

A long-time industrial policy objective in Vietnam has been to build up conglomerates of international competitiveness to be the flag-carriers of the Vietnamese economy. This is the rationale for creating 19 conglomerates or ‘Large Economic Groups’ (LEGs) from existing state enterprises. In pursuing this course of action, Vietnam may also be encouraged by the success of conglomerates in countries like Japan (keiretsu), South Korea (chaebol), China (enterprise groups) and Taiwan (business groups).

However, it needs be noted that there are major differences between these groups and Vietnam’s LEGs. Conglomerates in Japan, South Korea and Taiwan are all private sector enterprises groups operating in primarily market economies, although with links to government much closer than Western conglomerates. These conglomerates compete fiercely in a vibrant private sector, with government support conditional on meeting performance benchmarks. Failure to meet these benchmarks means withdrawal of government support. In China, where enterprise groups are part of a still important state sector, the private sector is also growing and extremely competitive. The discipline of the market is brought to bear on these enterprise groups through the employment of professional management which separates ownership from management, through the participation of outside investors and through public listing on international exchanges like Hong Kong and New York. Vietnam’s LEGs, which concentrate greater power in a smaller number of enterprises, are subject to none of these restraints.¹ The small private sector remains disadvantaged

¹ By 2007, SOEs accounted for only 2 percent of the number of enterprises, but 20 percent of total industrial output.
compared to the preferential treatment meted out to the state enterprise sector. Slow equitization (and privatization) of SOEs has brought in few outside investors,\(^1\) without the discipline of the market, there is nothing to ensure that the LEGs will not magnify the inefficiencies now plaguing existing SOEs.

Their very size also poses heightened risks in several other ways:

- Without the checks and balances imposed by the market in a vibrant market economy, poor corporate governance would not only lead to the entrenchment of inefficiencies but also increase the economy’s vulnerability to instability.

- The greatest risk of instability will come with LEGs, owning, controlling or even just working closely with the state-owned banks, allowing them easy access to credit, which can then be used for diverse ventures, including speculation in real estate, in which these LEGs have little expertise, and which inevitably fuel asset bubbles.

- When the above ill-conceived ventures collapse, these LEGs can lay claim to being ‘too big to fail’, so that the government then has to step in to bail them out. The result is moral hazard – LEG managers’ incentive to exercise prudence is diminished by their knowledge that the government would always come to their rescue.

- Their very size, and market power that comes with it, gives LEGs few incentives to innovate. Indeed, it is likely that, given their considerable bargaining power, they will grow instead through accumulation, a strategy unlikely to help Vietnam’s quest for high-income status.

- The LEGs would make demands on credit, which was already growing too fast for reasons already elaborated.

\(^1\) The state has often retained a share of 50 percent or more in equitized SOEs. The larger the SOE, the more the state share of capital has exceeded 50 percent.
Financial institutions will find it harder to resist these demands.

- With little oversight, these groups could end up using their resources for non-core activities like real estate, not only creating a bubble but also making for unfair competition against the private sector. The result is to distort market signals with obvious consequences for efficiency. Such diversification also works against the need for specialization (discussed earlier) that is essential for the economy to move from middle- to high-income.

- Given the lack of transparency of existing state enterprises, the new LEGs would provide additional opportunities for corruption that are now, by virtue of their size, harder to check. The even greater danger is of ‘state capture’, the diversion of public resources for private gain.

- LEGs are unlikely to behave differently from the original state enterprises from which they are constituted in terms of the use of assets. Inefficient use of these assets, a hallmark of Vietnam’s SOEs, would thus be entrenched and exacerbated.

Given that existing risks associated with existing SOEs are likely to be magnified, Vietnam’s advocacy of LEGs require careful thought. However accomplished, they must be subject to the discipline of the market and held to performance standards through independent audits.

1.8 Concluding Remarks

The changed circumstances facing Vietnam over the next decade and beyond will require an economy that can adapt quickly to change and an economic model of development that can deliver sustainable and equitable growth over the long term. This model will necessarily be a major departure from that which had served Vietnam well for over two decades since Doi Moi. In this new
model, vital and complementary roles will be played by both the state and private sector.

The many areas that require new strategic thinking have been reviewed in this report. Although separately discussed, the many strategies – ranging from macroeconomic management to governance – need to be coordinated and set within a framework designed to achieve Vietnam’s overarching objective of achieving industrial nation status by 2020.

Given the many strategies proposed, what might be the most urgent? Strategies that require the greatest attention are those needed to deal with the most serious risks. These risks and the context under which they occur, and proposed breakthrough interventions, are shown in Table 1.1 below.

**Table 1.1: Major Risks and Priority Strategic Interventions**

<table>
<thead>
<tr>
<th>Context</th>
<th>Risks</th>
<th>Institutional Breakthroughs</th>
</tr>
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<tbody>
<tr>
<td>Macroeconomy,</td>
<td>Foreign Exchange Exposure</td>
<td>Professionalize Monetary Policy-making Process</td>
</tr>
<tr>
<td>Banking</td>
<td>Asset Bubbles</td>
<td></td>
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<td></td>
<td></td>
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<tr>
<td>Large economic</td>
<td>Productivity decline if LEGs not</td>
<td>LEGs should only be kept if they:</td>
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<tr>
<td>groups</td>
<td>contained</td>
<td>1. Have scale economies in the sector</td>
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<td></td>
<td></td>
<td>2. Contribute to market expansion</td>
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<td></td>
<td></td>
<td>3. Demonstrate capacity for productivity catch-up</td>
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<td></td>
<td></td>
<td>4. Upgrade technology</td>
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<td></td>
<td></td>
<td>Other requirements:</td>
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<tr>
<td></td>
<td></td>
<td>1. Regulator separated from operator</td>
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<td></td>
<td>2. Improve corporate governance</td>
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<td></td>
<td>3. Pay rent and dividends</td>
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<td></td>
<td>4. Do not inhibit competition</td>
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<td></td>
<td>5. Be covered under existing Enterprise Law</td>
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<td></td>
<td>6. Not be allowed to own or control a financial institution</td>
<td></td>
</tr>
<tr>
<td>Corruption, State capture</td>
<td>Abuse of power worsening inequality, Land, capital, licenses</td>
<td>International standards for FEZs Cadastral maps for land administration</td>
</tr>
</tbody>
</table>

Not all the above interventions will yield immediate returns. Nor can they be accomplished with the same degree of ease. Indeed, institutional and governance reforms, to cite an example, will take time, given the likelihood of resistance by vested interests that will require strong political will to overcome. While these difficulties should call for careful planning and consensus-building among stakeholders, they should not be the excuse for delay. Unless undertaken now, Vietnam’s risk of not achieving its long-term development objective will be that much greater.

*Source: Authors.*
References


Chapter 2

MANAGING VIETNAM’S MACROECONOMIC AND FINANCIAL RISKS IN THE NEW GLOBAL CONTEXT

Nguyen Duc Thanh

2.1 Introduction

After more than two decades of economic reform, Vietnam has made remarkable socioeconomic progress, and its economy has become increasingly diverse. It can be said that Vietnam’s economy in the recent period has undergone profound and comprehensive changes through three major processes: marketization, financialization and internationalization, all on a large scale.

Vietnam enters the decade of 2011-2020, domestically with a legacy from the two decades of reforms, and externally in the face of tremendous turmoil in the world economy after the most damaging global crisis since the Great Depression of 1929-1933. This implies that Vietnam’s economy is facing a period in which internal change demands a new transformation, but this has to take place in a rapidly changing international environment. Therefore, planning and building a vision for the next decade is essential to the development of Vietnam.

This chapter examines fundamental weaknesses in the Vietnamese macroeconomy in the context of the current state of the global economy, and analyzes the risks in the macroeconomy and financial system of the country. It suggests tentative solutions to minimize these risks, and that should contribute to sustaining economic growth in the long-term.
The primary hypothesis in this chapter is that the sources of macroeconomic and financial risks in a country like Vietnam (with three principal characteristics: developing, transitional and highly open) can come from both inside and outside of the economy (Figure 2.1). For those originating from inside, financial and macroeconomic instability arise mainly from the weakness of the financial system, the underdevelopment of the institutions supporting the market, poorly governed enterprise systems, structural imbalances, all of which are associated with the inconsistencies in design and implementation of macroeconomic policies. For those originating from outside, unpredictable fluctuations of foreign capital flows, associated with economic shocks from the world and the region can weaken the economy or ignite turmoil from within if macroeconomic policies fail to deal with them. The two sources of risks are closely related to each other and can generate self-enforcing effects, which accumulate risks to the overall economy.

**Figure 2.1: Potential Sources of Economic Turmoil in Vietnam**

![Diagram showing potential sources of economic turmoil in Vietnam](source: Author)

This chapter has five sections. The first reviews theories and international experience related to economic and financial crises,
summarizing the major causes, consequences and measures to prevent crises. The second section briefly reviews the development of the Vietnamese macroeconomy, with special attention to the recent turmoil and difficulties. The next section examines the major macroeconomic imbalances of the economy, with the core concern stemming from the imbalance between savings and investment. The fourth section studies the current state of the Vietnamese financial system from a macroeconomic perspective. This section also discusses developments related to the process of liberalization in the financial sector, together with relevant aspects of the fiscal and monetary systems, and of the exchange rate. The final section summarizes the potential risks experienced by Vietnam’s economy, and proposes policy options to support the sustainable growth of the economy in general and the financial system in particular.

2.2 Economic and Financial Crises and Their Main Characteristics

Macroeconomic risks arise from deterioration in the performance of macroeconomic variables, leading to unexpected reduction in aggregate output, leading to worsening social welfare, and negatively affecting the economic growth in the long-run.

Macroeconomic risks normally arise from crises in the financial system. The two types of crises (economic and financial) can have a bi-directional causality relationship, or may occur at the same time due to some common causes.

The following section discusses concepts and classification of economic crises, especially those of financial origin. The next section reviews the major causes of the crises and measures commonly used to prevent them.

2.2.1 Concepts

An economic crisis can be understood as an event causing disruption, turmoil or chaos in economic activities on a large scale. Consequently, economic activities are interrupted, while economic signals are strongly distorted, leading the economy to
diverge from its equilibrium growth path. This is accompanied by the breakup of a large number of economic institutions.

An economic crisis is typically associated with a financial crisis, whether as a cause, or as a companion due to some common causes. However, as is usually the case, a financial crisis is normally part of an economic crisis. There may be a financial crisis without economic crisis, but economic crises often bring financial crisis.

Financial crises are more common than economic crises. Based on the nature of financial crisis, there are different ways to conceptualize and define financial crises, and this has implications for economic policy.

An early and classical definition by Friedman and Schwartz (1963) consider a financial crisis to be identical to a banking crisis. They argued this was the case because its consequence is the reduction of total money supply which leads to the impairment of economic activities on a large scale (the whole economy). This view is consistent with the monetarist doctrine.

According to these authors, those events that look like crises in some important financial markets (such as real estate and stocks) but do not create a banking crisis are not considered a real financial crisis, because they do not generate risks that can affect the entire economy. They call them the “pseudo financial crises”. This has an important implication for macroeconomic policy, as there is no need to intervene in pseudo financial crises, leaving bankruptcy under the law of the market to deal with them. If the government intervenes too soon, by providing financial support and bailing out failing companies, it is in fact helping to keep afloat the weak elements in the economy. In addition, these interventions may lead to an increase in the money supply and hence, trigger inflation.

Other authors such as Kindleberger (1978) and Minsky (1972) have broader definitions of financial crisis. According to them, a financial crisis could be a sharp decline in asset prices, collapse of large number of financial and non-financial enterprises, deflation or disinflation, collapse of the foreign exchange market,
or a combination of these events. The authors suggested that these
turbulence potentially affect overall economic activity, so the
government needs to intervene early when they break out. This
definition is relatively broad, causing many to fear that its use
opens the way for the government to intervene too much and too
early in any turmoil on financial markets.

Mishkin (1991), based on a theoretical framework of
asymmetric information, proposes a relatively moderate definition
of a financial crisis as the disruption of financial markets in
which problems of adverse selection and moral hazard escalate,
leaving these markets unable to effectively provide capital to those
with investment needs. As a result, a financial crisis could push
the economy out of equilibrium with high output and efficient
financial markets into a state where output declines sharply. He
saw five factors that can lead to financial crises: (1) an increase in
interest rates, (2) the decline in the stock market, (3) increasing
uncertainty in the economy, (4) bank panic, and (5) sudden decline
of the general price level.

Based on historical observation, he believes the first three
factors occur with higher frequency, but lead to modest financial
crises. More severe crises are associated with the fourth factor.
And finally, the fifth factor determines crises’ severity and long-
term impact.

The above definitions deal with major crisis in a closed
economy, so they take banking crisis as a core. However, in the
context of globalization, economies are progressively liberalizing,
and a new crisis, namely currency crisis, has surfaced. Since the
second half of the 1970s, when the system of fixed exchange rates
established after World War II collapsed, currency crises took
place with higher frequency, not only in the emerging economies
(such as Latin American and Southeast Asian economies), but also
in more developed countries like the Nordic bloc.

One can define a currency crisis as simply as the sudden
devaluation of a currency, including the switch from a fixed
exchange rate regime to floating one (Kaminsky and Reinhart, 1996). How “sudden” depends on how it is measured. For example, Rogoff and Reinhart (2010) considered a devaluation of more than 15 percent in a year as a signal of a currency crisis. Kaminsky and Reinhart (1996) also note a currency crisis may be considered to occur without a real devaluation, because the central bank can defend the currency by reducing exchange reserves. Therefore, a sudden reduction in foreign exchange reserves can also be considered a signal of currency crisis.

In their pioneering study linking the relationship between banking crises and currency crises, Kaminsky and Reinhart (1996) notice a very close relationship between these two types of crises, and they often occur together. Thus, the two types of crises are also known as the twin crises.

Another type of crisis that developing countries face in a globalized world is the debt crisis. A country falls into a debt crisis when the government fails to pay its foreign debt (interest and part of principal) as scheduled. The government must announce that it cannot pay the debt, or refuse to pay the debt or ask for restructuring the debt from the creditors. Debt restructuring, in this context, is usually unfavorable to the creditors (Reinhart and Rogoff, 2010).

2.2.2 Causes of and Measures to Prevent Economic and Financial Crises

When an economy experiences a financial crisis or economic crisis, it may have to suffer from severe and long lasting socio-economic consequences. As Reinhart and Rogoff (2009) point out, the consequences of the collapse of the asset market may reduce asset prices significantly over a relatively long time. For example, of the housing bubble busts around the world, the average duration from the bust to recovery usually takes up to six years, and the market loses approximately 35 percent of market value. For banking crises, the consequences are often associated with output contraction and increase in unemployment, decrease
in social welfare, and impoverishment of part of society, while leaving prolonged psychological and social scars. These crises also lead government debts to surge, because to respond to crisis, the government must increase spending to rescue important business institutions and provide an economic stimulus. Since in these difficult times, revenues normally decline, the government must inevitably offset the budget deficit by dramatically increasing borrowing. This makes the macroeconomic situation worse, as interest rates are raised, public policy space contracts, and the national financial system becomes highly vulnerable. This has been proven to reduce economic growth in the long term.

Numerous attempts have been made to study the causes of the crisis, the relationship between them and the measures to prevent and recover from financial crisis.

Banking crises, as observed by Mishkin (1991), are often associated with a period of economic difficulty (cyclical by nature), such as the collapse of asset markets, or economic uncertainty, forcing interest rates to rise. Prior to this, there is often a phase of economic expansion and bank loans are relatively easy because of perceived good profit opportunities. However, when an economic shock occurs, such as a signal of recession, difficulty in exports, or the asset market crashes, many borrowers are pushed into a situation where they cannot find cash flows to repay their bank loans. Large amounts of debt then turn bad. Uncertainty and the effects of asymmetric information (adverse selection and moral hazard) push interest rates higher, making even repayment more difficult. The result is the economy falling more deeply into crisis and banks start to collapse.

According to Minsky (1982), a financial crisis stems from the inherent fragility of the financial system, whose soundness is determined by the type of investment in the economy. He distinguished between three types of investment: hedge investment, speculative investment and Ponzi investment. Hedge investment is the type of investment that creates income streams (cash inflows) always greater than the cash outflows needed to pay for the cost
of capital (interest), meaning projects involving hedge investment always generate real positive cash inflows during the whole project duration. Speculative investment is that which cannot guarantee an income stream that can offset the costs of capital, but expect to do so fully after a point in time. A Ponzi investment is one that does not generate enough inflow to compensate for current capital expenditures at any point of time. With this kind of Ponzi investment, the investor must borrow to pay interest, or be forced to sell property to pay debts.

During the phase when the economy performs well, hedge investments predominate. With the growth of the economy and investors’ optimism, investments using debt are increasing, causing a higher leverage ratio. In this period, speculative investments begin to increase because of the expectation of asset price increases, and more and more hedge investments are displaced by speculative investments (as more and more investors expect to offset their debts partially from the rise in asset prices). Debt in the economy grows rapidly and some Ponzi investments began to appear. As a result, the proportion of hedge investment declines, and the other two types of investment gradually increase. This is the time the economy enters the ‘bubble’ phase.

As the economy approaches its peak, some adverse shocks may appear, and they can easily activate a reverse trend and prices tend to decrease, or just simply cease to rise. Meanwhile, a number of Ponzi investments must begin to sell assets to cover the interest costs. A crisis begins since lower asset prices lead to capital flight. Capital stops flowing into the market and interest rates rise. Due to the rising cost of capital, speculative investments turn into Ponzi investments, and hedge investments turn into speculative investments. As a result, the economy shifts to a point where the proportion of speculative and Ponzi investments predominate. Asset price deflation leads to the kind of negative economic impact, including banking crisis, already discussed.

For currency crises, there have been three generations of theoretical models. The first generation, with major contributions
by Krugman (1979), focuses on the incompatibility between the government’s commitment to maintain a fixed exchange rate and the fundamental problems within the economy, such as excessive expansion of credit or a large budget deficit. The result is that foreign exchange reserves must keep declining to defend the exchange rate, and the economy suffers from potential currency attacks as speculators expect that the government would have been rendered helpless by depleted reserves, and exchange rates will be forced to float.

The second-generation models, starting from the study of Obstfeld (1986), consider the economy to have multiple currency equilibria as the government can choose different combinations of policy targets (such as between the growth or stability targets). When choosing a shift from one target to another, the government must change its exchange rate policy, or accept a currency crisis. Being aware of this situation, speculators can launch speculative attacks to turn expectations into reality. Thus, currency attacks can happen regardless of the level of foreign exchange reserves, but are related to the economic situation at that time.

The third-generation models are more diverse and more connected with domestic conditions. For example, when the banking system is so vulnerable such that it cannot stand rising interest rates anymore, it may be the appropriate time for an attack to start, as there is no room to increase interest rates to defend the domestic currency. Many models of this generation explore elements in the financial structure of banks and corporations (balance-sheet approach), in which there exists a mismatch of assets dominated by the local currency and foreign currencies. Thus, the exchange rate risk becomes very high in the entire system. On that basis, the models of this generation emphasize a close relationship between the currency crisis and banking crisis, or debt crises (twin crises).¹

¹ See Burnside et al. (2007) for a concise summary of three generations of currency crisis models.
To predict crises, much effort in developing early warning models has been made. These models try to construct a system of major economic and financial indicators to help identify imbalances in the economy.

One can summarize the major causes leading to financial and currency crises and the major macro risks as follows:

- The fundamentals within the economy weaken (for example, persistent high budget deficit and/or high trade deficit, moral hazard in the financial system increases, rapid foreign debt growth, rapid financial liberalization, loss of control of international capital flows and domestic credit growth).
- Macroeconomic policy inconsistency, or wrong policies or combination of policies.
- Adverse international conditions, such as interest rate of the USD on international markets increases, devaluation of the Chinese Yuan, or contagion from an international crisis.

For Vietnam, policy analysts seemed to start paying attention to the risk of crises to the economy after the Global Financial Crisis broke out in 2008. However, Vietnam has currently many domestic signals that point to the potential of a crisis similar to the Asian financial crisis. This will be analyzed further in the rest of this chapter.

**Box 2.1: Views on the Causes of the 1997 Asian Financial Crisis**

Choi (2000) lists 21 reasons that having been cited as causes of the Asian Financial Crisis:

1. Victims to international speculative capital
2. Victims to conspiracy
3. Crony capitalism and corruption
4. Decline in international competitiveness
5. Failure of the Asian business model
6. Government control and interference (including bailing out of bankrupt institutions)
7. Inadequate government monitoring and regulation
8. Lack of transparencies regarding government policies and accounting
9. Family control of business groups
10. Excessive corporate borrowing
11. Underdeveloped domestic capital markets and institutions
12. Current account deficit and excess consumption
13. Rising external debt
14. Low international reserve assets
15. Liquidity problem due to high ratio of short-term debt
16. Non-sustainability of ‘fixed’ exchange rate policy
17. International contagion
18. Lack of global perspectives
19. Authoritative decision making structure
20. Ego and stupidity of top business and government officials in charge

Lee and Park (2000) point to the weaknesses of the Asian economies:

1. Real sector: over-investment; lack of transparency in corporate governance.
2. Financial sector: rapid credit expansion, lack of oversight and supervision; misguided financial deregulation.
3. External areas: a fixed exchange rate regime, increase in current account deficit, massive inflows of foreign capital, inadequate levels of foreign exchange reserves.

According to Dean (2000), the path to crisis is as follows:

1. High domestic savings rates led to rapid physical and human capital formation, creating high economic growth;
2. Capital account liberalization combined with high economic growth attracted capital inflows;
3. Fixed exchange rate regimes combined with strong capital inflows led to rapid monetary growth;
4. The problems in the financial intermediation system (asymmetric information) together with rapid monetary growth led to over-investment and misallocation of capital;
5. Ceilings on price inflation for goods and services, added to rapid monetary growth and moral hazard problem, leading to asset bubbles;
6. Limits in budget capacity of bailing out banking system, asset bubble bursts and turns into asset deflation;
7. High debt ratios associated with falling asset prices led to difficulties in debt serving and exacerbated currency crises.

Yang (2000) and Lingle and Mondejar (2000) both note that the Asian countries needed large amounts of long-term capital for economic development (e.g. for investment in infrastructure), but had to rely on short-term capital inflows, causing a maturity mismatch problem.

Haggard (2000) criticizes the close, collusive relationship between government and business in Asian countries. This relationship created increasing moral hazard problems (through the financial system and industrial policy), weakened the economy whose general rate of returns of capital was decreasing, and at the same time made the economy less flexible and less effective in defending against external shocks.

2.3 Macroeconomic Characteristics of the Vietnamese Economy

2.3.1 Economic Growth

Compared to the previous decade, Vietnam witnessed a period of low economic growth in the first decade of the 21st century. In the late 1990s, Vietnam’s economic growth slowed down due to uncertainties in the process of economic reform from 1996. Concurrently Vietnam was negatively affected by the 1997 Asian Financial Crisis. Consequently, the economy experienced a period
of both declining growth and deflation in the years 1999-2001 (see Figure 2.2).

**Figure 2.2: Economic Growth and Inflation, 1995-2009**

![Graph showing economic growth and inflation from 1995 to 2009](image)

*Source: General Statistics Office (GSO) (2010).*

Under these circumstances, an economic stimulus plan of loosening credit and expanding state investment began to be implemented from 2000. In the following years, the continuation of the stimulus policy helped the economy regain its growth, but has also sowed the seeds of high inflation, which emerged from mid-2007. In addition, joining the World Trade Organization (WTO) in November 2006 led to deepening integration into the global economy, increasing trade and making for a surge in capital inflows (both direct and indirect investment). The need to achieve VND stability required the State Bank of Vietnam to neutralize a large amount of foreign currency, thus contributing to high inflation in 2008. Overall, macro-control in this period was weak. These factors together with the severe impact of the Global Financial Crisis brought the economy a period of low economic growth and high inflation from 2008-2009.
Figure 2.3 shows the contribution by economic sectors to GDP growth of the economy in the period 1996-2009. It can be easily seen that for more than a decade services and the processing industry (manufacturing) have been the spring-board of economic growth. Due to the impact of the crisis, however, the contribution of the processing industry significantly decreased in 2009. Under the influence of economic stimulus packages, construction and services became the most important industries for growth. This is understandable because both industries, as non-trade industries, do not participate in international trade, and are thus the main objects of domestic stimulus policy. The third industry to become important was mining, due to the quick price recovery of raw materials and minerals, the result of high demand from China. That the mining industry became more important is not only a one-off occurrence in the context of recovery after the crisis, but rather, as Coxhead (2007) has pointed out, that it is likely to be part of a longer-term trend. It is the rise of China that has caused the Southeast Asian countries, which develop more slowly than China, to shift from exporting processed goods towards exporting resource-intensive goods. This he called a “new resource curse”.

Source: Phạm Văn Hà (2010).
Figure 2.4 shows the structural shift of GDP in the period 2000-2009. Generally, the shift is consistent with the experience of developing countries, with a falling share of agriculture and expanding shares of services and industries.

**Figure 2.4: Industry Shares in GDP at Constant Price, 2000-2009**

Table 2.1 provides information on the growth rate of industrial output by ownership. Very clearly, that the domestic sector strongly grew, followed by the Foreign Direct Investment (FDI) sector. The growth of SOEs slowed. This shows, to some extent, the process of economic restructuring in the direction of expanding both domestic and foreign invested sectors.

**Table 2.1: Industrial Output Growth by Ownership, 2005-2009**

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>17,1</td>
<td>16,8</td>
<td>16,7</td>
<td>13,9</td>
<td>7,6</td>
</tr>
<tr>
<td>SOEs</td>
<td>7,2</td>
<td>5,9</td>
<td>5</td>
<td>2,7</td>
<td>1,6</td>
</tr>
<tr>
<td>Central</td>
<td>12,4</td>
<td>8,9</td>
<td>6,8</td>
<td>4,8</td>
<td>4,1</td>
</tr>
</tbody>
</table>

*Source: Phạm Văn Hà (2010).*
From the demand side of the economy, the growth rate of all components of aggregate demand decreased in 2009, with net export growth turning negative. This explains why this year’s growth rate was much lower than those of previous years (Table 2.2). Concurrently, the inflation rate’s slowing down signals that the economy was growing below its potential, due to suppressed demand.

**Table 2.2: Growth Rate of Aggregate Demand Components, 2005-2009**

<table>
<thead>
<tr>
<th>Component</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>8,44</td>
<td>8,23</td>
<td>8,46</td>
<td>6,31</td>
<td>5,32</td>
</tr>
<tr>
<td>Investment</td>
<td>11,15</td>
<td>11,83</td>
<td>26,80</td>
<td>6,27</td>
<td>4,31</td>
</tr>
<tr>
<td>Fixed asset accumulation</td>
<td>9,75</td>
<td>9,90</td>
<td>24,16</td>
<td>3,82</td>
<td>8,73</td>
</tr>
<tr>
<td>Change in inventory</td>
<td>33,48</td>
<td>37,17</td>
<td>54,56</td>
<td>26,98</td>
<td>-26,18</td>
</tr>
<tr>
<td>Final consumption</td>
<td>7,34</td>
<td>8,36</td>
<td>10,63</td>
<td>9,17</td>
<td>4,03</td>
</tr>
<tr>
<td>State</td>
<td>8,20</td>
<td>8,50</td>
<td>8,90</td>
<td>7,42</td>
<td>7,60</td>
</tr>
<tr>
<td>Private</td>
<td>7,26</td>
<td>8,35</td>
<td>10,80</td>
<td>9,34</td>
<td>3,68</td>
</tr>
<tr>
<td>Net export of goods and services</td>
<td>-18,87</td>
<td>25,01</td>
<td>184,19</td>
<td>17,23</td>
<td>-8,19</td>
</tr>
</tbody>
</table>

Table 2.3 shows the component structure of aggregate demand over time, in which the growing rate of final consumption and
investment can be clearly seen. This must be paired with trade deficit (negative net exports) in order to create macroeconomic balance. In the next section, this phenomenon will be further analyzed.

**Table 2.3:** Final Demand Components in GDP, 2005-2009

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total</strong></td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td><strong>Investment</strong></td>
<td>35.58</td>
<td>36.81</td>
<td>43.13</td>
<td>39.71</td>
<td>38.13</td>
</tr>
<tr>
<td><strong>Fixed asset accumulation</strong></td>
<td>32.87</td>
<td>33.35</td>
<td>38.27</td>
<td>34.61</td>
<td>34.52</td>
</tr>
<tr>
<td><strong>Change in inventory</strong></td>
<td>2.71</td>
<td>3.46</td>
<td>4.86</td>
<td>5.10</td>
<td>3.61</td>
</tr>
<tr>
<td><strong>Final consumption</strong></td>
<td>69.68</td>
<td>69.38</td>
<td>70.81</td>
<td>73.53</td>
<td>72.77</td>
</tr>
<tr>
<td><strong>State</strong></td>
<td>6.15</td>
<td>6.03</td>
<td>6.05</td>
<td>6.12</td>
<td>6.30</td>
</tr>
<tr>
<td><strong>Private</strong></td>
<td>63.53</td>
<td>63.35</td>
<td>64.76</td>
<td>67.41</td>
<td>66.47</td>
</tr>
<tr>
<td><strong>Net export of goods and services</strong></td>
<td>-4.18</td>
<td>-4.56</td>
<td>-15.85</td>
<td>-15.21</td>
<td>-10.35</td>
</tr>
<tr>
<td><strong>Error and omissions</strong></td>
<td>-1.08</td>
<td>-1.63</td>
<td>1.91</td>
<td>1.97</td>
<td>-0.55</td>
</tr>
</tbody>
</table>

*Source: GSO (2010).*

### 2.3.2 The State Budget

A high deficit is a fundamental characteristic of Vietnam’s state budget. At the same time, public debt has continuously increased over the past 10 years. Figure 2.5 shows budget revenue (in GDP) increasing continuously and steadily from about 21 percent of GDP in 2000 to nearly 28 percent of GDP in 2007. However, budget expenditure increased just as rapidly as budget revenue, creating a persistent deficit at 5 percent of GDP. The deficit was particularly high in 2009 due to the implementation of a large economic stimulus package to counter the economic slowdown.
Public debt (government debt and debt guaranteed by government) as a share of GDP has gradually increased over the past decade, from less than 40 percent to approximately 50 percent in 2010 (Figure 2.6). Meanwhile, foreign debt has been mostly stable at below 35 percent, and only increased during the years affected by world economic crises.
2.3.3 International Trade

International trade is a field currently receiving particular attention in Vietnam as the country is increasingly integrating into the global economy, signing more bilateral free trade agreements, and participating in multilateral organizations such as the World Trade Organization. Such deep integration, however, has brought not only many opportunities but also many new challenges to Vietnam. Since 2002, Vietnam’s current account has returned to deficit, primarily because of trade. However, remittance flows have begun to rise, which has somewhat helped to balance the current account. Also, this is a relatively strong period for capital inflows into Vietnam, thus creating a capital account surplus. As a result, the country’s foreign exchange reserves have continuously improved (Figure 2.7). In 2007, the first year of Vietnam’s joining the WTO, the current deficit skyrocketed, but capital account surplus also increased at a faster rate. However, with the slowdown of capital inflow with the Global Financial Crisis in 2008, the current account deficit has not narrowed. As a result, Vietnam was forced to reduce foreign exchange reserves to offset the foreign exchange deficit.

**Figure 2.7:** Current Account Deficit and Foreign Exchange Reserves, 2000-2009

A continuous current account deficit, along with high domestic inflation, created problems for Vietnam’s exchange rate. Looking back at nominal VND/USD exchange rates over the past decade, we can see a clear depreciation trend especially since 2007. However, the real exchange rate has exhibited an opposite trend, with a widening gap between nominal and real exchange rates, especially in 2008 and 2009 (Figure 2.8). Vietnam’s consumer price index (CPI) increased by 99.5 percent during the period from 2000 to 2009, while that of the US increased by only 23.7 percent over the same period. The VND/USD rate increased only 23.6 percent over the period. Thus, if we take the year 2000 as the base year, the VND has appreciated by 38 percent in real terms. This would have contributed to a more severe trade deficit for Vietnam after 2003.

Figure 2.8: Real and Nominal Exchange Rate VND/USD, 2000-2009

(base year=2000)

The macroeconomic characteristics of Vietnam can thus be summarized as follows:

- Growth rates are high in comparison with regional neighbors but are decelerating; at the same time, growth still depends heavily on investment expansion.
• The economy is becoming increasingly unstable with its integration into the world economy (stronger price fluctuation and inflation);

• The budget is in deficit, and so is trade (dual deficit);

• Even when supported by large remittance flows, the current account balance remains negative. The overall balance sheet is supported by a high level of capital account surplus. However, under the influence of international conditions, capital flows tend to be gradually less stable, leading to the probability of high fluctuation between surplus and deficit.

• With the exchange rate pegged flexibly on the USD (crawling peg), the domestic currency tends to appreciate.

According to the analysis in the first section of this chapter, the characteristics mentioned above show the economy’s macroeconomic instabilities and risks. For further analysis, we need to examine the macroeconomic imbalance causing these. Also, we need to survey the financial system in this context in order to find out whether or not it is sustainable under pressure from that imbalance. These are the contents of the next two sections.

2.4 The Major Imbalances of the Economy

The macroeconomic characteristics outlined in the previous section show that macro-imbalances have persisted in the Vietnamese economy, thus leading to the volatility of the most important macro variables. Basic theories of macroeconomic analysis allow us to analyze linkages among the major balances in the economy, in a relatively simple framework.

The equation of total demand balance in the economy is:

\[ Y = C + I + (X-M) \]  

(1)

\( Y \) is gross domestic output, \( C \) is final consumption, \( I \) is total investment, and \( (X-M) \) is net exports. By adding net income from
abroad (including factor income and transfers), the above equation can be rewritten as:

\[ YD = C + I + CAB \]  \( \text{(2)} \)

\( YD \) is disposable income, and \( CAB \) is the current account balance. Since the total savings of the economy \( S = YD - C \), we can change the above equation into the following simple form:

\[ S - I = CAB \]  \( \text{(3)} \)

This equation describes a fundamental relationship in open economies, where the current account balance equals the difference between savings and investment in the economy.

We can continue to separate investment and savings by the public and private sectors:

\[ (Sp + Sg) - (Ip + Ig) = CAB \]  \( \text{(4)} \)

or:

\[ (Sp - Ip) + (Sg - Ig) = CAB \]  \( \text{(5)} \)

Equation (5) shows the relationship between sectors of the economy: the current account deficit equals total deficits of savings - investment in the private and public sectors.

The estimates of total savings and investment in Vietnam have varied among published studies. In this paper, we use IMF data (Table 2.4).

**Table 2.4: Savings – Investment Gaps (percent of GDP), 2002-2009**

<table>
<thead>
<tr>
<th>Year</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total savings (S)</td>
<td>31,3</td>
<td>30,6</td>
<td>32</td>
<td>34,5</td>
<td>36,5</td>
<td>31,8</td>
<td>31,2</td>
<td>25,1</td>
</tr>
<tr>
<td>Private (Sp)</td>
<td>23,9</td>
<td>23,3</td>
<td>23,6</td>
<td>26,7</td>
<td>28,1</td>
<td>26,2</td>
<td>26,1</td>
<td>23</td>
</tr>
<tr>
<td>State (Sg)</td>
<td>7,4</td>
<td>7,3</td>
<td>8,4</td>
<td>7,8</td>
<td>8,4</td>
<td>5,6</td>
<td>5,1</td>
<td>2,1</td>
</tr>
<tr>
<td>Total investment (I)</td>
<td>33,2</td>
<td>35,4</td>
<td>35,5</td>
<td>35,6</td>
<td>36,8</td>
<td>41,6</td>
<td>41,5</td>
<td>33,2</td>
</tr>
<tr>
<td>---------------------</td>
<td>------</td>
<td>------</td>
<td>------</td>
<td>------</td>
<td>------</td>
<td>------</td>
<td>------</td>
<td>------</td>
</tr>
<tr>
<td>Private (Ip)</td>
<td>21,5</td>
<td>20,8</td>
<td>22,9</td>
<td>24,1</td>
<td>26,4</td>
<td>30,3</td>
<td>32,2</td>
<td>24</td>
</tr>
<tr>
<td>State (Ig)</td>
<td>11,7</td>
<td>14,7</td>
<td>12,6</td>
<td>11,5</td>
<td>10,4</td>
<td>11,4</td>
<td>9,3</td>
<td>9,2</td>
</tr>
<tr>
<td>Difference in Sp-Ip</td>
<td>2,4</td>
<td>2,5</td>
<td>0,7</td>
<td>2,6</td>
<td>1,7</td>
<td>-4,1</td>
<td>-6,1</td>
<td>-1</td>
</tr>
<tr>
<td>Difference in Sg-Ig</td>
<td>-4,3</td>
<td>-7,4</td>
<td>-4,2</td>
<td>-3,7</td>
<td>-2</td>
<td>-5,8</td>
<td>-4,2</td>
<td>-7,1</td>
</tr>
<tr>
<td>Current account deficit</td>
<td>-1,9</td>
<td>-4,8</td>
<td>-3,5</td>
<td>-1,1</td>
<td>-0,3</td>
<td>-9,8</td>
<td>-10,3</td>
<td>-8,1</td>
</tr>
</tbody>
</table>


Table 2.4 shows that until 2006, the private sector (enterprises and households) always had a surplus of net savings, while the public sector always had a deficit of net savings. The net savings deficit of the public sector can be considered the state budget deficit, because there has been over-investment by the state sector in comparison with its ability to pay. Overall, during this period, the budget deficit was mainly financed by the savings surplus of the private sector. Therefore, the current account deficit was not too large. However, since 2007, both sectors have been in deficit, causing the current account deficit to increase sharply, up to around 10 percent of GDP.

Therefore the essence of the current account deficit (and the trade deficit) is derived from the structure of the economy, with its core of the imbalance between savings and investment. In this case, state investment plays a major role in causing the imbalance between savings and investment.

2.4.1 The Savings – Investment Gap

First, it is necessary to recognize the core imbalance of the economy as the growing gap between investment and savings. Figure 2.9 shows the contribution of the state and non-state sectors, as well as FDI, to total investment.
The proportional contribution of the public sector has fallen rapidly, but still accounts for a major part of total investment. In 2008, this proportion had dropped to nearly 34 percent. However, to mitigate the impact of the Crisis, the government provided much support to enterprises. This restored the health of the SOEs, but derailed the SOEs’ reform process. Also, Vietnam’s WTO accession rapidly increased foreign direct investment, reflecting foreign investors’ optimism for Vietnam’s economic future, as well as for the accrual of benefits to international trade. As a result, the proportion of investment by the domestic private sector in total investment declined slightly.

**Table 2.5:** Total Investment as a Share of GDP, 2005-2009

*Unit: %*

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>QI</td>
<td></td>
<td></td>
<td></td>
<td>37,4</td>
<td></td>
</tr>
<tr>
<td>QII</td>
<td></td>
<td></td>
<td></td>
<td>37,4</td>
<td></td>
</tr>
<tr>
<td>QIII</td>
<td></td>
<td></td>
<td></td>
<td>37,4</td>
<td></td>
</tr>
<tr>
<td>QIV</td>
<td></td>
<td></td>
<td></td>
<td>37,4</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>40,9</td>
<td>41,5</td>
<td>46,5</td>
<td>41,5</td>
<td>42,7</td>
</tr>
</tbody>
</table>
Fiscal expansion was reflected in a 50 percent increase in infrastructural investment from the state budget in 2009 compared to the year 2008 (or an increase of more than 50 trillion VND - Figure 2.10). Investment from the state budget increased during the year and represented about 9.3 percent of GDP in the fourth quarter, a record rate in 2005-2009. Investment from both the central and the local governments increased, with investment by the central government increasing faster as funds were directed to large-scale projects.

**Figure 2.10**: Infrastructure Investment from State Budget, 2005-2009

*Unit: VND trillion*

In 2009, FDI decreased in comparison to 2008. However the reduction was not entirely because of the Global Financial Crisis. In 2008, with high expectations from Vietnam’s WTO entry, committed FDI jumped substantially to US$ 64 billion, a record

### Table 2.1

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>State Sector</td>
<td>19.3</td>
<td>19.0</td>
<td>17.3</td>
<td>14.1</td>
<td>18.4</td>
</tr>
<tr>
<td>Non-State Sector</td>
<td>15.5</td>
<td>15.8</td>
<td>17.9</td>
<td>14.6</td>
<td>12.7</td>
</tr>
<tr>
<td>FDI Sector Investment</td>
<td>6.1</td>
<td>6.7</td>
<td>11.3</td>
<td>12.8</td>
<td>6.2</td>
</tr>
</tbody>
</table>

*Source: Pham Van Ha (2010).*
between 2005 and 2009. In fact, the US$ 21.5 billion of committed FDI in 2009 is not low in comparison with the average of the period of 2005-2007 (perhaps the only worrying sign is the fall of the FDI growth rate). Most importantly, the actual FDI was US$ 10 billion, slightly lower than in 2008 but still high by the standards of the 2005-2009 period (see Figure 2.11).

**Figure 2.11: FDI Inflows, 2005-2009**

*Unit: USD billion*

![Figure 2.11: FDI Inflows, 2005-2009](image)

*Source: Pham Van Ha (2010).*

The favorite FDI destinations in 2009 were real estate, hotels and restaurants. The two sectors accounted for 76 percent of the total registered capital and additional capital commitment from outstanding projects. Tradable sectors such as manufacturing, mining and agriculture accounted for a modest share of only 16 percent in the total newly registered FDI (Figure 2.12). It is notable that the two sectors above are non-tradeables sectors. Thus in the long term this investment structure cannot improve industrial production capacity.
Thus, it can be said that the rapidly increasing difference between savings and investment in recent years has been primarily due to a dramatic increase in investment, and a nearly constant domestic savings rate. The budget deficit played a major role in the total savings deficit.

### 2.4.2 The Budget Deficit

The budget deficit is currently an important issue; in early 2009 many people feared that the stimulus policy which propped up the economy from damage by the Global Financial Crisis but which led to revenue decline would push the deficit to very high levels (from 7 percent to 10 percent). However, this is actually a medium and long term problem, because the Vietnamese budget deficit has been at 5 percent of GDP in recent years (Figure 5). In 2009, the budget deficit was officially estimated at 6.9 percent of GDP. In 2010, because the economy remains weak, this deficit is forecasted to remain high, possibly not much lower than in 2009. To solve the problem of budget deficits, the state will have to either raise taxes or borrow through bond issue. Both actions adversely affect economic growth.
Deficit problems over a relatively long time can be somewhat justified by the “Developmental State”, in which during the early stages of development, the state invests in areas that are highly productive or might produce large externalities such as infrastructure, education, and healthcare. However, it should exercise prudence, because a large state sector may not serve the state well. The main purpose of a large state sector is to support the dynamic and creative development of the private sector. Thus, successfully developing states all need to implement a strategy of gradually retreating from the market, instead of maintaining a large state sector. Failure to accomplish this will hinder economic growth in the medium and long terms.

Table 2.6: The State Budget, 2005-2010

<table>
<thead>
<tr>
<th>ID14</th>
<th>Proportion of GDP (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Actual</td>
</tr>
<tr>
<td>Indicators</td>
<td>2005</td>
</tr>
<tr>
<td>A Total revenue and grants</td>
<td>28,4</td>
</tr>
<tr>
<td></td>
<td>Tax and fees</td>
</tr>
<tr>
<td>---</td>
<td>--------------</td>
</tr>
<tr>
<td>1</td>
<td>26,1</td>
</tr>
<tr>
<td>2</td>
<td>1,8</td>
</tr>
<tr>
<td>3</td>
<td>0,5</td>
</tr>
<tr>
<td>B</td>
<td>5,4</td>
</tr>
<tr>
<td>C</td>
<td>33,3</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Pham Van Ha (2010).
Table 2.6 shows the structure of the state budget in recent years. One of the important issues of budget deficits is the burden of spending and investment of the state budget for state-owned sectors. This is an area with low capital-use efficiency and many potential business risks. In some privileged monopoly industries, their losses may not happen. Their opportunity cost of capital, however, is not as high as in the private sector. Thereby the value of investment items must increase to become higher than the average level of society, thus increasing the difference in savings-investment in the economy.

Additionally, due to Vietnam’s production structure, investment is primarily associated with procurement of equipment and materials through imports. Thus, this is a direct cause of trade imbalances.

2.4.3 The Trade Deficit

During the renovation and international economic integration of Vietnam, the excess of imports over exports is a perpetual problem, hence, a cause for serious concern by analysts and policy makers.

Looking at Figure 2.14, we can see some fairly clear trends of the Vietnamese economy in the integration process. First, both exports and imports of Vietnam (as shares of GDP) have increased continuously. As a result, the openness of the economy, defined by the ratio of total trade (exports plus imports) to GDP, has increased rapidly. In 1999, it was only about 80 percent (exports and imports were relatively balanced, each equal to about 40 percent of GDP). However, after a decade, the openness of the economy has increased almost linearly, exceeding 160 percent, with imports more than 90 percent of GDP, and exports of nearly 75 percent of GDP. Year 2009 marked an era of declining international trade, resulting in the decrease of all the criteria mentioned above. It can be seen, however, that the tendency towards increasing openness is relatively sound, and will be continuous in the future.
Second, although both exports and imports also increased, imports tend to rise faster than exports. As a result, net exports since 1999 have been consistently negative, and becoming more so. This is the phenomenon of trade deficit, or excess of imports over exports.

**Figure 2.14:** Openness and Trade Deficit of Vietnam, 1999-2009

Source: GSO statistical data, various years

In facing the phenomenon of such a chronic and increasingly serious trade gap, policy makers have tried to decrease it. But so far, policies have been administrative, ranging from criteria planning to more import restrictions. In addition, there has recently been a tendency to favor import restrictions of luxury goods, such as motor cars. However, as already explained, the trade deficit is due to macro imbalances between aggregate investment and total savings. Therefore, it is capital goods and raw materials that have played a key role in causing the deficit. In reality, consumer goods (including luxury goods), as considered by policy makers account for only a small proportion of imports. We can see this clearly through the structural composition of imports.
Figure 2.15 shows the import structure of Vietnam. Three kinds of goods, making up three quarters of total imports, are mainly used for production. These are capital goods (machinery and equipment), raw materials (fertilizers, plastics, etc) and fuels (mainly oil). The rest are mostly classified as final consumption goods.

**Figure 2.15:** Import Structure of Vietnam, 2007-2009

![Import Structure of Vietnam, 2007-2009](image)

In Figure 2.16, we consider the rates of three imported goods: new medicine, automobile units, and motorcycles in recent years. Motorcycle imports have decreased significantly, while new medicine and automobile units have increased. But as noted above, even when the automobile units used for business and production purposes were also classified into this category, the total automobile imports did not exceed 2 percent of total imports. Automobile imports are also only slightly larger than new medicine. This indicates that anti-deficit through import restriction of a particular item, even when imports of this item seem very high (for example, cars), is not a viable solution to the current trade deficit.

*Source: GSO statistical data, various years*
For example, if we succeeded in reducing the amount of imported cars in half, it would only reduce total imports by less than 1 percent. Meanwhile, to prevent car imports on such a large scale will create a terrible distortion of the automobile market, and interest groups related to this area (including entrepreneurs in the field of domestic automobile assembly and customs officers) will enjoy huge profits. From a policy-making perspective, it is necessary to carefully consider both the benefits the economy receives (nearly 1 percent of import decrease) and the costs it incurs, due to distortions in the market.

**Figure 2.16:** Proportion of Selected Goods in Total Imports, 2007-2009

While dependent on the outside world for most intermediate goods, Vietnam still exports low-tech, low value-added goods that are mainly resource-intensive. Figure 2.17 shows goods that Vietnam has had comparative advantage in over the past decade.
Another key feature of Vietnam’s trade deficit is its current exchange rate mechanism. Even though the State Bank of Vietnam has declared a single official rate for all domestic trading, black market rates still exist. Private traders have limited access to foreign exchange from the banking system. During the 1990s, due to the export discrimination between SOEs and private businesses, private business found it extremely hard to tap into foreign exchange sources from the banking system. At present, such discrimination is still applied by certain commercial banks toward private businesses or other entities that have been categorized as “not to be encouraged” in using foreign exchange such as those that use foreign exchange for traveling or to import luxurious goods or other goods that can be produced domestically. Such discrimination is the reason for the existence of parallel black markets in Vietnam (Nguyen Thi Thu Hang et al., 2010, p. 143).

The exchange rate scene in Vietnam can be divided into two phases. Phase 1 corresponds to periods with major economic changes: (i) 1989-1992 with its comprehensive economic reforms to transform Vietnam’s economy from its central planning stance; (ii) 1997-2000, with great adverse impacts from the Asian
financial crisis; and (iii) 2008-2009, with the Global Financial
Crisis. Associated with such volatile periods, were big gaps
between official and parallel market exchange rates. The pressures
from foreign exchange supply and demand forced the State Bank
of Vietnam to either considerably widen the exchange rate band
or to officially devaluate the VND - with the result that the VND
depreciated (sometimes greatly) in comparison to the previous
period.

Phase 2 corresponds to periods where the Vietnam economy
recovered from crisis and started to have stable growth, such as
1993-1996 and 2001-2007. Such stable periods were accompanied
by rather rigid arrangements for the exchange rate. These are also
periods where parallel market rates were close to official rates. The
reason is that official rates had increased continuously during the
volatile period and matched parallel market rates by the end of
such periods.

Table 2.7 presents the real exchange rate indices of different
currencies against the USD. With the exception of the Japanese Yen
and Taiwan dollar, the USD also depreciated considerably against
other currencies of Vietnam’s major trading partners. However,
despite the general real appreciation against the USD, the VND
appreciated more than other currencies such as the Singapore
Dollar, Korean Won, Malaysian Ringgit and Thai baht. This real
appreciation of the VND has reduced the competitiveness of
Vietnam’s exports in the global market.

Table 2.7: Real Exchange Rate Indices of Selected Currencies against
USD (Base year=2000)

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>CNY</td>
<td>100,00</td>
<td>101,67</td>
<td>104,95</td>
<td>104,11</td>
<td>104,07</td>
<td>103,85</td>
<td>100,64</td>
<td>91,90</td>
<td>84,30</td>
<td>84,87</td>
</tr>
<tr>
<td>Euro</td>
<td>100,00</td>
<td>105,12</td>
<td>88,56</td>
<td>73,50</td>
<td>68,70</td>
<td>80,51</td>
<td>72,30</td>
<td>65,32</td>
<td>68,45</td>
<td>66,56</td>
</tr>
<tr>
<td>Yen</td>
<td>100,00</td>
<td>118,75</td>
<td>111,19</td>
<td>101,61</td>
<td>101,73</td>
<td>120,05</td>
<td>123,32</td>
<td>122,18</td>
<td>97,60</td>
<td>102,48</td>
</tr>
<tr>
<td>Currency</td>
<td>NEER</td>
<td>REER</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Singapore Dollar</td>
<td>100.00</td>
<td>109.50</td>
<td></td>
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</tr>
<tr>
<td>Taiwan Dollar</td>
<td>100.00</td>
<td>109.64</td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Australian Dollar</td>
<td>100.00</td>
<td>108.49</td>
<td></td>
<td></td>
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<td></td>
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</tr>
<tr>
<td>Korean Won</td>
<td>100.00</td>
<td>103.03</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Thai Baht</td>
<td>100.00</td>
<td>105.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Malaysia Ringgit</td>
<td>100.00</td>
<td>104.57</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>VND</td>
<td>100.00</td>
<td>104.57</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Nguyen Thi Thu Hang et al. (2010)

To measure the real appreciation of the VND compared to Vietnam’s major trading partners, we estimated the nominal effect exchange rate (NEER) and real effective exchange rate (REER) of the VND.

**Figure 2.18:** Vietnam’s NEER and REER  
(Base year = 2000)

Source: Nguyen Thi Thu Hang et al. (2010).
Figure 2.18 also shows that the trend of the nominal exchange rate during the period 2000-2003 supported Vietnam’s export-promotion strategy. Both NEER and REER increased during these years, which means that as the VND depreciated, Vietnam’s exports became more competitive (in price terms) compared to exports from other countries. These movements of the exchange rate helped Vietnam’s economy recover from the negative impacts of the Asian Financial Crisis. However, since 2004, because the inflation rate continued to increase at a faster rate than the rate of nominal depreciation of the VND, the official rate had moved away from REER. The VND has been appreciating in real terms, thus reducing the competitiveness (in price terms) of Vietnam’s exports in comparison to other trading partners (Nguyen Thi Thu Hang et al., 2010, p. 152). In fact, large and prolonged trade deficits in recent years provide the most convincing evidence of the impact of the real appreciation of the VND.

During the 2004-2009 period, Vietnam’s exchange rate was out of line with its export-promoting strategy due to continuous real appreciation. This fact creates further pressure on exchange rate management during the Global Financial Crisis when there are decreases in both export value and foreign investment inflows (both direct and indirect).

The State Bank of Vietnam’s efforts in devaluing VND at the end of 2009 and early 2010 have helped REER slightly reverse the appreciation trend. However, the current calculated REER still shows considerable appreciation against the basket of currencies chosen. This means that Vietnam’s competitiveness in the world market is still negatively affected, and that trade deficits are still a serious problem (Nguyen Thi Thu Hang et al., 2010, p. 153).

2.5 Problems in the Financial System

Financial and banking reform in Vietnam was accompanied by economic reform from the late 1980s. In the 1990s, however, financial development did not experience sudden change. This was a period in which the financial system was still relatively closed,
and mainly dominated by SOEs. At the end of 1998, for example, over 80 percent of total assets in the banking system belonged to the four big state banks. Meanwhile, the joint-stock commercial banking system (a mixture of public and private ownership) was developed along with the system of people insurance funds. Commercial banks mainly operated locally or in rural areas. Thus, as can be seen in Figure 2.19, financial depth did not increase in the 1990s.

From 2000, however, there were major changes in the financial system, which significantly deepened over time. This period began with the opening of the stock market. In addition, this was the period in which Vietnam was preparing for the Bilateral Trade Agreement with the United States (U.S. BTA). International commitments enormously impacted the development of Vietnam’s financial market, as was demonstrated by its official accession to the WTO in late 2006. This has been the time of a strong boom in the market, with liberal reform and optimistic expectations for the future of the economy that prompt investors to expand their operations.

**Figure 2.19:** Development of the Financial Depth, 1990-2008

*Source: ADB (2009).*
Figure 2.20 shows changes in Vietnam’s money supply in recent years. There was very strong monetary growth in 2007, just before the Global Financial Crisis broke out. However, this was just a coincidence, because 2007 was a boom year for both commercial banks and the stock market. This came from the over-optimistic expectations of investors, both foreign and domestic, towards Vietnam’s WTO accession.

During this period, there were some notable points of changes in interest rates (Fig. 2.21). First, from 2000 to the end of 2004, nominal interest rates fluctuated with inflation, while real interest rates were positive. After 2005, however, interest rates did not keep pace with inflation, causing real interest rates to be negative. Only in 2009, after the period of high inflation in 2008, did real interest rates return to positive. It can be said that high inflation in the period 2005-2008 distorted interest rate signals, contributing to the complicated changes in the capital market.

Figure 2.20: Money Supply, 2005-2009

Unit: percentage increase compared to the previous year

The Vietnamese financial system’s rapid development had a sudden adverse impact from the Global Financial Crisis, rendering the whole system vulnerable. As a country under transformation in the early stages of development, Vietnam still has a financial system in which the banking system is at its center. Thus, bank credit plays an important role in economic cycles. The enterprise system and asset markets are associated with the banking system. The situation of these two systems also affects the level of risk and sustainability in the banking system. Thus, when analyzing the financial system, we must consider all three areas.

2.5.1 The Banking System

Over the past 20 years, and especially in the past 10 years, the scale and structure of the Vietnamese banking system has changed dramatically. According to Mihaljek (1999), the banking system of Vietnam was dominated in the late 1998 by 4 large state banks, which accounted for 82 percent of total assets of the banking system, 51 joint-stock banks, which makes up 10 percent of total assets and 23 branches of foreign banks and 4 joint-venture banks, which accounted for 8 percent. Total assets of the banking
system were equal to 38 percent of GDP. Total debt was equal to 22 percent, and total deposits equal to 20 percent of GDP.

But after only a decade, the picture became quite different. According to Moody’s (2009), total assets of the banking system had reached 120 percent of GDP by late 2008. The system included 4 state banks, 38 joint-stock commercial banks, 5 joint-venture banks, 2 foreign banks and 33 branches of foreign banks (There are also two banks for policy: The Vietnam Bank for Social Policies\(^1\) and The Vietnam Development Bank).\(^2\)

Thus, the number of joint-stock banks fell dramatically. However, a distinctive feature of this stage is the rapid growth of joint stock commercial banks and foreign banks, which has far exceeded the growth of state banks. This suggests that non-state banks grew in terms of asset accumulation and market share expansion. According to Fitch Ratings’ estimation (2009), in late 2008, the 4 state banks accounted for only 52 percent of the total assets of the banking system, 36 banks accounted for 25 percent, and foreign banks or branches of foreign banks accounted for 23 percent.

As remarked above, the development of the banking system in particular, and of the financial system in general, is closely related to the international commitments of this period. Two important commitments are the Bilateral Trade Agreement with the U.S. (2001) and accession to the World Trade Organization (late 2006). According to the framework of the US BTA, the banking system had to be liberalized before 2010. Thus, the reform process of joint-stock bank system proceeded rapidly. Banks, especially joint-stock commercial banks, grew at an outstanding rate during this period.

Table 2.8 shows changes in the banking market structure, with a sudden strong shift towards stock commercial banks, in

\(^1\) Established in October 2002 from reorganizing the Bank for the Poor (established in August 1995).

\(^2\) Established in May 2006 from reorganizing the system of the Development Assistance Fund (established in July 1999)
2006, the transitional period when Vietnam officially joined the WTO.

### Table 2.8: Market Shares of Commercial Banks, 2000-2007

<table>
<thead>
<tr>
<th>Year</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Deposit market share</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>State-owned commercial bank</td>
<td>78.4</td>
<td>80.8</td>
<td>80.5</td>
<td>79.5</td>
<td>78.1</td>
<td>78.6</td>
<td>70.0</td>
<td>58.0</td>
</tr>
<tr>
<td>Joint-stock commercial bank</td>
<td>11.3</td>
<td>9.2</td>
<td>10.1</td>
<td>11.2</td>
<td>13.2</td>
<td>14.3</td>
<td>22.0</td>
<td>29.0</td>
</tr>
<tr>
<td>Branches of foreign bank and joint-venture bank</td>
<td>10.3</td>
<td>10.0</td>
<td>9.4</td>
<td>9.3</td>
<td>9.7</td>
<td>7.1</td>
<td>8.0</td>
<td>13.0</td>
</tr>
<tr>
<td><strong>Lending market share</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>State-owned commercial bank</td>
<td>72.0</td>
<td>73.0</td>
<td>74.0</td>
<td>73.0</td>
<td>75.0</td>
<td>68.0</td>
<td>63.0</td>
<td>54.0</td>
</tr>
<tr>
<td>Joint-stock commercial bank</td>
<td>11.0</td>
<td>13.0</td>
<td>15.0</td>
<td>15.0</td>
<td>14.0</td>
<td>16.0</td>
<td>27.0</td>
<td>38.0</td>
</tr>
<tr>
<td>Branches of foreign bank and joint-venture bank</td>
<td>17.0</td>
<td>14.0</td>
<td>12.0</td>
<td>13.0</td>
<td>12.0</td>
<td>16.0</td>
<td>10.0</td>
<td>8.0</td>
</tr>
</tbody>
</table>

*Source: Leung (2009).*

It is estimated that the size of domestic credit in Vietnam's commercial banking system in 2000-2009 reached about 60 percent of GDP. This level is relatively consistent with the development of Vietnam (moving from low-income to low-average income), but much lower than that of China (in 2000, when China had GDP/capita similar to that of Vietnam in 2009, see Table 2.9). This may imply that the competitiveness of the Vietnamese commercial banking system will be relatively weaker than China under the pressure of international financial integration.
Table 2.9: Domestic Credit through Commercial Banking System in Selected Countries (percent of GDP), 2000

<table>
<thead>
<tr>
<th>Country</th>
<th>Domestic Credit (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low income countries</td>
<td>45.31</td>
</tr>
<tr>
<td>Low-average income countries</td>
<td>85.35</td>
</tr>
<tr>
<td>High income countries</td>
<td>181.9</td>
</tr>
<tr>
<td>China</td>
<td>177.8</td>
</tr>
<tr>
<td>India</td>
<td>57.32</td>
</tr>
<tr>
<td>Indonesia</td>
<td>55.7</td>
</tr>
<tr>
<td>Vietnam</td>
<td>52.47</td>
</tr>
<tr>
<td>Uganda</td>
<td>12.46</td>
</tr>
<tr>
<td>South Africa</td>
<td>15.82</td>
</tr>
<tr>
<td>Russia</td>
<td>27.57</td>
</tr>
<tr>
<td>Brazil</td>
<td>61.08</td>
</tr>
</tbody>
</table>


The strong growth of the banking system has been accompanied by the risks of overheated growth. Overheated growth, particularly in the commercial banking system, has exerted pressure on loan quality and risk management. Table 10 shows the fundamental problems of the current commercial banking system. For state banks, the fundamental problem was a low ratio of capital over total assets, and high bad debt ratio. The low ratio of capital over total assets reflected these banks’ advantage of long-standing government support. High bad debt ratio reflected low quality loans. Many loans of these types were loans for SOEs by state banks, which were also usually supported or guaranteed by the government.

Meanwhile, commercial banks could only use a leverage equal to about 10 times of their own capital. However, commercial banks experienced highly significant asset growth (associated with loans
and deposits) in the years 2006-2007. In addition, joint-stock banks were usually more strongly dollarized than state banks.

Commercial banks also had total debt almost equal to total deposits. However, deposits were often short-term, while loans were often long-term. Thus, joint-stock banks had to face double risks of mismatching: in terms of both maturity and currency (Vo Tri Thanh and Pham Chi Quang, 2007).

Table 2.10: Selected Indicators of the Soundness of the Banking System

<table>
<thead>
<tr>
<th></th>
<th>State commercial bank</th>
<th>Joint-stock commercial bank</th>
<th>The whole system</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan growth</td>
<td>15.5</td>
<td>30.3</td>
<td>25.0</td>
</tr>
<tr>
<td>Deposit growth</td>
<td>28.9</td>
<td>24.1</td>
<td>12.1</td>
</tr>
<tr>
<td>Capital in total assets</td>
<td>4.1</td>
<td>5.1</td>
<td>5.1</td>
</tr>
<tr>
<td>Bad debt in total loans</td>
<td>3.2</td>
<td>1.9</td>
<td>3.9</td>
</tr>
<tr>
<td>Reserves over total bad debt</td>
<td>40.6</td>
<td>113.4</td>
<td>74.4</td>
</tr>
<tr>
<td>Total loans over deposits</td>
<td>78.4</td>
<td>82.3</td>
<td>86.2</td>
</tr>
<tr>
<td>Foreign currency loans over total loans</td>
<td>17.6</td>
<td>18.2</td>
<td>17.0</td>
</tr>
<tr>
<td>Foreign currency deposits over total deposits</td>
<td>22.7</td>
<td>21.1</td>
<td>23.4</td>
</tr>
</tbody>
</table>

2.5.2 Credit to the Enterprise System

The way in which credit flows to the business sector is an important determinant of risks in the financial system. A distinctive feature of the Vietnamese economy is that although the proportion of the state-owned sector has continued to fall in recent years, it remains high (about 35 percent of GDP), while the private sector is small (about 10 percent of GDP). This is indicated in Figure 2.22, showing the changing shares of sectors by ownership from 1995 to 2008.

As shown in Figure 2.22, the economy was moving in a positive way, with continuous growth of the private economic and non-state sectors. However, in comparison to other economies in the region, including China, the state still dominated the Vietnamese economy. Until 2005, the state economy still accounted for almost 38.5 percent of GDP. This rate decreased only slightly to 34.4 percent in 2008, due to equitization of SOEs in recent years. Despite the large proportion of non-state economy, reaching 47 percent in 2008, this sector was still dominated by the collective economy and individual economy. The official private sector made up only 10.8 percent of GDP in 2008, modestly from 6.3 percent in 1995.

**Figure 2.22:** GDP Contribution by Ownership (percent), 1995-2008

![GDP Contribution by Ownership (percent), 1995-2008](image)

*Source: Nguyen Duc Thanh and Dinh Tuan Minh (2010).*
With such an economic structure, credit to the SOE sector accounted for about 30 percent of the total (Table 2.11). Due to the high moral hazard in banks’ lending activities to SOEs, the economy was endangered by the appearance of market shocks (as demonstrated by the recent case of Vinashin).

Table 2.11: Credit to SOEs and non-SOEs

<table>
<thead>
<tr>
<th>Year</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit to the economy</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>To SOEs (percent)</td>
<td>32.8</td>
<td>31.5</td>
<td>31.3</td>
<td>30.9</td>
</tr>
<tr>
<td>To other components (percent)</td>
<td>67.2</td>
<td>68.5</td>
<td>68.7</td>
<td>69.1</td>
</tr>
</tbody>
</table>


The maintenance of such a large state sector makes the economy less efficient. According to the latest assessment of Vietnam’s economic structure by a research team at CIEM (2009), the SOE sector still confronts several major problems.

- Even after reform, SOEs are still favored in matters like land and credit access. Land price and the price of fixed assets are not calculated correctly and fully in many cases, and neither are business costs. Although this phenomenon has gradually diminished, especially after Vietnam’s accession to the WTO, the SOEs still receive many historical privileges, in fields such as credit (the advantage of borrowing from state-owned banks without security) or in receiving soft budgets.

- SOEs have remained closed companies that cannot actively raise their own capital from outside investors. Therefore, SOEs are still heavily reliant on credit and natural resources for their investment in business expansion. Consequently, financial leverage is always high and may continue to rise. There is significant risk and danger of instability in business.
• SOE administration is weak. The “administration, governing” mechanism has been dispersed, lacking in transparency, and accounting responsibility. Thus it should be replaced by a new and more suitable mechanism. People assigned to represent state capital in enterprises have been consistently passive, and receive only limited information about each enterprise’ objective, supervision and evaluation. Furthermore, there appears to be a great risk of power abuse for personal interests (instead of productivity maximization to serve the state).

Thus, in the coming period, SOE reform is a major challenge in promoting economic development and reducing financial risks. The slowing down of SOE reform in recent years indicates that this is by no means an easy task.

2.5.3 Asset Markets

In this chapter, asset markets are understood as comprising the real estate market, stock market, gold market and foreign exchange market (held by inhabitants and businesses as assets). An important feature of Vietnam’s asset markets is their strong growth in recent years, currently reflecting a large capital inflow into the markets, which production areas are not able to absorb.

*The Stock Market*

Hồ Chí Minh Stock Exchange (HOSE, early HOSTC) began operations in July 2000. Only since 2006, when Vietnam began moving towards WTO accession, however, the intensity of development of this market is obvious. Figure 2.23 shows that trading volume was limited and had settled down before 2006, but has been increasing since 2007.

The stock market experienced a bubble period starting in 2006, when great expectations for the economy after Vietnam’s WTO accession began to spread over domestic as well as foreign investors. This was a period of an unprecedentedly large scale of indirect capital influx into Vietnam. As a result, the market
underwent a period of “manias”, using Kindleberger’s (1978) term. This bubble was broken when inflation began rising in late 2007, and the adverse effects of the world financial crisis incited a reversal of foreign indirect capital flow from late 2008 onwards.

**Figure 2.23:** Developments of HCM Stock Market, 2003-2010

![Graph showing developments of HCM Stock Market from 2003 to 2010](https://www.vndirect.com.vn)

The capitalization value of the stock market is now relatively stable, at about 40 percent of GDP (Figure 2.24). If one compares the capitalization value of Vietnam’s stock market with that of different regions in the world, especially the average capitalization value in the Asia region, Vietnam’s stock market would still have much room for development. For example, if compared with the average of small-market economies in Europe or Latin America, Vietnam’s stock market would reach only about half of its potential. If compared with the average of the whole world, it would only reach one third, and if compared with the U.S. and Asia where the stock market dominates in attracting capital flows, it would reach only approximately 20-25 percent of its potential (see Table 2.12).

The continued reform and equitization process of enterprises will help to increase market size. This also implies that the bubble phenomenon in the market will increasingly affect the financial system and the economy as a whole.
Figure 2.24: Capitalization Value of Stock Market (percent GDP), 2000-2010

Table 2.12: Capitalization Value of Stock Market by Region

<table>
<thead>
<tr>
<th>Region</th>
<th>Stock Market Capitalization (% GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>The whole world</td>
<td>119</td>
</tr>
<tr>
<td>EU</td>
<td>94</td>
</tr>
<tr>
<td>North America</td>
<td>145</td>
</tr>
<tr>
<td>Emerging market</td>
<td>121</td>
</tr>
<tr>
<td>Asia</td>
<td>179</td>
</tr>
<tr>
<td>Latin America</td>
<td>63</td>
</tr>
<tr>
<td>Middle East</td>
<td>82</td>
</tr>
<tr>
<td>Africa</td>
<td>107</td>
</tr>
<tr>
<td>Europe</td>
<td>73</td>
</tr>
</tbody>
</table>

Source: Arouri et al. (2008), p. 25.
Vietnam’s real estate market is still rife with unknown and unqualified risks. Firstly there are limited statistics on these markets, especially transaction volume. The proof is that there has not yet been any official indicator of the real estate market. Secondly, the real estate market, especially with regard to land use rights, is distorted because the real estate supply is dominated by the public sector (for conversion of land use) and with no specific plan or timing. Unclear supply leads to prolonged speculation and long-term high pricing of real estate, resulting in systematically distorted price signals. As a result, the price of land and real estate may be held at a bubble level for a relatively long time, as in the current situation.

It can be said that price signals do not operate effectively in the real estate market because the correlation between asset values and asset rents does not correspond to capitalizable land property (in correlation with interest rates). Specifically, the rate of land or real estate rents over the market value of assets in large cities is often significantly lower than that of current interest rates. This proves that real estate owners primarily expect to profit from an increase in asset price (capital gains). This situation has occurred for some time, with a general belief that asset price could only continue to increase. This reflected the rigidity of price in this market. Only with a significant and steady increase in the supply of real estate over a long time, or with the economy’s sinking into decline or crisis, will the real estate bubble break. The first case requires a clear strategy of supply regulation by the Government. However, this strategy may be hampered by interest groups. The second one can occur at a bottom of a crisis cycle. This means that the economy will continue to be sinking into decline because lower asset price may increase the difficulties of the economy.

Figure 2.25 depicts the important effect of the real estate market on the financial system, especially the commercial bank system, and ultimately on the entire economy. If deflation occurs in the real estate market, the banking system would be under heavy
pressure of security value loss. This, in turn, would decrease the banks’ assets and may cause a wave of sell-off, inducing the serial collapse of many financial institutions. This was a preliminary part of the recent world financial-economic crisis (a crisis of subprime home loans). The same thing can happen in other asset markets if the capitalization value of those markets is big enough to cause damage to the asset balance sheets of financial and banking institutions. In Vietnam, the same thing had happened to the stock market in mid 2007.

**Figure 2.25:** Effects of Real Estate Deflation on the Economy

![Diagram showing the effects of real estate deflation on the economy](image)

The real estate market underwent particularly abnormal developments in 2009. The real estate price increased in the North, due to the many difficulties that the economy was facing (Figure 2.26).
Many believe that this was a consequence of economic stimulus packages in 2009, in which a large amount of preferential loans was flowing into the real estate market instead of into the productive sectors as originally planned.

Overheated real estate prices clearly augmented the systematical risk when prices stall or decline. Concurrently, quickly rising land prices absorb funds which are intended for infrastructure investment, thus limiting government investment in infrastructure and inhibiting development.

**Figure 2.26: Real Estate Price Index for Hanoi, 2008-2009**

Source: Pham Van Ha (2010)

**Gold and Foreign Currency Markets**

Unlike developed countries or countries with low and stable inflation, Vietnam had gold and foreign currencies playing important anti-risk roles when the VND was continuously depreciating. Thus, besides the gold and foreign currencies held by the State Bank, people and businesses were also storing many of these assets. In 2009, for example, when worries about economic decline were associated with predictions that scarcity would lead to an appreciation of the USD, there was widespread speculation and holding of the USD by many people and enterprises. There
were no official statistics, but from examining the abnormally high level of errors and omissions in the balance of payments, up to about USD 10 billion (over 10 percent of GDP) was involved. The actual amount of USD held was less than that figure. This was just the amount of USD raised by holders in 2009.

Like the USD, gold is also a favorite stored asset. Specifically, the rapidly increasing price of gold before and during the Global Financial Crisis caused public demand for gold to increase. Figure 2.27 shows the considerably large scale of gold held by Vietnamese people as an asset. This scale surpassed those of China, Thailand and the U.S.

**Figure 2.27:** Gold Retail Investment in Selected Countries (tons), 2006-2008

![Gold Retail Investment Chart](chart.png)


The numbers in Figure 2.27 depict the significance of gold in the Vietnamese economy. Compared to China, it can be said that the two nations may have a similar mindset of preference for gold due to cultural similarity. However, since the CNY tends to
appreciate, while VND tends to devaluate, the investment demand for gold in such a large country as China is lower than in Vietnam. Meanwhile, the demand for gold in Vietnam from 2006 and 2007 far exceeded that of Thailand, the U.S. and Europe. It can be said that the difference between Vietnam and these countries stemmed from cultural factors and levels of economic development. In 2008, the increasing demand for gold of these countries can be mainly explained by people’s aversion to risk. The same thing happened to China and Vietnam. However, compared with other countries, the growth of gold demand was not unexpected. It showed that the demand for risk prevention in Vietnam had already taken shape before the Global Financial Crisis (because this was also a high inflationary period of Vietnam). Alternatively, it also reflected the fact that current asset investment demand in Vietnam was very high, but people did not select many different kinds of assets for their investment.

The fact that people and businesses stored a large amount of gold and foreign currencies on a considerable and unpredictable scale (GDP) exerted major influence on monetary policy. In some cases, this may render policy goals unfeasible.

2.6 Measures to Prevent Potential Macroeconomic and Financial Risks in Vietnam

The analyses in the previous sections have shown the basic characteristics and fundamental macroeconomic and financial relationships in the economy. With the identification of these, in this section, a framework to describe the origins of macroeconomic risks in the economy of Vietnam was proposed. Subsequently, an evaluation of the current risks of the economy was carried out, and in the final section, are proposed solutions to prevent such risks in the future.

2.6.1 The Origins of Macroeconomic and Financial Risks

The characteristics and relationships containing risks for the economy can be summarized as follows:
Vietnam’s economy is suffering from major macroeconomic imbalances, whose core is the imbalance between savings and investment. Within this imbalance, the savings-investment gap in the public sector, or the budget deficit, plays a key role.

These imbalances, which exist persistently on a large scale, is derived from the investment-based growth model, in which state investment plays a significant role. The economy’s net savings deficit causes interest rates to be held at high levels, while the persistent budget deficit may be the reason why inflation is at a high level in many years.

The net savings deficit itself leads to a current account deficit. In particular, the trade deficit is the core of the current account deficit.

In the context of high and continuous inflation, Vietnam is still pursuing policies to peg the nominal exchange rate, leading to the continuous appreciation of the VND in the last five years. This has contributed to eroding the competitiveness of Vietnam, exacerbated the trade deficit, and at the same time, increased exchange rate risk.

Under pressure of the growth model based on investment, accompanied with the financial liberalization and international integration occurring particularly rapidly since 2007, the commercial bank system has been expanding quickly, generating pressures on credit expansion as well as needs for capital. With the presence of a large SOE sector, whose loans are normally supported by the government, there are signs of excessive credit having been directed to this sector (over-borrowing), while moral hazard of the loans increases. This creates increasing risk for the commercial banking system.

Asset markets receive a large amount of capital and tend to generate bubbles, creating another risk for the banking system.
Because of the economic difficulties stemming from the macroeconomic instability since 2007, plus the negative effects of the Global Financial Crisis, interest rates were kept at a high level over a long period, causing the banking system to accumulate risks.

From the above analysis, we propose a model that links factors containing potential risks in the macroeconomy of Vietnam. This is shown in Figure 2.28.

**Figure 2.28:** Model Identifying Potential Risks in the Vietnamese Economy

*Source: Author.*
It can be seen from Figure 2.28 that the root cause of macro risks comes from structural imbalances of the economy under the pressure of the growth model based on investment expansion. However, the risk is centered in the commercial banking system because this is the sector that suffers the highest pressures from other sectors in the economy.

In the era of economic integration, risk factors can be classified as internal and external:

*Internal Risk Factors:*

- The unfavorable fundamental factors include a huge savings deficit (of which the main contributor is the budget deficit) leading to a high trade deficit. Another factor is the low competitiveness of the enterprise system in which the state sector overpowers the private sector. In addition, the asset market is small and susceptible to be manipulated by large amounts of idle capital. The rapid growth of commercial banks reduces the credit quality and monitoring capabilities.

- The macro policies are inconsistent due to the difficult choice between high growth and macroeconomic stability. Accelerating economic growth by expanding investment, in which public investment plays a vital role, causes a large budget deficit, and high pressure on inflation and financial repression under various forms. Furthermore, economic integration in general and financial integration in particular are still passive and do not follow a clear strategy. Consequently, the possibility of accumulating external risks quickly arises through uncontrolled indirect capital flows.

In terms of macroeconomic policies, it should be added that Vietnam has never emphasized controlling inflation as seriously as other countries in the region. While the inflation rates of other countries in the region have always been kept at approximately 5 percent in long-term (to maintain stable growth), the rates
for Vietnam stem to always fluctuate around high margins (see Figure 2.29)

**External Factors:**

- Given its high level of openness, Vietnam is being affected more by real economic shocks, such as the decrease in export demand due to regional and international economic crises and the pressure of global competition.

- In addition, the economy is also vulnerable to financial shocks such as the changes of USD’s interest rates, the devaluation of the Yuan or from foreign financial crises.

- These external factors will affect the economy more seriously when the official exchange rates deviate from market exchange rates. This leaves little room for official exchange rate changes, since such changes would have serious effects on many sectors in the economy.

**Figure 2.29:** CPI of Some Countries and Vietnam, 1980-2009

![CPI Graph](image)

*Source: Nguyen Duc Thanh and Dinh Tuan Minh (2010).*
2.6.2 Evaluating Risks

With the economic characteristics of Vietnam as stated above, one can identify the main risks in the economy.

The huge savings – investment gap, which includes a large budget deficit, causes interest rates to remain high, which impedes growth and accumulates financial risks, particularly in the banking system. Simultaneously, the large budget deficit and high interest rates reduce the effectiveness of monetary and fiscal policies, making it hard for macroeconomic policies to respond to economic shocks, and, when they do respond, they create huge financial burden.

The savings – investment gap can only be filled by foreign capitals, which means that the capital accounts must always be in surplus. Meanwhile, the current account must always experience a deficit that equals to the savings – investment gap. If the capital inflow is larger than the current account’s deficit, the value of VND is under no pressure to appreciate and this makes it possible to reduce VND’s interest rates. However, risks will emerge when the capital inflow remains stable or decrease, which in turn leads to a depreciation of the VND. To prevent this, interest rates must be raised, which then heighten risks to the commercial banking systems in particular and to the financial system in general. This is the scenario of a twin-crisis.

At the same time, the situation of the financial system itself is also precarious: market information is asymmetric; credits to enterprises entail high moral hazard risk, especially to SOEs (which account for about 30 percent of total credit). Supported by a soft budget constraints and other incentives and subsidies from the government, SOEs also enjoy lower interest rates than the private sector, which can lead to over-borrowing. Combining with moral hazard risks, this causes an accumulation of risks in the banking system. When facing unfavorable conditions, enterprises are in difficulty or go bankrupt; the commercial banks will be affected adversely.
In addition, as the asset market is still weak and highly affected by foreign and domestic capital flows, bubbles in the overall market are likely to remain for long time, especially in the real estate market. Meanwhile, the commercial banks traditionally prefer mortgages in the form of real estate. Therefore, when the bubbles burst or real estate’s prices decrease excessively, the commercial banking system might be paralyzed due to the effect of decreasing asset prices.

With the current structure of the banking market, many small banks that have low competitiveness are highly vulnerable to the above mentioned risks. Consequently, it is necessary to improve banking supervision to enable early warnings to be made.

Concerning government debt, it can be said that the current major indices are still in the safe zone. However, if banking or monetary crisis, and especially a twin-crisis, occurs, the Government will have to take actions to save the banking system and this will quickly increase Government debt. In that case, a debt crisis is more likely to happen.

To sum up, the major risks in Vietnam’s economy in recent times come from unfavorable conditions: high interest rates maintained for a long time; the VND appreciating but official exchange rates kept relatively stable; SOEs’ excessive borrowing with poor credit’s quality; and the asset market being sensitive to capital movements. All these factors put pressure on the system of commercial banks and render them vulnerable to adverse macro-economic changes.

When some adverse factors affect the commercial banking system and the overall economy, portfolio capital flows might reverse quickly. This easily leads to a crisis in the balance of payments or to a monetary crisis. Thus, when a banking crisis happens, it will be associated with a monetary crisis. Furthermore, a debt crisis is likely to occur when the Government intervenes to deal with the above crises. All the unfavorable movements will negatively affect the economy for a long time, invariably impeding long-term growth.
2.6.3 Solutions

Based on all the above analyses, Vietnam’s economic fundamentals need strengthening. Besides re-emphasizing the basic strengths of the economy, it is necessary to draw up a rational process of financial integration.

As stated above, the major imbalances in the economy in recent time mainly comes from the huge gap between savings and investment, in which the imbalance between savings and investment of the Government plays a vital role. Consequently, fiscal discipline is vital to establish a reform program to recover the vitality of the economy. This should be the starting point, and the bottleneck that should be first eliminated.

Fiscal discipline should be restored, which is manifested by the declining ratio of budget deficit over GDP in the following years. To achieve this, it is significant to reduce the pressure on Government’s expenditure and to improve Government’s revenue.

To reduce pressure on public expenditure, the Government should firmly steep out of the economic activities by selling assets in the SOEs (equitization). The purpose of this is not to increase Government’s revenue but to reduce pressure on Government spending in the future, and to mitigate financial risks (for example, bankruptcy or inefficiency of big state-owned enterprises that always needs Government support).

By reducing the size of the state sector, it is possible to improve the quality of investment and also to prevent excessive investment. The gap between savings and investment can then be reduced and the deficit in the current account controlled effectively. In addition, it helps to enhance transparency in the enterprise system, and contributes to limiting moral hazard of risk accumulation. This is perhaps the best solution to prevent macroeconomic risks in the future.

Another aspect of fiscal discipline that should be followed is to gradually separate the activities of the State Bank of Vietnam from the direct influence of the Government. This is not only to establish
an independent state bank, but also to limit the possibility of the Government financing budget deficit by printing money (inflation tax). Thus, this aspect of fiscal discipline helps the Government to clearly determine its targets in stabilizing the macroeconomy (e.g., reducing inflation).

To improve the government’s budget revenues, it is important to reduce its dependence on the state sector, to increase its revenue from the enterprise sector in general and even from the personal income tax (broadening the tax base to increase tax revenue).

After establishing fiscal discipline, financial liberalization should be implemented in two stages. The main purpose of this process is to minimize the risks from quick financial liberalization, especially in the capital account, to protect the VND from big shocks in the economy due to unpredictable movements of the portfolio capital flows (and this prevents the occurrence of a monetary crisis).

The main task of the first stage is to strictly control the external capital flows and the capital account within the framework of current commitments in the on-going international integration of Vietnam (WTO and bilateral agreements). At the same time, the domestic financial market should also be improved by increasing policy quality together with liberalizing this market (interest rates and exchange rates). This is also the time to establish a foreign exchange market with various derivatives that allow the financial and enterprise systems to develop a range of measures to prevent exchange rate risks.

In the second stage, providing that the overall market and the domestic financial institutions have already operated smoothly and competitively, the capital account control should be loosened to achieve more liberalization. This completes the process of financial liberalization and integration into the global financial market.

The first stage is more critical to the successful development of the whole process, therefore policies in this stage should be to:
• Adjust exchange rates following market conditions (by balancing supply and demand), and reduce intervention to peg the exchange rates. Exporting and importing enterprises should be directed to be familiar with exchange rate fluctuations and tools to prevent exchange rate risks. However, the Government should carry on with strict supervision and monitoring of foreign currency supply by controlling international capital flows, especially portfolio flows. The Government should also apply measures to control capital flows (indirectly) to ensure the effectiveness of this process.

• Increase the effectiveness of monetary policy and build a sound framework of laws and regulations to improve financial depth and the ratio of credit through the domestic banking system.

• Adopt the same credit policies for SOEs and other enterprises to avoid over-lending and to offer more opportunities for non-state enterprises.

• Control foreign debt and government debt in general. If budget discipline is successfully established and the reform of the enterprise system is implemented effectively, foreign and government debts will no longer be a threat to Vietnam’s economy.

• Have macroeconomic policies aim at variables like inflation and budget deficit, instead of exclusively at the growth rate. The Government should only forecast the growth rate rather than utilize all possible resources to realize it.

• Supervise and detect problems in the asset markets as soon as possible to make appropriate interventions.

• Establishing a monitoring system on national level and make it become an institution that has real power over the entire financial system. This institution will also build up
an early warning system to inform the Government and other administrative institutions in the financial market.

- Exclude portfolio capital flows as a source to fund the current account deficit. Instead, it should be treated as a neutral tool for the State Bank to increase foreign reserves. Therefore, these plans should be in accordance with the specific monetary policies of each period to avoid inflation (as the lesson drawn from the economic disturbance of 2007).
References


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Chapter 3

VIETNAM’S EXPORT-LED GROWTH MODEL IN THE NEW GLOBAL CONTEXT

Nguyen Duc Nhat and Nguyen Ngoc Anh

3.1 Introduction

Economic growth has been a main theme of economic research and a desired outcome of most government policies planning and implementation. Furthermore, economic growth is the only way out for nations to escape poverty, and there is extensive literature to show how countries have been able to achieve this. A nation’s capabilities to escape poverty together with its resilience to avoid and/or to recover from crises are the two main requirements for any transition economy to successfully move beyond low-income status. These two factors are both complementary and contradictory both in terms of process and goals. On the one hand, sustained economic growth would build national resilience against crisis. On the other hand, high economic growth also exposes the economy’s structural weaknesses rendering it vulnerable to crisis. Vietnam has been successful in surviving a number of crises, e.g. hyperflation in the 1980s, the Asian Financial Crisis in the 1990s and the recent Global Financial Crisis. While national resilience has served Vietnam well in these situations, a critical question is whether, given the new global context, the export-led growth model of the last decade is still appropriate.

Forecasts of stagnation of the U.S and other main import markets and emerging trends of global rebalancing have created considerable uncertainty for those countries which rely on an
export-led growth (ELG) model. In this context, two questions need answers: i) whether the ELG model is still viable for transition economies in general and for Vietnam in particular; and ii) which Vietnamese exports can be promoted in the next decade and what needs to be done to promote them? This chapter provides a review of theories and experiences in light of stylized facts about Vietnam’s economy.

The chapter is organized as follows. The first section presents a review on growth and ELG theories and some empirical evidence of how this model performed. This section also reviews successful ELG cases in terms of matching their policy implementation with exports and growth performance. The second section analyses the trade performance and relevant policies of Vietnam up to the present. The third section presents an assessment of mid-term growth prospects for Vietnam in the new global context and the fourth section presents the conclusions and policy recommendations.

3.2 Export-led Growth Models and International Experiences

3.2.1 History and Revolution of Growth Theories

Economic history has shown the strong relationship between economic growth and trade. Adam Smith (1776), discussing the accumulation of stock and division of labor laid a solid foundation for growth theories in classical economics that continues to have considerable appeal today. According to Smith, the desire of a person to better his or her personal and social status is the locomotive to undertake a series of activities which bring about long-term growth. He and Smithian economists support free trade in the sense that market expansion and productivity improvement are the key factors to growth.

David Ricardo (1817) introduced the concept of comparative advantage that stresses trade expansion as being crucial to growth through better and more efficient resource allocation through trade. John Stuart Mill (1848) believed that economic growth can
be achieved by acquiring capital and technology through trade enhancement.

The classical economic approach provides a meaningful explanation of growth sources i.e. capital accumulation, productivity, and market expansion. From a national perspective, market expansion through trade leads to growth as it supports both capital accumulation and productivity improvement.

Marx (1860) introduced the theory of surplus value which provides an additional explanation on sources of growth to the previous economists. Marx and Marxian economists emphasize that accumulation of fixed capital can be carried out through trade, plunder and usury.

Keynes with the General Theory of Employment, Interest and Money (1936) broke with the orthodox economics of that time when he stated that economies through its economic agents often destabilize the economy, leading to economic crisis, unemployment and inflation. The government should then take an active role in reviving growth through stimulating consumption, investment and capital goods production. The Keynesian formula shows the direct impact of net exports to the output and growth.

Based on business cycle analysis, Harrod (1939) and Domar (1943) introduced the Harrod-Domar model which explained an economy’s growth rate in terms of the level of savings and productivity of capital. In this model, growth totally depends on the quantity of labor and capital; and more investment leads to more capital accumulation, which generates economic growth. Even though the model was criticized, the implication of savings for growth is still valid for economic policy today.

Rostow in his Stages of Economic Growth (1960) based on the generalization of the British case, defines stages of growth: preconditions for takeoff, takeoff, and self-sustained growth. The underlying strategy is one of developed countries and underdeveloped countries cooperation for the containment
of nationalistic violence as well as Communism, to enable the “democratic way of life” to persist and to lift an economy out of low-income stagnation on to a sustained growth path through significant increase in the share of savings and investment in national income. For this to happen, a new class of entrepreneurs must emerge. Further, to desegregate the nature of the growth process, Rostow introduces the concept of the primary, or leading, sector, which plays a key role both during the takeoff of many economies (Rostow, 1956: 73-125).

Solow (1956) pioneered the neo-classical approach to provide a growth model that shows how an economy could achieve stable equilibrium economic growth through technology. His model introduced technology as an exogenous factor with the implication that those economies with the similar technology and preferences will converge to the same steady state. However, this implication was supported by very limited empirical evidence. Also, the Solow model failed to explain many economic phenomena such as the differences in worker wages in the long-run, investment intensification in the developed countries rather than developing ones, the non-convergence of many economies and the random walk behavior of output following technology and economic shocks.

New growth models have been introduced in the 1980s which explained the difference in countries’ growth rates based on the introduction of the increasing return to scale of some inputs such as human capital. Models introduced by Rebelo (1987), with the contribution of human and physical capital to output, Romer (1987) with his endogenous growth models, Lucas (1988) with the Lucas-Uzawa model, and Agion and Howit (1989), with the Schumpeterian model of creative destruction that brought endogenous growth models into the mainstream.

As shown in Figure 3.4, Vietnam is half-way between resource-based growth and catch-up growth. Most literature on economic growth shows that there is a possibility for developing countries to achieve high growth on the hypothesis that poorer
economies’ per capita incomes tend to grow at faster rates than richer economies. This economic convergence, called catching-up growth, is explained by the low-income economies’ abundant labor supply. In the course of industrialization and economic expansion, new investment and economic restructuring would bring underemployed workers out of traditional agriculture into more productive work in the cities and industry.¹ And this can only be realized through trade and openness which enables labor mobility and technology transfer from developed to developing countries. This is what guides policy in many labor-intensive countries including Vietnam.

3.2.2 Theories and Empirical Evidence of Export-led Growth (ELG) Models

The ELG Model

As already indicated, it can be said that the export-led growth (ELG) model has its roots in Adam Smith’s (1776) dictum “the division of labour is limited by the extent of the market”. Kaldor (1966, 1972) spelt out the “Kaldor laws” based on empirical generalizations. As summarized by Thirwall (1983), they state that the growth of manufacturing output is not constrained by labor supply but fundamentally determined by demand for agriculture products in the early stage of development and exports in the later stages and a fast rate of growth of exports and output will tend to set up a cumulative process, or virtuous circle of growth, though the link between output growth and productivity growth. From the success case of Japan in 1960s and East Asian countries following its footsteps, it is realized that export expansion not only brings nations net export income but also better domestic resource allocation; higher production efficiency through technological development and capital formation; economies of scale from market expansion, and employment generation through exports. This is the basis for promoting the ELG model to developing countries.

countries, first by the World Bank in the 1980s and later by Frankel and Romer (1999). To implement the ELG model as a development strategy, countries use an incentives system via policies, regulations and administrative measures to promote exports with the aim to boost economic growth.

**Figure 3.1: ELG Virtuous Cycle**

![ELG Virtuous Cycle Diagram](image)

*Source: Authors.*

**Empirical Evidence of ELG Strategies**

Among 95 less developed countries for the period 1976-1985, Dollar (1992) found that outward-oriented countries grew faster than inward-oriented countries. Awokuse (2002) found that the ELG hypothesis is supported in the Canada case both in long-run and the short-run. Tan et al. (2007) showed the ELG hypothesis to have supported all four Asian economies, namely Singapore, South Korea, Taiwan and Thailand. Similarly, studies by Felipe et al. (2005) also found that both exports and domestic demand growth contributed to GDP growth in China, India and Thailand. Shirazi et al. (2005) reached the same conclusion in their study of Bangladesh, Pakistan, and Nepal.

In spite of the positive association between exports and GNP growth in many studies, the issue of causality remains controversial.
The literature also contains evidence which do not support the ELG hypothesis. India and Sri Lanka were cited as examples by Shirazi et al. (2005).

For a country like Costa Rica, Emilio (2000) found that while exports acted as an additional engine of growth, the impact was relatively small and limited.\textsuperscript{1} Jung and Marshall (1985) found little support for the ELG hypothesis in their study of 37 countries. In addition, Pham Mai Anh (2008) study on growth in Vietnam also lends little support for the ELG hypothesis. This contradictory empirical evidence poses the question to Vietnam’s policy-makers as to whether or not the ELG strategy is still valid in the next decade; and if it is, how should it be implemented? We shed light on this by reviewing both policies and economic performance of three leading ELG-led countries, China, Korea and other NIEs.

### 3.2.3 Export-led Growth and Policy Implementation in Newly Industrialized Economies (NIEs)

Weiss (2005) noted a wave of Asian countries after Japan which illustrates the successful application of ELG. The first tier of “Asian Miracle” countries – Republic of Korea, Chinese Taipei, Chinese Hong Kong, and Singapore – started their take off in 1960, the second tier – Malaysia, Thailand and Indonesia – in the 1980’s, followed in the 1990’s by China, and to a lesser extent Vietnam.

In its study of the East Asian miracle, the World Bank (1993) observed links between economic performance in the first tier Miracle countries to high saving and investment rates, relative income equality, high growth rate of human and physical capital, high growth rate of agricultural productivity; and low rate of fertility. However, some of these features are not observed among the second tier countries, especially China and Vietnam.

In terms of policies to support the ELG model, the following were observed from the NIEs.

---

\textsuperscript{1} Medina-Smith (2000) *Is the Export-led Growth Hypothesis Valid for Developing Countries? A Case Study of Costa Rica.* UNCTAD/ITCD/TAB/8
i) Most countries started with labor-intensive exports and moved toward more capital intensive exports.

ii) Some NIEs started their ELG with primary exports, other started by replacing import substitution prevalent in Southeast Asia in the late 1960s and early 1970s by export promotion.

iii) There is a general pattern of shifting from primary exports to heavy industries promotion and exports embodying higher technology.

iv) High-tech products dominate the exports of the first tier country group\(^1\) while low- and medium-tech products are the main exports of the second tier countries. Primary products continue to play a key role in exports of Indonesia and Vietnam.

Table 3.1 captures the policy shifts in several Miracle countries in pursuit of the ELG path.

**Table 3.1: Trade Policy Shift in Selected Asian Countries**

|--------------------|---------------------------------------------------------------|-------------------------------------------------|----------------------------------------|-------------------------------|----------------------------------------|----------------------------------------------|

1. The first tier countries managed to enter the high technology exports market while the second tier countries still focused on general trade promotion. Only Singapore and Hong Kong have a high share of service trade.
1974-1981 Oil and commodity boom
1980-1990 Gradual trade liberalization and move to less selectivity
1986 onwards Gradual trade liberalization and export promotion
1973-1976 Industrial consolidation
1980 onwards Trade liberalization and export promotion
1973-1984 Upgrading export structure

1986- onwards Gradual trade liberalization and export promotion
1990 onwards Trade liberalization and high-tech exports
1981 onwards High tech industrialization
1985 onwards Export promotion of high tech and services


It can be noted from the Table 3.1 that by 1970s the first tier countries Singapore, Korea and Taiwan all implemented export promotion policies and quickly upgraded their export structure toward more high technology production. The policies resulted in a very high proportion of high-tech goods out of their total exports in the 1980s (Table 3.2). The second tier group of Thailand, Malaysia and Indonesia were about one decade behind the first tier countries.

Table 3.2 shows that Vietnam is far behind the regional exporters in terms of technology advancement. Vietnam’s exports are heavily based on the primary commodities which account for almost half of its national exports in the last decade. The process of shifting toward medium- and high-technology has been very slow. This is also reconfirmed by a study of UNCTAD/ITC in 2003 that provides evidence of Vietnam’s underperformance in these areas (See Annex 3.1).

Table 3.2: Export Composition by Technological Category 1985 – 2008

<table>
<thead>
<tr>
<th>Country</th>
<th>Resource-based</th>
<th>Low-Tech</th>
<th>Medium-tech</th>
<th>High-tech¹</th>
</tr>
</thead>
<tbody>
<tr>
<td>CHINA</td>
<td>29.54</td>
<td>13.48</td>
<td>5.32</td>
<td>20.73</td>
</tr>
</tbody>
</table>

1. The technological differences are categorized based on the authors’ classifications in Annex 3.6.
<table>
<thead>
<tr>
<th>Country</th>
<th>Year 2007</th>
<th>Year 2008</th>
<th>Year 2009</th>
<th>Year 2010</th>
<th>Year 2011</th>
<th>Year 2012</th>
<th>Year 2013</th>
<th>Year 2014</th>
<th>Year 2015</th>
<th>Year 2016</th>
<th>Year 2017</th>
<th>Year 2018</th>
<th>Year 2019</th>
<th>Year 2020</th>
</tr>
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<td>17.96</td>
<td>5.37</td>
<td>11.98</td>
<td>11.06</td>
<td>11.49</td>
<td>11.06</td>
<td>11.49</td>
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<td>53.85</td>
<td>62.04</td>
<td>53.85</td>
<td>62.04</td>
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<td>SINGAPORE</td>
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<td>10.85</td>
<td>20.35</td>
<td>5.53</td>
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<td>1.00</td>
<td>5.47</td>
<td>4.97</td>
<td>4.14</td>
<td>40.55</td>
<td>68.55</td>
<td>53.36</td>
<td>53.36</td>
<td>53.36</td>
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<tr>
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<td>25.46</td>
<td>24.66</td>
<td>18.52</td>
<td>19.16</td>
<td>5.94</td>
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<td>35.39</td>
<td>44.12</td>
<td>44.12</td>
<td>44.12</td>
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<tr>
<td>MALAYSIA</td>
<td>60.47</td>
<td>22.68</td>
<td>32.15</td>
<td>4.77</td>
<td>6.18</td>
<td>4.10</td>
<td>5.73</td>
<td>7.25</td>
<td>7.93</td>
<td>25.97</td>
<td>56.69</td>
<td>35.45</td>
<td>35.45</td>
<td>35.45</td>
</tr>
<tr>
<td>PHILIPLINES</td>
<td>38.13</td>
<td>17.33</td>
<td>12.68</td>
<td>9.92</td>
<td>10.77</td>
<td>5.28</td>
<td>8.18</td>
<td>5.27</td>
<td>7.71</td>
<td>8.37</td>
<td>22.48</td>
<td>69.60</td>
<td>69.60</td>
<td>69.60</td>
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<tr>
<td>INDONESIA</td>
<td>79.17</td>
<td>47.35</td>
<td>57.03</td>
<td>5.82</td>
<td>20.36</td>
<td>10.32</td>
<td>11.22</td>
<td>16.90</td>
<td>12.03</td>
<td>0.68</td>
<td>8.94</td>
<td>13.05</td>
<td>13.05</td>
<td>13.05</td>
</tr>
<tr>
<td>HONGKONG</td>
<td>2.16</td>
<td>2.74</td>
<td>7.62</td>
<td>43.35</td>
<td>38.97</td>
<td>19.33</td>
<td>3.79</td>
<td>4.70</td>
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<td>37.46</td>
<td>16.52</td>
<td>16.52</td>
<td>16.52</td>
</tr>
<tr>
<td>VIETNAM*</td>
<td>51.35</td>
<td>43.60</td>
<td>29.94</td>
<td>29.87</td>
<td>1.99</td>
<td>7.27</td>
<td>7.23</td>
<td>12.34</td>
<td>12.34</td>
<td>12.34</td>
<td>12.34</td>
<td>12.34</td>
<td>12.34</td>
<td>12.34</td>
</tr>
</tbody>
</table>

* Vietnam data are for 1997 – 2008.

Source: Calculations based on U.N Comtrade 2009 data

Observing trends in different country groups may show common features, but to determine to what extent the ELG model succeeded in each country requires reviewing the policies and measures applied and the particular national context. Besides some demographical similarity to Vietnam, Korea and China have been chosen as countries with experience from which Vietnam can gain insights. The ELG model has been implemented in a very comprehensive way in both countries i.e. combining export promotion with structural transformation to move up the ladder of comparative advantages (Weiss, 2005). The next sections highlight some key policies in the context of Republic of Korea and China.

### 3.2.4 Export-led Growth and Policy Implementation in the Republic of Korea

The Republic of Korea pursued an export-oriented growth strategy led by the government and reliant on its labor force since the early 1960s. When it began its development push, it recognized
that its poor natural resource endowment, weak private sector and an abundant labor supply left it with few options but to adopt an ELG strategy through industrialization. It implemented a set of incentives under a proactive industrial policy to upgrade its exports. This industrial policy also shifted from import-substitution to export-oriented industrialization in the first half of the 1960s. Although focusing on labor intensive manufacturing early on, the government, starting from around 1970, promoted heavy industries such as iron and steel, chemicals, non-ferrous metal, machinery, shipbuilding and electronic machinery through supply of cheap credit. In the 1980s, although the country had to deal with over-investment, excess capacity negative growth, it stuck to its strategy of long-term investment in the high-tech exports, which contributed to the big take-off in the next decade. Globalization of Korea’s industries in 1990s reached a milestone in the nation’s history when Korea joined the high income group, only the second in Asia to do so.\(^1\)

**Key Policies Supporting the ELG Model**

The export promotion strategy is clearly spelt out in every Five Year Economic Development Plan since 1967. The general goal is to strengthen industrial competitiveness and boost exports to overseas markets, with specific targets for each plan period. For instance, the Five year Plan of 1967-1971 focused on shifting from primary exports to labor intensive manufacturing sectors such as clothing, wigs, shoes, plywood, cotton and textiles. Support for this came from:

i) Preferential export financing

ii) Preferential tariff on imports/of intermediate goods which were inputs for export production

These policies are implemented within the framework of both regulatory reform (promulgation of new International

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1. Tae-Yong Yoon, Senior Deputy Director, Financial Policy Division, Ministry of Finance and Economy, Gyunggido, Republic of Korea.
trade law) and administrative support (establishment of Korea Trade Promotion Corporation - KOTRA and Export and Import Bank - EXIMBANK). The result is an average annual growth of around 9.2 percent over the 1960s’ period, with the manufacturing industry growing fastest. As a result, manufacturing became an increasingly large share of GDP (from 14.4 percent in 1962 to 21.2 percent in 1970) and exports (from 27.0 percent in 1962 to 83.6 percent in 1970).¹

The 1972 – 1976 Five Year Plan shifted the policy focus to the development of heavy and chemical industries (steel, shipbuilding, electronics and machinery, petrochemicals, nonferrous metals) through:

i) Provision of cheap credit (short and long-term) to targeted heavy industries.

ii) Tax privileges and incentives to these industries

The policies in this Plan were more selective than in the previous Plan and implemented through both regulatory framework changes (promulgation of new National Investment Fund Laws and amendment of Regulation Law on Tax Reduction and Exemption, issuance of Presidential Decree) and administrative support (establishment of National Investment Fund). As a result, the heavy and chemical industries’ share in manufacturing increased from 39.2 percent in 1970 to 50.9 percent in 1979 and their share in exports from 15.5 percent in 1970 to 40.1 percent in 1979. The growing role of heavy industries would exact a price on the Korean economy in the following decades.

In the 1980s the policy focus was to support technological development and strengthen international competitiveness of industries, with the private sector leading the economy. At the same time, the Korean government gradually phased out the credit support policies which brought some Korean conglomerates like

¹ Data for this section are from the Republic of Korea Ministry of Finance and Industry (2000).
Daewoo to the brink of collapse. This period also saw the beginning of trade liberalization in Korea with the gradual elimination of trade restrictions and discriminatory treatment against imports and non-exporting sectors. FDI found Korea a good destination as compared to other Asian restrictions at the same time, research and development (R&D) activities were facilitated through government policies. More importantly, those heavy industries that spearheaded the Korean economy in the previous stages were rationalized, opening the way for new technology manufacturing and services to grow.

In the 1990s, Korea’s policies emphasized international integration and standardization which made overall industries globally competitive. With the onset of the Asian Financial Crisis in 1997, inefficient chaebol were restructured, the financial sector liberalized, and the proactive industrial policy to promote exports almost came to an end. From the late 1990s up to the present, preferential credit and loans, as well as tax incentives, continues to be available mostly as R&D subsidies which are allowed under WTO rules. High technology and investment in human capital have become the new focus.

Despite the success story of ELG in Korea, one should still be mindful of the trade impact on total factor productivity (TFP) growth. Kim et al (2008) found that exports had no impact on Korean TFP growth in 1980-2003, but imports had. However, this finding must be understood in the context of what estimated TFP actually represents, which remains in dispute.

3.2.5 Export-led Growth and Policy Implementation in the People’s Republic of China

China pursued on export-oriented growth strategy in the context of late industrialization in the 1970s and 1980s at a time the East Asian early-starters Japan, Korea and Taiwan were beginning to feel the need to relocate and diversify their production bases. Substantial Chinese reforms over 30 years had responded effectively to this need and to regional and global trade liberalization, and
with its huge, skilled and low-cost labor force, have made China an outstanding example of ELG success.

Among the late industrializing nations, China has adopted a comprehensive ELG strategy, using incentives in all governmental policies including FDI policy, industry and trade policies, the regulatory framework (new laws and regulation in all aspects of Chinese economic and trade reforms), and administrative guidance and support (establishment of economic and technological development zones (ETDZs) and directive measures to lead finance and investment to the key sectors). Unlike Korea’s gradual approach, China’s policies concurrently impact all sectors of exports including primary goods, intermediate goods and finished products. The ELG policies were implemented over two stages: fostering the processing trade in the early stage and enhance global market dominance in the late stage.

Key Policies Supporting the ELG Model

**FDI Policy:** China drove export orientation and technology advancement in its FDI projects by allowing 100 percent foreign ownership only if they adopted advanced technology and the bulk of their production was exported. China’s targeted FDI policies discouraged domestic market seeking FDI in favor of export-oriented firms which used China as a production base to export to the global market. Reduced land use fees and assistance with recruitment also facilitated exports oriented FDIs. As a result, the FDI share in China’s exports increased from 1.94 percent in 1986 to 54.8 percent in 2003.¹

**China’s Processing Trade Policy:** China exempts imports for production to exports from tariff and VAT which is a major support to exporters (0 percent compared by the more than 40 percent average import tariff in 1992). Exports through export and special economic zones have been encouraged. Imports for R&D center establishment and operation are also exempted from tariff and VAT. In 2002 more than 400 R&D centers of global brands were in operation in China. Besides, China also encouraged domestic

¹. China Ministry of Commerce and Customs Statistic 2003
content in exports by applying the VAT reimbursement policy for exports and corporate income tax discount for firms with 70 percent or higher of their turnover exported.

In terms of market expansion, China pursued a comprehensive international trade integration agenda with the “right time” and the right “package” to ensure the gradual phase-in of competition in domestic production and market expansion of Chinese exports. Preferential treatment to Chinese exports takes the form of mutual tariff concessions in bilateral and regional trade arrangement and through WTO membership in 2001. As a result, Chinese exports have been able to penetrate global markets.

**Industrial Policy:** China’s broad-based support for exports represents a departure from the promotion of selective sectors or products approach of its neighbors in the 1970s. Most of industries which contributed to Chinese exports received very comprehensive support from the country’s undervalued currency, tax incentives, investment incentives and most importantly, the incentive system to enable commercialized R&D.

As a result of the above measures, it only took only about two decades to make China the number 1 exporter of the world. Currently, Chinese exports are competitive in primary, low-tech, medium-tech and high-tech products, with a trend towards moving up the technology ladder without giving in to other countries in low-tech exports.

The common feature of both Korea and China is the use of effective incentive systems to support export market expansion. The broad based support policies were introduced at an early stage of export promotion in China and that shortened considerably the ELG path.

**3.3 Vietnam’s Exports Performance and Export-led Growth Strategy**

The main objective of this section is to analyze Vietnam’s export performance and the link between economic growth and the ELG model during the last decades.
### 3.3.1 Vietnam’s Economic Performance and Growth

#### Table 3.3: Vietnam’s Growth Accounting 1986-2008

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP (Billion VND 1994)</th>
<th>GDP Growth</th>
<th>Labor (employed, Million People)</th>
<th>Labor Growth</th>
<th>Investment (Billion VND 1994)</th>
<th>Gross capital stock (K/Y=2)</th>
<th>Capital growth</th>
<th>Growth rate of Total Factor Productivity</th>
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<tbody>
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<td>1986</td>
<td>109,189</td>
<td>2.79</td>
<td>27</td>
<td>1.35</td>
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<td>1987</td>
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<tr>
<td>1988</td>
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<td>28.5</td>
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<td>861,126.23</td>
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<td>3.93</td>
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</tbody>
</table>
Table 3.3 looks at the sources of Vietnam’s growth using a growth accounting framework. From the above calculations, it can be noted that over the past decade, labor force growth remains low at between 1 and 2 percent while the growth in capital stock is high at above 10 percent. The TFP growth rate is modest even if positive in recent years.

Table 3.4: Classification of Vietnam’s Exports 2000-2008

<table>
<thead>
<tr>
<th>Year</th>
<th>Human capital intensive production</th>
<th>Resources intensive production</th>
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<tbody>
<tr>
<td></td>
<td>High technology</td>
<td>Medium technology</td>
</tr>
<tr>
<td></td>
<td>Labor force</td>
<td>Capital</td>
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<td>2000</td>
<td>139,331</td>
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<tr>
<td>2001</td>
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</tr>
<tr>
<td>2002</td>
<td>89,108</td>
<td>23,098</td>
</tr>
<tr>
<td>2003</td>
<td>151,235</td>
<td>22,584</td>
</tr>
<tr>
<td>2004</td>
<td>279,327</td>
<td>35,650</td>
</tr>
<tr>
<td>2005</td>
<td>326,599</td>
<td>52,935</td>
</tr>
<tr>
<td>2006</td>
<td>345,304</td>
<td>71,952</td>
</tr>
<tr>
<td>2007</td>
<td>456,208</td>
<td>93,782</td>
</tr>
<tr>
<td>2008</td>
<td>545,962</td>
<td>139,091</td>
</tr>
</tbody>
</table>

Source: Calculations based on UN Comtrade database
Table 3.4 reviews the nature of Vietnam’s exports in terms of factor intensity and technology content. Vietnam’s exports in the period 2000-2008 consist of labor intensive products, with increasing representation from resource-intensive products. One positive sign is rapid expansion of exports, which is human capital intensive.

3.3.2 Vietnam’s Export Structure

This section examines Vietnam’s export dynamism. Since the launch of an outward-looking policy in early 1990, Vietnam has experienced a trade deficit every year (Figure 3.2). However, together with China and India, Vietnam’s export growth rate is among the highest in Asia (Table 3.5).

**Figure 3.2**: Vietnam Trade Balance 1997-2009

Source: Plotted from UN Comtrade data 2010.
### Table 3.5: Growth Rate of Exports, Selected Asian Countries, 2002-2008

<table>
<thead>
<tr>
<th>Country</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007*</th>
<th>2008*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cambodia</td>
<td>12.7</td>
<td>17.9</td>
<td>24.1</td>
<td>12.4</td>
<td>26.9</td>
<td>14.3</td>
<td>9.4</td>
</tr>
<tr>
<td>China</td>
<td><strong>22.4</strong></td>
<td><strong>34.6</strong></td>
<td><strong>35.4</strong></td>
<td><strong>28.5</strong></td>
<td><strong>26.0</strong></td>
<td><strong>18.0</strong></td>
<td><strong>16.0</strong></td>
</tr>
<tr>
<td>Hong Kong</td>
<td>4.9</td>
<td>12.1</td>
<td>15.9</td>
<td>11.2</td>
<td>9.0</td>
<td>3.6</td>
<td>10.1</td>
</tr>
<tr>
<td>India</td>
<td><strong>20.3</strong></td>
<td><strong>23.3</strong></td>
<td><strong>28.5</strong></td>
<td><strong>23.4</strong></td>
<td><strong>20.0</strong></td>
<td><strong>16.0</strong></td>
<td><strong>15.0</strong></td>
</tr>
<tr>
<td>Indonesia</td>
<td>3.1</td>
<td>8.4</td>
<td>10.4</td>
<td>22.9</td>
<td>18.1</td>
<td>9.8</td>
<td>12.0</td>
</tr>
<tr>
<td>Korea</td>
<td>7.9</td>
<td>20.7</td>
<td>30.6</td>
<td>12.1</td>
<td>14.8</td>
<td>13.5</td>
<td>14.2</td>
</tr>
<tr>
<td>Laos</td>
<td>2.3</td>
<td>21.6</td>
<td>11.0</td>
<td>31.4</td>
<td>50.9</td>
<td>15.3</td>
<td>31.0</td>
</tr>
<tr>
<td>Malaysia</td>
<td>7.2</td>
<td>11.0</td>
<td>20.9</td>
<td>12.0</td>
<td>16.9</td>
<td>9.5</td>
<td>10.6</td>
</tr>
<tr>
<td>Philippines</td>
<td>9.9</td>
<td>2.7</td>
<td>9.8</td>
<td>3.7</td>
<td>14.0</td>
<td>6.5</td>
<td>9.5</td>
</tr>
<tr>
<td>Singapore</td>
<td>3.0</td>
<td>15.0</td>
<td>24.3</td>
<td>15.6</td>
<td>18.3</td>
<td>10.5</td>
<td>10.0</td>
</tr>
<tr>
<td>Thailand</td>
<td>4.8</td>
<td>18.2</td>
<td>21.6</td>
<td>15.0</td>
<td>17.4</td>
<td>7.9</td>
<td>8.9</td>
</tr>
<tr>
<td>Vietnam</td>
<td><strong>11.2</strong></td>
<td><strong>20.6</strong></td>
<td><strong>31.4</strong></td>
<td><strong>22.5</strong></td>
<td><strong>23.0</strong></td>
<td><strong>19.0</strong></td>
<td><strong>18.0</strong></td>
</tr>
</tbody>
</table>

*Source: UNCTAD, various years*

### Figure 3.3: Vietnam’s Exports of Manufactured Goods, by Technology Content, 2001-2008

*Source: Plotted from UN Comtrade data (2009).*
Figure 3.4: Vietnam’s Exports to the U.S., by Technology Content, 2001-2008

Source: Plotted from UN Comtrade data (2009).

Figure 3.5: Vietnam’s Exports to the E.U., by Technology Content, 2001-2008

Source: Plotted from UN Comtrade data (2009).
Figures 3.3 to 3.7 show that Vietnam’s exports are mostly resource-based and embody medium technology regardless of destination. Export growth is highest in both low- and middle-income Asian economies and high-income Asian countries.
Vietnam’s traditional markets, the U.S. and E.U., witnessed significant contraction in growth rates for all types of exports. As a result, seven Asian countries are among the top 10 markets for Vietnam exports in 2008 compared to five in 2002 (Table 3.6).

**Table 3.6: Top Markets for Vietnam’s Exports 1997-2008**  
(USD Thousands)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Japan</td>
<td>1675423</td>
<td>United States</td>
<td>2453230</td>
<td>United States</td>
<td>11902834</td>
</tr>
<tr>
<td>2</td>
<td>Singapore</td>
<td>1215919</td>
<td>Japan</td>
<td>2436958</td>
<td>Japan</td>
<td>8467750</td>
</tr>
<tr>
<td>3</td>
<td>Taiwan, China</td>
<td>814468</td>
<td>China</td>
<td>1518330</td>
<td>China</td>
<td>4850110</td>
</tr>
<tr>
<td>4</td>
<td>China</td>
<td>474097</td>
<td>Australia</td>
<td>1328333</td>
<td>Australia</td>
<td>4351580</td>
</tr>
<tr>
<td>5</td>
<td>Hong Kong, China</td>
<td>430692</td>
<td>Singapore</td>
<td>961126</td>
<td>Singapore</td>
<td>2713824</td>
</tr>
<tr>
<td>6</td>
<td>Korea, Rep.</td>
<td>417016</td>
<td>Taiwan, China</td>
<td>817689</td>
<td>Germany</td>
<td>2073424</td>
</tr>
<tr>
<td>7</td>
<td>Germany</td>
<td>411412</td>
<td>Germany</td>
<td>729029</td>
<td>Malaysia</td>
<td>2030402</td>
</tr>
<tr>
<td>8</td>
<td>Switzerland</td>
<td>331936</td>
<td>United Kingdom</td>
<td>571631</td>
<td>Philippines</td>
<td>1824666</td>
</tr>
<tr>
<td>9</td>
<td>United States</td>
<td>286767</td>
<td>Korea, Rep.</td>
<td>468716</td>
<td>Korea, Rep.</td>
<td>1793525</td>
</tr>
<tr>
<td>10</td>
<td>Netherlands</td>
<td>266796</td>
<td>Iraq</td>
<td>439881</td>
<td>United Kingdom</td>
<td>1581045</td>
</tr>
</tbody>
</table>

*Source: Calculations based on UN Comtrade data (2010)*

Table 3.6 also shows that Vietnam’s exports have expanded significantly over the last ten years, with the following being the major features:
i. At the early stage of opening up and outward orientation, Vietnam’s exports focused on the first tier group of countries – Japan, Singapore, Taiwan, Hong Kong and Korea. China’s importance stemmed partly from border trade and partly from the special relations between Vietnam and China.

ii. Just five years after the Bilateral Trade Agreement with the U.S, Western markets such as the U.S, Australia, Germany and U.K. including Japan, became the main destinations for Vietnam’s exports.

iii. Currently, though Western markets still account for the largest share of Vietnam exports, the emergence of China and ASEAN countries such as Malaysia and the Philippines is beginning to change the pattern of trade. Exports from Vietnam to China increased about 11 times in the ten-year period 1997-2008. Australia is the main importer of Vietnam’s primary products.

Exports to Hong Kong, Singapore and Taiwan fell relatively to exports to Western markets. This reflects the fact that Vietnam has comparative advantage in resource-based products and low-tech finished products, not in mid- and high-tech products.

**Table 3.7:** Top Exporters to the Vietnamese Markets 1997-2008

(USD Thousands)

<table>
<thead>
<tr>
<th>Year</th>
<th>1997</th>
<th>2002</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Country</td>
<td>Value</td>
<td>Country</td>
</tr>
<tr>
<td>1</td>
<td>Singapore</td>
<td>2127959</td>
<td>Singapore</td>
</tr>
<tr>
<td>2</td>
<td>Korea, Rep.</td>
<td>1547831</td>
<td>Taiwan, China</td>
</tr>
<tr>
<td>3</td>
<td>Japan</td>
<td>1509281</td>
<td>Japan</td>
</tr>
<tr>
<td>4</td>
<td>Taiwan, China</td>
<td>1484659</td>
<td>Korea, Rep.</td>
</tr>
<tr>
<td>5</td>
<td>Hong Kong, China</td>
<td>598884</td>
<td>China</td>
</tr>
</tbody>
</table>
In terms of imports, there is a shift from imports from first tier countries to imports from other countries (Table 3.7). In 2008, China, Taiwan and Hong Kong together exported about US$26 billion worth of goods to Vietnam, exceeding imports from any G-7 country.

From the experience of early ELG model proponents, a nation that is able to implement this model should be able to take advantage of trade to promote innovation, testing, new products and their dissemination. Given Vietnam’s underperformance of exports in the medium and high technology areas (see Table 3.2 and Annex 3.1); it is hard to argue that Vietnam has been completely successful in its ELG strategy.

### 3.3.3 Vietnam’s Relative Competitiveness in Comparison with some Trading Partners - An RCA Approach.

There is a rich literature on comparative analysis in trade. One of the orthodox measures is the revealed comparative advantage index (RCA) which was introduced by Balassa (1965) on the basis of observed trade pattern in line with Heckscher-Ohlin (H-O) theory. The index is expressed as follows:

\[
RCA = \frac{X_{ij} / X_{it}}{X_{nj} / X_{nt}}
\]

where \(X\) represents exports, \(i\) is a country, \(j\) is a commodity...
(or industry), t is a set of commodities (or industries) and n is a set of countries. A country is said to have revealed comparative advantage against the set of the comparator countries if the RCA > 1.

We calculate the RCA index for specific sectors of exports of Vietnam in 2000 and 2008 (Table 3.8). From the above table, it can be noted that by 2000, Vietnam’s comparative advantage is revealed in the following sectors:

**Table 3.8:** RCA Vietnam/the World >1, by Product Groups. 2000 and 2008

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>85</td>
<td>15.49</td>
<td>85</td>
<td>13.66</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>12.50</td>
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<td>11.73</td>
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</tr>
<tr>
<td>7</td>
<td>11.39</td>
<td>7</td>
<td>9.79</td>
<td>23</td>
</tr>
<tr>
<td>23</td>
<td>7.05</td>
<td>23</td>
<td>8.99</td>
<td>7</td>
</tr>
<tr>
<td>83</td>
<td>6.03</td>
<td>83</td>
<td>6.08</td>
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</tr>
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<td>4</td>
<td>6.00</td>
<td>4</td>
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<td>4</td>
</tr>
<tr>
<td>84</td>
<td>4.18</td>
<td>84</td>
<td>4.64</td>
<td>82</td>
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<td>33</td>
<td>2.99</td>
<td>33</td>
<td>4.17</td>
<td>83</td>
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<td>5</td>
<td>2.57</td>
<td>5</td>
<td>3.01</td>
<td>8</td>
</tr>
<tr>
<td>8</td>
<td>2.40</td>
<td>8</td>
<td>2.95</td>
<td>32</td>
</tr>
<tr>
<td>32</td>
<td>2.01</td>
<td>32</td>
<td>2.41</td>
<td>61</td>
</tr>
<tr>
<td>42</td>
<td>1.75</td>
<td>42</td>
<td>2.16</td>
<td>5</td>
</tr>
<tr>
<td>82</td>
<td>1.62</td>
<td>82</td>
<td>1.56</td>
<td>24</td>
</tr>
<tr>
<td>22</td>
<td>1.47</td>
<td>22</td>
<td>1.55</td>
<td>33</td>
</tr>
<tr>
<td>9</td>
<td>1.47</td>
<td>9</td>
<td>1.53</td>
<td>65</td>
</tr>
<tr>
<td>9</td>
<td>1.42</td>
<td>9</td>
<td>1.44</td>
<td>41</td>
</tr>
<tr>
<td>RCA</td>
<td>Sector</td>
<td>Sector</td>
<td>RCA</td>
<td>Sector</td>
</tr>
<tr>
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<td>--------</td>
<td>--------</td>
<td>-----</td>
<td>--------</td>
</tr>
<tr>
<td>1.36</td>
<td>40</td>
<td>1.05</td>
<td>2</td>
<td>*</td>
</tr>
<tr>
<td>1.24</td>
<td>2</td>
<td>0.96</td>
<td>89</td>
<td>**</td>
</tr>
<tr>
<td>1.21</td>
<td>63</td>
<td>0.95</td>
<td>12</td>
<td>**</td>
</tr>
<tr>
<td>1.10</td>
<td>6</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Source: Calculations based on UN Comtrade database.*

* = the sectors where $RCA>1$ both in 2008 and in 2000.

** = the new sectors in 2008 compared with 2000.

i) Labor intensive sectors such as: furniture (HS 82), apparel (83), yarn and fabric (65), leather products (62), travel goods and hand bags (84) and footwear (85);

ii) Agricultural product groups such as meat and preparations (01), dairy products and eggs (02), fish and shellfish (03), Cereals/cereal preparations (04), Vegetables and fruit (05), Coffee/tea/cocoa/spices (07);

iii) Crude/synthesis rubber (23), Coal/coke and briquettes (HS group 32);

iv) Some other groups with minor comparative advantages.

There are a number of groups for which Vietnam has revealed comparative disadvantage (RCD) such as:

i) Machines and equipment HS 71 to HS79

ii) Manufactured goods group HS 6

iii) Chemical products group and Plastic products group HS 5

This confirms that Vietnam has comparative advantage in the low-tech and natural resource-based exports. It is interesting to note that after 10 years of deep integration into the global economy and with a milestone of normalization of trade relations with the U.S in 2001, there has been almost no change in the pattern of comparative advantage in Vietnam; the RCA index in 2008 remains almost the same as in 2000.
We conducted the same analysis comparing Vietnam with China and ASEAN and found that Vietnam has comparative advantage in a number of key exports to China and to ASEAN. For China, from 2000 to 2008, the RCA of Vietnam increased significantly from 24 product groups to 39 product groups between 2000 and 2008. The new groups include furniture, apparel, and handbags. Besides, Vietnam retains its RCA over China for some traditional product groups such as agricultural and food products, metal ores and footwear. With ASEAN, the RCA structure of Vietnam’s exports is similar to that to the rest of the world, with the dominance of low-tech and natural resource exports. However, the number of RCA sectors has been expanded from 26 groups to 32 groups, a positive signal pointing to the increasing competitiveness of Vietnam’s exports to ASEAN countries.

In the aggregate, Vietnam has RCA in about 30 percent of the total HS list, this share actually expanding in trade with the exporting powers of China and ASEAN countries. This confirms that Vietnam’s exports will remain competitive in the years ahead, thus lending support to the continuation of the ELG strategy.

3.3.4 Vietnam’s Policies to Support Exports-led Growth

Vietnam uses a range of policies to support its ELG strategy. First, there are policies used to promote trade openness:

i) In 1995 Vietnam joined the ASEAN Free Trade Area and also began the negotiation process of accession to the World Trade Organization (WTO).

ii) In 2001, the US-Vietnam Bilateral Trade Agreement (BTA) was signed, giving Vietnam ‘Normal Trade Relations’ status and providing vital support to the country’s WTO accession.

iii) In 2003, the European Union and Vietnam established a bilateral agreement allowing Vietnam to be recognized as a developing country, thus benefiting from the Generalized System of Preferences (GSP) tariff schedule.
iv) In 2006, Vietnam became an official member of WTO.

v) From 2007, Vietnam has been in the process of negotiating FTAs with various trading partners and also regional FTAs to expand market access to its exports.

vi) Greater attention is being paid to trade facilitation and trade financing.

In addition to tariff cuts, the government supports trade promotion and export development, especially through the National Export Strategy and various exports promotion programs, including credit for promoting national trademarks and increasing the ease of making investments. The government and ministries formulate and implement a number of sectoral export strategies through the industrial policies for key export products and services from manufacturing (footwear and garment) to agricultural (rice, sea foods) products. Associations of sectoral exporters are encouraged and supported by the Government to boost intra-sectoral connectedness and competitiveness.

Exchange rate policy in recent years was a stumbling block as it has sent a confusing message to exporters. At the beginning of the opening-up era, the reform of exchange rate policy in Vietnam significantly contributed to the ELG model as it unified the distortionary multiple exchange rate system. The Vietnamese Dong at that time was also overvalued and the reform helped exports promotion. However, in subsequent years, the real appreciation of the Vietnamese Dong was 22 percent over 1992-

1. The government undertook trade promotion and export development in a comprehensive way i.e.: (i) legal reforms, (ii) entering into international treaties to lower trade barriers to Vietnam’s exports; (iii) institutional and administrative reforms – restructuring the Ministry of Trade and establishing the Trade Promotion Agency and streamlining the export-import control department and local divisions; iv) industrial policy reforms, e.g. boosting intra-sectoral linkages by establishing various industrial associations in many keys exports sectors such as garment and apparel; seafood processing, wood and furniture, agro products such as coffee, rice, etc.
2004 (Chu Thi Trung Hau and Dickie, 2006). This appreciation remains one of the obstacles to Vietnam exports expansion today. The dollarization of Vietnam in the same period (Figure 3.8) and the constraints imposed by balance of payments and accumulated debt issues did not help.

**Figure 3.8** : Dollarization in Vietnam 1992-2004

![Figure 3.8: Dollarization in Vietnam 1992-2004](image)


### 3.4 Midterm Prospects of Vietnam’s Exports-led Growth Model

#### 3.4.1 New Trends in Global Economy and Trade: Shifts in Global Demand and Supply

**New Trends in Global Supply**

The global pattern of exports has changed over the last decade. Except for Germany which increased its relative share of the world exports from 8.7 percent in 2000 to 9.2 percent in 2008, most of the developed economies lost relative shares. The U.S’ share of world exports fell from 12.3 percent in 2000 to 8.3

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1. Statistics for this section are authors’ calculations using the WTO and ITC database 2008.
percent in 2008, a reduction of almost 50 percent. Japan’s share also fell from 7.6 percent to 4.9 percent. The E.U. maintained its share of around 38 to 39 percent of world exports over the last decade.

By contrast, developing East Asia raised its share of the world’s exports from 12.3 percent to 15.6 percent, an increase of 27 percent, while South Asia and West Asia also increased their shares substantially. These developments could be explained by the strong emergence of China, India, ASEAN members and the Middle East countries in the last decade.

**Shifts in Global Demand**

In the last ten years, there is a clear shift in global demand with total exports to the developed economies sliding from about 65 percent of global exports in 2000 to 55 percent in 2008. In each region of the developed world, many structural changes are observed. Except for the E.U which retained its proportion of the world market (about 40 percent), the U.S and Japan all experienced significant reduction in share - the U.S from 18.6 percent in 2000 to 12.8 percent in 2008, and Japan from 5.4 percent to 4.5 percent. On the other hand, the developing markets of East Asia, South Asia and West Asia all increased their shares respectively.

**3.4.2 The Emergence of China**

The above analysis showed that there is an ongoing shift in global demand from the developed world to Asia. This trend can be explained by the economic rise of Asia, particularly China (Kharas, 2010).

China has clearly not only dominated low cost production but also begun to move up the value-added ladder of the global supply chains. Because of its relative low-cost labor, favorable foreign investment environment, and incentive structure, China has emerged as a final processing and assembly platform for finished goods that previously were manufactured in
neighboring countries but destined for markets in EU, North America, and high income Asian countries (Somwaru et al., 2007). In 2007, almost half of China’s exports are machinery and transport equipment (47 percent), while computers are among the top exports from the 2005 onward. Figures 3.9 to 3.11 provide a snapshot of China’s growing trade surplus with the rest of the world and the changing nature of its trade. Figure 3.12 shows China’s trade balance with its trading partners. It runs large trade surpluses with the developed Western world but deficits with developed Asia and with East Asia and Southeast Asia. With Vietnam (Figure 3.13), China runs a growing trade surplus, moderated only by the impact of the Global Financial Crisis in 2009.

**Figure 3.9:** China’s Trade Balance since 1994

![China's Trade Balance since 1994](image)

*(Bln US$ by year)*

**Figure 3.10:** Growth Pattern of China’s Trade in Intermediate Goods 1980-2005

Source: Somwaru et al. (2009).

**Figure 3.11:** Growth Pattern of China’s Trade in Capital Goods 1963-2005

Source: Somwaru et al. (2009).
Figure 3.12: China’s Trade Balance with its Trading Partners


Figure 3.13: China’s Trade with Vietnam 2001-2009

3.4.3 Infrastructure as the Ultimate Challenge for Vietnam’s Exports-led Strategy

Of the many challenges Vietnam faces in advancing its ELG strategy, none is greater than the poor state of the country’s trade-related infrastructure. This is clearly shown in Table 9. All indicators in the Global Enabling Trade Report show Vietnam to be ranked quite low among over 100 countries. The Doing Business Index 2010 also ranks Vietnam at a low level in terms of ease at trading across borders, with Vietnam ranked 121 out of 187 economies covered in the survey. Most of sub-indicators like time and cost to exports and imports are lower than comparators in the region.

Table 3.9: Vietnam’s Enabling Trade Sub-indexes Compared with Best Practice, 2009

<table>
<thead>
<tr>
<th>INDICATOR</th>
<th>RANK/121</th>
<th>SCORE</th>
<th>BEST PERFORMER</th>
<th>SCORE</th>
</tr>
</thead>
<tbody>
<tr>
<td>2nd pillar: Efficiency of customs administration</td>
<td>Burden of customs procedures</td>
<td>83</td>
<td>3.3</td>
<td>Singapore</td>
</tr>
<tr>
<td></td>
<td>Customs services index</td>
<td>112</td>
<td>2.0</td>
<td>United Kingdom</td>
</tr>
<tr>
<td>3rd pillar: Efficiency of import-export procedures</td>
<td>Effectiveness and efficiency of clearance</td>
<td>37</td>
<td>2.9</td>
<td>Netherlands</td>
</tr>
<tr>
<td></td>
<td>Time for import</td>
<td>67</td>
<td>23</td>
<td>Singapore</td>
</tr>
<tr>
<td></td>
<td>Documents for import</td>
<td>66</td>
<td>8</td>
<td>France</td>
</tr>
<tr>
<td></td>
<td>Cost to import</td>
<td>35</td>
<td>901</td>
<td>Singapore</td>
</tr>
<tr>
<td></td>
<td>Time for export</td>
<td>82</td>
<td>24</td>
<td>Multiple economies</td>
</tr>
<tr>
<td></td>
<td>Documents for export</td>
<td>42</td>
<td>6</td>
<td>Malaysia</td>
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<tr>
<td></td>
<td>Cost to export</td>
<td>22</td>
<td>734</td>
<td>Malaysia</td>
</tr>
<tr>
<td>5th pillar: Availability and quality of transport infrastructure</td>
<td>Airport density</td>
<td>102</td>
<td>0.2</td>
<td>Norway</td>
</tr>
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<td></td>
<td>Transshipment connectivity index</td>
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<td>64.3</td>
<td>United Kingdom</td>
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<td></td>
<td>Pavement roads</td>
<td>79</td>
<td>251</td>
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<td></td>
<td>Road congestion</td>
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<td>n/a</td>
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</tr>
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<td></td>
<td>Quality of air transport infrastructure</td>
<td>84</td>
<td>3.9</td>
<td>Singapore</td>
</tr>
<tr>
<td></td>
<td>Quality of railroad infrastructure</td>
<td>64</td>
<td>2.4</td>
<td>Switzerland</td>
</tr>
<tr>
<td></td>
<td>Quality of roads</td>
<td>92</td>
<td>2.6</td>
<td>France</td>
</tr>
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<td></td>
<td>Quality of port infrastructure</td>
<td>106</td>
<td>2.8</td>
<td>Singapore</td>
</tr>
<tr>
<td>6th pillar: Availability and quality of transport services</td>
<td>Liner Shipping Connectivity Index</td>
<td>47</td>
<td>18.7</td>
<td>China</td>
</tr>
<tr>
<td></td>
<td>Ease and affordability of shipment</td>
<td>45</td>
<td>3.0</td>
<td>Netherlands</td>
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<tr>
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<td>Competence of the logistics industry</td>
<td>54</td>
<td>2.8</td>
<td>Netherlands</td>
</tr>
<tr>
<td></td>
<td>Ability and ease of tracking</td>
<td>51</td>
<td>2.9</td>
<td>Singapore</td>
</tr>
<tr>
<td></td>
<td>Timeliness of shipments in reaching destination</td>
<td>64</td>
<td>3.2</td>
<td>Singapore</td>
</tr>
<tr>
<td></td>
<td>Postal service efficiency</td>
<td>49</td>
<td>5.2</td>
<td>Switzerland</td>
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<td></td>
<td>GATS commitments in the transport sector</td>
<td>10</td>
<td>49.4</td>
<td>Moldova</td>
</tr>
</tbody>
</table>

3.5 Policy Recommendations

3.5.1 Export-led Growth as a Development Strategy for 
Vietnam in the New Global Context

In the next decade, there is likely to be a degree of rebalancing of the global economy with important consequences for trade. Stagnation in demand in the key markets of the U.S, E.U, and Japan is likely to persist for years. This poses a threat to the growth of most developing countries that hugely depend on trade. Additionally, the expansion of China will pose both opportunities and challenges. However, the impact will differ from country to country. Vietnam has the potential to replace some of China’s labor intensive exports (Shahid, 2009). The rising incomes of Asian countries and formation of economic blocs also presents opportunities for competitive exporters like China, Vietnam, Indonesia and Thailand (Kharas, 2010).¹

On the other hand, fierce competition in medium and low tech manufacturing exports and new technical trade barriers under the pressure of global rebalancing and security-tightening pose challenges to every exporter including Vietnam. The scale of Chinese manufacturing can also keep prices low, and with the inevitable increase of the average wage in Vietnam will squeeze Vietnam’s export competitiveness in low- and medium-tech manufacturing. Also, sooner or later, Vietnam will run out of exhaustible resources, rendering these types of exports no longer viable in the long run. And global systemic risks are an inevitable byproduct of any globalized economy like Vietnam.

Global warming and climate change also pose challenges to later industrializers like Vietnam in that production of low- and medium-technology goods might become very costly if international proposals for the global carbon tax or emission cuts are accepted and enforced. Natural disasters may also destroy or severely damage the physical capital stock of countries including Vietnam.

¹ According to Kharas (2009), by 2020 more than half of the world’s middle class could be in Asia, and Asian consumers could account for over 40 per cent of global middle class consumption in case the equality assumption in the developing countries in Asia is satisfied.
Since domestically generated growth in Vietnam is unlikely to generate the momentum needed to sufficiently propel Vietnam’s economic advance to achieve the government’s 2020 objective, and given the clear benefits of export promotion, the ELG model should be continued.

i) Exports contribute to building up foreign reserves that can help address the foreign exchange constraints faced by the economy.

ii) Exports create jobs and upgrade skills of the labor force, many of whom are migrants from rural areas. The current low-tech manufacturing exports provide job opportunities for women.

iii) Export expansion closes the technology gap through spillover effects and competition.

iv) Exports create chances to pilot new institutions/governance which are vital for international competitiveness.

In the next decade, promoting exports remains the best way for technology transfer to the national manufacturing industry and to unlock the huge potential for boosting labor productivity, which is constrained by the large agriculture sector and limited domestic market. Most of the old and selective industry policies such as discrimination against non-export sectors, tariff and border controls as well as trade related investment measures such as local content regulations are inconsistent with WTO rules and norms. Another disadvantage is the low saving rate of Vietnam compared to other ELG-driven competitors. It is possible that in the course of ELG strategy implementation, the policies have encouraged both capital formation and higher imports, which erodes net exports.

From the previous analysis, it can be concluded that while more balanced and equitable growth in exports and imports across the world is required in future, an ELG strategy for Vietnam remains viable as markets in other emerging countries still provide room for Vietnam’s exports. However, this strategy must be carried
out as a comprehensive program that emphasizes ‘the right timing’ and ‘the right pack’. Last but not least, the ELG model must fuel investment and not consumption, and this can only be achieved through higher national saving. In the course of ELG strategy implementation, the following obstacles should be addressed.

First, without structural reform, the trade deficit will grow, partly as a result of the high import content (or low value added) of exports. Moving up the global value chain is a must, given the fact that our natural resources are exhaustible. The key issue is how to achieve both export growth goals of more value added (to reduce the trade deficit and ensure sustained long-term growth) and more volume (enhance job creation and add to foreign reserves). This may continue to rely on resource-based exports in the interim. At the same time, Vietnam should promote more technology-based exports through a strong policy to stimulate research and development (R&D) investment, both domestic and international.

Second, the immature real estate market is putting severe pressure on business costs due to the rocketing prices of land and space lease. It also diverts investment away from real production activities toward real estate investment, with an asset bubble the likely consequence.

Third, the export business is fueled and maintained by a competitive labor force dependent on free mobility and labor productivity. The former depends on the availability of urban infrastructure and an accommodative social structure. To enhance labor mobility, the current practice of household registration involving extensive documentation should be reviewed and amended. Labor productivity can be raised through enhancing the quality and the coverage of vocational training and general education.

Fourth, commodities exchanges need to be established. These institutions are urgently needed to facilitate the flow of production inputs and add value to exports in general and resource-based exports in particular.
Last but not least, further efforts are needed in capital market formation. This is vital not only to driving economic growth, but also to ensure macroeconomic stability and to avoid crises.

3.5.2 Recommendations

The above analysis leads to the following recommendations. These are to review:

- Vietnam’s export structure with specific analysis of main export groups, i.e. primary, low-tech, medium-tech, and high-tech in terms of their potential for and impact on growth.

- The incentives system for export promotion in terms of plans, implementation, coordination, effectiveness and efficiency. This review must cover all relevant policies from industrial, investment as well as trade policies.

- The conventional trade policies such as the exchange rate policy in terms of long-term development.

- And design industrial and investment policy to promote the development and transfer of technology to those industries contributing to Vietnam’s exports in the next ten years. Besides the criterion of technology, connectedness to the global supply chain and markets should also be emphasized in national FDI policies and administrative measures.

- And implement an improved national trade facilitation program which would create an enabling platform for Vietnam’s exports to compete internationally in the new global context.

Beyond providing social and macroeconomic stability as well as further liberalizing the private sector, can the Vietnamese Government also undertake those initiatives needed to ensure broad-based growth through an effective ELG strategy? This remains to be seen.
References


Romer, P. M. (1987). “Growth Based on Increasing Returns due to


Roy F. Harrod. (1939) *Essay in Dynamic Theory*


UN COMTRADE DATA 2009,2010


World Bank (1993). The Asian Miracle

Annex 3.2: The Average Change Model

The paper employs a simple average change model to review Vietnam’s exports and imports by 2020. The average change model is based on the premise that the forecast value is equal to the actual value in the current period plus the average of the absolute changes experienced up to that point in time. The one step ahead forecast is given as:

\[ F_{t+i} = Y_t + \text{Average of changes} \]

Average of changes = \( \frac{\Delta Y_{t-1} + \Delta Y_{t}}{2} \)

\[ F_{t+i} = Y_t + \frac{\Delta Y_{t-1} + \Delta Y_{t}}{2} \]

Or the current predicted value is

\[ F_t = Y_{t-1} + \frac{\Delta Y_{t-2} + \Delta Y_{t-1}}{2} \]

This model is useful when the historical data being analyzed are characterized by period-to-period changes that are approximately of the same size. However, this model tends to lag behind turning points and that all periods are weighted equally, irrespective of their importance, when deriving the forecast values. The Forecast error formula and Mean Error are the same as the Simple average moving (SMA) method or the Average percent Change model.
### Annex 3.3: Technological Categorization of Products

**Resource based:**

<table>
<thead>
<tr>
<th>Product</th>
<th>Product Name</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>Food and live animals</td>
</tr>
<tr>
<td>2</td>
<td>Crude materials, inedible, except fuel</td>
</tr>
<tr>
<td>3</td>
<td>Mineral fuels, lubricants and related</td>
</tr>
<tr>
<td>4</td>
<td>Animal and vegetable oils, and fats</td>
</tr>
</tbody>
</table>

**Low-tech:**

<table>
<thead>
<tr>
<th>Product</th>
<th>Product Name</th>
</tr>
</thead>
<tbody>
<tr>
<td>61</td>
<td>Leather, leather manufactures, n.e.s.and dr</td>
</tr>
<tr>
<td>65</td>
<td>Textile yarn, fabrics, made-up articles</td>
</tr>
<tr>
<td>82</td>
<td>Furniture and parts thereof</td>
</tr>
<tr>
<td>83</td>
<td>Travel goods, handbags and similar</td>
</tr>
<tr>
<td>84</td>
<td>Articles of apparel and clothing ac</td>
</tr>
<tr>
<td>85</td>
<td>Footwear</td>
</tr>
</tbody>
</table>

**Medium-tech**

<table>
<thead>
<tr>
<th>Product</th>
<th>Product Name</th>
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</thead>
<tbody>
<tr>
<td>62</td>
<td>Rubber manufactures, n.e.s.</td>
</tr>
<tr>
<td>63</td>
<td>Cork and wood manufactures (excluding fuel)</td>
</tr>
<tr>
<td>64</td>
<td>Paper, paperboard, articles of paper</td>
</tr>
<tr>
<td>66</td>
<td>Non-metallic mineral manufactures</td>
</tr>
<tr>
<td>67</td>
<td>Iron and steel</td>
</tr>
<tr>
<td>68</td>
<td>Non-ferrous metals</td>
</tr>
<tr>
<td>69</td>
<td>Manufactures of metal ,n.e.s.</td>
</tr>
<tr>
<td>Product</td>
<td>Product Name</td>
</tr>
<tr>
<td>---------</td>
<td>--------------</td>
</tr>
<tr>
<td>71</td>
<td>Power generating machinery and equipment</td>
</tr>
<tr>
<td>72</td>
<td>Machinery specialized for particular use</td>
</tr>
<tr>
<td>73</td>
<td>Metalworking machinery</td>
</tr>
<tr>
<td>74</td>
<td>General industrial machinery &amp; equipment</td>
</tr>
<tr>
<td>75</td>
<td>Office machines &amp; automatic data processors</td>
</tr>
<tr>
<td>76</td>
<td>Telecommunications &amp; sound recording eqpt</td>
</tr>
<tr>
<td>77</td>
<td>Electrical machinery, apparatus &amp; appliances</td>
</tr>
<tr>
<td>78</td>
<td>Road vehicles (incl. air cushion vehicles)</td>
</tr>
<tr>
<td>79</td>
<td>Other transport equipment</td>
</tr>
<tr>
<td>87</td>
<td>Professional, scientific &amp; control instruments</td>
</tr>
<tr>
<td>88</td>
<td>Photographic apparatus, optical goods</td>
</tr>
</tbody>
</table>
Annex 3.4: Paul Romer’s Development of Endogenous Growth Theories

Annex 3.5: Generalized Endogenous Growth Model

Annex 3.6: Country Groupings Based on Active Growth Mechanisms

<table>
<thead>
<tr>
<th>Country Growth Classifications</th>
<th>Characteristics</th>
<th>Role of Education/Human Capital</th>
<th>Outcome</th>
</tr>
</thead>
<tbody>
<tr>
<td>Endogenous Growth</td>
<td>Self Sustained Increases in Income</td>
<td>Technological Innovation Facilitated by Human Capital</td>
<td>Innovation raised income which stimulates further innovation</td>
</tr>
<tr>
<td>Catching Up Growth</td>
<td>Capital Flows and Technological Diffusion</td>
<td>Aids in absorbing of technology</td>
<td>In time, investment in education may create start of endogenous cycle</td>
</tr>
<tr>
<td>Resource Based Growth</td>
<td>Raw Material Booms and Busts</td>
<td>Limited Schooling often foreign no technological links</td>
<td>Growth dictated by external events</td>
</tr>
<tr>
<td>Malthusian Decline</td>
<td>Falling Incomes--Population Outstripping Capacity of Resources</td>
<td>Limited due to financial constraints</td>
<td>Brain Drain</td>
</tr>
<tr>
<td>Economic Isolation</td>
<td>Physical or Policy Induced Isolation from Word Markets</td>
<td>Isolation limits absorption new ideas/methods</td>
<td>Sub-optimal Growth and Development</td>
</tr>
</tbody>
</table>

*Source: Looney (2001).*

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
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<td>VN/World</td>
<td>VN/World</td>
<td>VN/China</td>
<td>VN/China</td>
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<td>3.483778877</td>
<td>4.95407474</td>
<td>8.44286803</td>
</tr>
<tr>
<td>Live animals except fish</td>
<td>0.137571483</td>
<td>0.063677191</td>
<td>0.130569207</td>
<td>0.20593831</td>
</tr>
<tr>
<td>Meat &amp; preparations</td>
<td>0.245172595</td>
<td>0.128859786</td>
<td>0.350822332</td>
<td>0.73396001</td>
</tr>
<tr>
<td>Dairy products &amp; eggs</td>
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<td>0.111189452</td>
<td>16.58559071</td>
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<td>Fish/shellfish/e.t.c.</td>
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<tr>
<td>Cereals/cereal preparation</td>
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<td>4.730019025</td>
<td>6.672043981</td>
<td>48.5666922</td>
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<tr>
<td>Vegetables and fruits</td>
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<td>2.157845514</td>
<td>2.143856062</td>
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<td>Sugar/sugar prep/honey</td>
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<td>1.980200585</td>
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</tr>
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<td>Beverages and tobacco</td>
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<td>2.84703912</td>
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<td>Beverages</td>
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<td>0.250562578</td>
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<td>0.945578088</td>
<td>0.647761099</td>
<td>3.99591434</td>
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<tr>
<td>Crude mater.ex food/fuel</td>
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<td>1.050471729</td>
<td>1.465225952</td>
<td>4.97256362</td>
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<tr>
<td>Hide/skin/fur - raw</td>
<td>0.603931454</td>
<td>0.245569958</td>
<td>12.77517669</td>
<td>43.7377509</td>
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<td>Oil seeds/oil fruits</td>
<td>1.474417119</td>
<td>0.316978483</td>
<td>2.080226044</td>
<td>1.6367843</td>
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<tr>
<td>Crude/synthetic/rec rubber</td>
<td>7.053703135</td>
<td>9.790743387</td>
<td>53.04822026</td>
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<td>Cork and wood</td>
<td>0.508662243</td>
<td>1.561055681</td>
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<td>0.00038051</td>
<td>0</td>
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<td>Textile fibers</td>
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<td>3.8856177</td>
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<td>0.25263391</td>
<td>0.844458466</td>
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<td>1.381141449</td>
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<td>Coal/coke/briquettes</td>
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<td>2.953668397</td>
<td>0.680235895</td>
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<td>Petroleum and products</td>
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<td>1.550940081</td>
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<td>Electric current</td>
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<td>----------------------------------------------</td>
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<td>------------</td>
<td>------------</td>
<td>------------</td>
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<tr>
<td>Fixed vegetable oils/fats</td>
<td>1.752602326</td>
<td>0.179351836</td>
<td>11.02769498</td>
<td>2.75626976</td>
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<td>Animal/vegetable oils processed</td>
<td>0.062057894</td>
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<td>0.650187862</td>
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<td>Chemicals/products n.e.s</td>
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<td>Organic chemicals</td>
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<td>Inorganic chemicals</td>
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<td>Dyeing/tanning/color materials</td>
<td>0.030160841</td>
<td>0.189791383</td>
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<td>Perfume/cosmetic/cleanser</td>
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<td>Manufactured fertilizers</td>
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<td>Plastics in primary form</td>
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<td>0.318434763</td>
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</tr>
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</tr>
<tr>
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<td>2018</td>
<td>2017</td>
</tr>
<tr>
<td>---------------------------------------</td>
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<td>---------------</td>
<td>---------------</td>
<td>---------------</td>
</tr>
<tr>
<td>Footwear</td>
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</tr>
<tr>
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<td>0.177379205</td>
<td>15.5393502</td>
<td>5.72570637</td>
</tr>
<tr>
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<tr>
<td>Gold non-monetary export ore</td>
<td>0.127179769</td>
<td>0.866841249</td>
<td></td>
<td>9054.07356</td>
</tr>
</tbody>
</table>

*Sources: Calculations based on the UN Comtrade*
4.1 Introduction

Vietnam is now at the critically important juncture as the country is preparing the National Socio-economic Development Strategy 2011-2020 (NSDS). The NSDS will guide the two five-year plans in the next decade, and provide key inputs for the Eleventh Party Congress, scheduled to be held in January 2011. After more than 20 years of economic reform, changing from a centrally planned economy into the market economy, Vietnam has undergone significant economic growth and is expected to become a ‘middle-income’ country in the next decade. The country’s patterns of growth will change as income levels change. Therefore, to avoid the middle-income trap by sustaining high rates of economic growth and poverty reduction, Vietnam realizes that it needs to re-structure the economy and become an industrialized country.

The importance of industrialization as an engine of economic growth and development has long been recognized by today’s industrialized and newly industrialized countries. A number of explanations have been offered to explain the empirical correlation between the degree of industrialization and per capita income in developing countries. Productivity is higher in the manufacturing sector than in the agricultural sector. Manufacturing is assumed
to be more dynamic than other sectors. A transfer of productive resources to more dynamic sectors contributes to growth. Capital accumulation can be more easily realized in manufacturing than in agriculture. The manufacturing sector offers special opportunities for economies of scale, which are less available in agriculture or services (Szirmai, 2008). Manufacturing generates employment at higher skill levels, facilitates better linkages across the services and agricultural sectors, between rural and urban areas, and between consumer, intermediate and capital goods industries. Prices of manufactured exports are less volatile and less susceptible to adverse business cycles, to long-term deterioration than those of primary goods, making it particularly strategic in highly commodity-dependent developing countries like Vietnam. In addition, industrialization is a critical tool in poverty eradication, employment generation, and regional development policies. Finally, it can spur technological upgrading and innovation as well as productivity gain and is hence able to play the development role more suitably than the agricultural sector (See Table 4.1).

Table 4.1: Characteristics of Agricultural versus Industrial Sectors

<table>
<thead>
<tr>
<th>Characteristics of the Agricultural Sector</th>
<th>Characteristics of the Industrial Sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>Diminishing returns</td>
<td>Increasing returns</td>
</tr>
<tr>
<td>Commodity competition</td>
<td>Dynamic imperfect competition</td>
</tr>
<tr>
<td>Extreme price fluctuations</td>
<td>Stable prices</td>
</tr>
<tr>
<td>Generally unskilled labor</td>
<td>Generally semi-skilled or skilled labor</td>
</tr>
<tr>
<td>Irreversible wages</td>
<td>Reversible and more stable wages</td>
</tr>
<tr>
<td>Innovation leads to lower prices</td>
<td>Innovation leads to higher revenues</td>
</tr>
<tr>
<td>Creation of a feudalist class structure</td>
<td>Creation of a middle class</td>
</tr>
</tbody>
</table>

Source: Authors.
Realizing the critical role that industrialization (and manufacturing) plays in economic development, virtually all of today’s industrialized nations actively supported and protected their industries through specific policies and institutions throughout their history of industrialization (Lall, 2004, Chang, 2002 and Chang, 2002). Following the initial success of economic reform, the government of Vietnam has recognized the importance of industrialization (and modernization) which is seen as a central part of the development agenda, and to facilitate the transformation of the country’s economic structure to that of a modern industrial economy. Vietnam has been experimenting with a number of diverse trade and industrial policies but much of it has been based upon wishful thinking rather than serious consideration and concerted strategy. Earlier efforts include a number of measures instituted to nurture infant industries.\(^1\) Nonetheless, the industrial capacity created did not always correspond to local demand and supply conditions and the developmental contribution of the industrial sector has been well below its potential. However, the world has witnessed profound changes in the last few decades. Like other late industrializing countries, Vietnam is now in a world in which conditions for implementing industrial policy have changed to the extent that it may be very difficult to adopt the industrialization strategy followed by now-industrialized countries and the Asian Tigers. According to Lall (2004), today’s world is different from that when the strategies of Asian Tigers were formulated. There are several factors affecting the changed environment for implementing industrial policies. Industrial strategy must be based on the analysis of the international situation and Vietnam’s current and future position in it.

\(^1\) These includes: over-valued (fixed) exchange rates that kept imported capital goods and intermediate inputs relatively cheap; FDI licensing only in selected sectors; import duties, drawbacks and rebates; licensing arrangements; the provision of direct loans and equity capital; and quotas allowing access to foreign exchange for imported inputs and remittances at subsidized official rates.
The Global Financial and Economic Crisis

Since 2008 the world has just gone through a severe economic and financial crisis since the last great depression. Although having its origin in the developed world, the global crisis has far-reaching consequences, and is also expected to shape the growth and development prospects for developing countries including Vietnam for the foreseeable future. The formulation and implementation of industrial policies for Vietnam should be put in this context. One of the often cited structural causes of the current global crisis is the unsustainable global imbalances between over-consumption in the US (large current account deficit) and over-saving in emerging China and other East Asian countries (large current account surplus). Such unsustainable global imbalances must be rebalanced either with a gradual decline or a sudden fall caused by a global crisis for example. As a result, the world consumption map may evolve into either a multi-polar (with the US, EU, Japan, and emerging consumption Asia, which is the more likely scenario) or Asia-centered single-polar map. In either case, the emergence of a consumption center in Asia (China, India and other current account surplus countries) may have important implications for Vietnam’s export strategy, production and industrialization.\textsuperscript{1}

The Accelerating Speed of Technical Change and Globalization of Production

These are the two important and defining characteristics of the fast changing economic world today. Rapid technical change reduces the scope for, and raises the risks of, some forms of industrial policy as free market forces are not conducive to costly and prolonged learning processes. Choosing wrong sectors would lead to costly consequences for national development. Similarly, globalization of production network renders some past industrial policy instruments less useful or most risky and costly. The more detailed implications that may have relevance for Vietnam can be found in a study by Yusuf

\textsuperscript{1} See Nguyen et al. (2010) for further discussion about global imbalances and their implications for Vietnam.
et al. (2004) which concluded that in the face of a global environment, economies in East Asia need to adapt to the changing character of global production networks and to nurture and develop technological capabilities in order to sustain their growth prospects.¹

Policy Liberalization

In 1995, Vietnam submitted its application for accession to the World Trade Organization (WTO) and became the 150th WTO member state in 2007. Vietnam’s trade liberalization and accession to WTO in particular has consequences for implementing industrial policies. Like other transition countries, Vietnam in its attempt to integrate back into the world economy after years of isolation has been reducing trade and investment barriers. Many effects of liberalization have been beneficial, allowing Vietnam to exploit its existing comparative advantages that were held back by inefficient controls in the planned economy. Increased exposure to competition both within domestic and international markets has forced enterprises to raise efficiency or go out of business. However, policy liberalization is causing devastating damage to some industries in Vietnam. Most important, the international commitments under WTO agreements as well as multilateral and bilateral agreements (i.e. ASEAN, US-Vietnam BTA) to remove trade interventions, streamline FDI licensing and local content requirements, open up and regulate government procurement, impose strict intellectual property rights, and liberalize the service sector takes away the most powerful tool for promoting new activities and developing infant industries.²

¹. Multinational corporations (MNCs) of the advanced countries including US, Japan, and Western Europe have been adopting global production network concept in their operation. This suggests that successful participation into global production networks is one of the necessary conditions for industrial upgrading and therefore for economic development of emerging economies including Vietnam.

². These commitments will narrow the role of government in economic life, and subject the economy to competition and globalization more strongly. To sum up, liberalization, technical change and globalization mean that countries are faced with much stronger technological and competitive challenges than
Emergence of New Big Players in the Global Economy

The emergence of big players in the world economy particularly China and to some extent India, has become a cause for concern around the world with critical implications for developing countries including Vietnam (see Winters and Yusuf, 2007; Lora, 2005; Mayer and Wood, 2009). The economic resurgence of China has sometimes been noted as a threat to Southeast Asia in particular, as fears abound of a diversion of FDI and a competitive disadvantage in exports (Ravenhill, 2006). China has been the world’s fastest-growing economy since the close of last century, with an average real growth rate of 9.4 percent per year. According to Mayer and Wood (2009) the entry of China into world markets over the past three decades has affected the broad sectoral structures of other economies, especially developing ones. In particular, they argue that the adversary effects of China on the labor intensive manufacturing and the primary sectors in other developing countries have aroused concerns and suspicions about retarded industrialization, reduced employment and increased inequality in Africa, Latin America and the rest of Asia. The labor-intensive manufacturing is often said to have been harmed by competition from China.¹ In a nutshell, Vietnam, like other

¹. The primary production sector on the other hand is often said to have gained from increased demand from China. According to Mayer and Wood (2009), China’s opening to trade effectively lowered the world average land/labor
latecomer industrializers, has to dance “with the Giants without getting one's toes stepped on” (Winters and Yusuf, 2007).

This chapter seeks to provide inputs for the debates and discussion along the preparation of the national development strategy. The chapter focuses on the relevance of industrial policy for national economic development and the role of large economic groups as an instrumental tool for implementing industrialization policy for the purpose of national economic development. The chapter is organized as follows. The first section reviews the policies adopted by Vietnam during the course of economic development through the lens of ‘industrial policy’ emulating the industrial policy framework adopted by other countries. The second section focuses on the role of large economic groups as an instrument for industrialization. The chapter is more of a selective review, discussing issues relevant for the policy review, debate and discussion in Vietnam. The authors argue that industrial policy is still relevant for Vietnam and large economic groups. While this could be viewed as a double-edged sword, it is still relevant and feasible for industrial policy implementation.

ratio and increased the share of workers with a basic education in the world labor force. The relative endowments of other countries were thus shifted in the opposite directions, which tended to move their comparative advantage away from labor-intensive manufacturing, which requires a lot of workers with a basic education but not much land. The corresponding increase in comparative advantage for developing countries was mainly in primary production, which uses a lot of land; for developed countries, it was mainly in skill-intensive manufacturing and services, which need workers with more than a basic education. The mechanism by which this shift in world average endowments took effect was a vast expansion of China's exports, concentrated on labor-intensive manufactures, in which its own endowments give it a comparative advantage, and of its imports, which are concentrated on primary products and skill-intensive manufactures, in which it has a comparative disadvantage. These changes in trade flows altered relative prices on world markets and shifted the demand functions faced by producers in other countries – inwards for labor-intensive manufactures, and outwards for primary commodities and skill-intensive manufactures. Fu et al. (2009) show that China's exports depressed global manufactures prices.
PART I – INDUSTRIAL POLICY

4.2 Industrial Policy and Development in East Asian Countries

Extensive debate has surrounded both trade and industrial policies in economic development. There has been a large and growing body of theoretical and empirical literature on the limits and merits of industrial policies, rendering it impossible to cover in details, all of the theoretical and empirical implications within the space of this paper. This section reviews the basic economic theories/rationales for government intervention, briefly visiting the contemporary debate on whether industrial polices should be comparative advantage-conforming or comparative advantage-defying (Lin and Chang, 2009). After a brief discussion of the definition of an industrial policy, I will consider arguments for and against industrial policy. Against this backdrop, we will evaluate whether industrial policy should be adopted by developing countries with special attention paid to the experience of the Latin American and East Asian countries.

4.2.1 Definition of Industrial Policy

There are a number of definitions of industrial policy and there is no consensus on what exactly constitutes industrial policy. Some authors argue that the appropriate term for industrial policy should be ‘selective industrial policy’. According to Chang (1994), selective industrial policy implies a certain group of policies that are inclined to privilege the development of a particular industry or sector over others in order to enhance national economic or social welfare in the long run. Methods to reinforce selective industrial policy may include trade subsidies, licenses, and the management of credit and capital allocation, prices and investment. There are two main definitions of  

1. The term “Washington Consensus” can be broadly interpreted to mean secure property rights, fiscal discipline, sectoral neutral tax and expenditure policies, financial liberalization, unified and competitive exchange rates, openness to foreign trade and investment, privatization, and deregulation.
industrial policy, focusing on either the industry or the market. Examples of the first type include the definition by Chang (1994) as “a policy aimed at particular industries (and firms as their components) to achieve the outcomes that are perceived by the state to be efficient for the economy as a whole” or by Pack (2000) as comprising of “a variety of actions designed to target specific sectors to increase their productivity and their relative importance within the manufacturing sector.” On the other hand, emphasizing the distortion effect of the intervention on the market, Lall (1996) defines industrial policy as “comprising all actions taken to promote industrial development beyond that permitted by free market forces.”

4.2.2 Arguments for and against Industrial Policy

The role of the State in a market economy is one of the most controversial issues in economic theory. Indeed, the strength of the argument of industrial policy depends on the appraisal of the possible benefits of industrial policies. There are a number of arguments for mounting industrial policies that can be found in economic theory. Rodrik (2008) draws an analogy between industrial policies and other government interventions in such areas as education, health, social insurance and even macroeconomics stabilization, all of which are motivated by externalities, asymmetric information. We could identify a number of circumstances where selective government intervention via industrial policy may be designed to obtain an increase in social welfare. They include the infant industry argument, economies of scale, knowledge as a public good, and imperfection of factor markets.

1. The World Economic Forum (2002) defines industrial policy as “interventions to skew the market’s outcome in a nation’s favor.”

2. Education and health interventions are motivated by human capital externalities, social insurance by asymmetric information, and stabilization policy by aggregate-demand (Keynesian) externalities.

3. A framework for analyzing the selective industrial policy should compare the benefits generated by a promoted industry with those that could have been generated if the resources had been allocated to another sector of the economy.
One of the most accepted justifications for government intervention through industrial policy is the “infant industry” argument. According to Chang (2002), the argument was first developed by Alexander Hamilton but is often attributed to Friedrich List. The infant industry argument suggests that protection of domestic industries from foreign competition is justified during the early stages of development of a new industry until sufficient scale and technological development have been achieved.¹ The infant industry argument is based on a dynamic theory of comparative advantage – looking at the long-run interest for the national economy. The most efficient long-run strategy may well be different from what is best initially.² The main debate concerning the “infant industry” argument concerns the degree of protection that should be imposed and exactly when to phase it out. Tension that is often reflected with government

1. It has been argued that this was precisely the industrial development strategy that was pursued by countries like the US and Germany during their rapid industrial development before the turn of the 20th century. Both the US and Germany had high tariffs during their industrial revolution periods. These tariffs helped protect fledgling industries from competition with more efficient firms in Britain and may have been the necessary requirement to stimulate economic growth. This strategy was later adopted by Japan and Korea.

2. Imperfection in the capital and goods market is another justification for government intervention. If there is a divergence (due to the lenders’ inability to make proper evaluations, to their “irrational” aversion to risk, or to their systematic over-estimation of the risk, or due to information asymmetry between lenders and borrowers) between the social opportunity cost of funds and the available market rate at which the potential borrowers can access, then government may intervene with subsidies, tax credit if the private rates are not appropriate. Another argument that is often used to justify government interventions in economic life is the public good nature of knowledge creation in certain specific industries such that the benefits of research and development efforts may be spread throughout society inevitably. Government intervention in this regard through selective industrial policies may include subsidies for private research and development costs. Particularly, encouragement may be created for firms to internalize the externalities associated with the creation of new technologies through the promotion of joint ventures for research and development. Use of production or export subsidies or protection of the domestic markets through selective industrial policies can also overcome this form of market failure. As a summary, Rodrik (2008) argues that it is not a question of whether we should have industrial policies, rather it is a question of how.
“picking winners” – choosing exactly which industries to nurture – illustrates the complexities of a broad interpretation of the infant industry argument.

In addition to the infant industry argument, government intervention may also be justified by economies of scale (both static and dynamic). For a certain sector where the entry costs is high or the learning curve is steep, leaving only a few firms capable of entering the sectors, there is a case for government industrial policies in the form of entry subsidies for the learning phase or entry phase. The government may also intervene for strategic reasons. Selective industrial policies may be undertaken by the government to support local firms in their efforts to compete with rival foreign firms. Classic examples include Boeing and Airbus, and the more recent success of Chinese aircraft industry. Entry subsidies may be considered because of the potential monopoly profits obtainable by one firm.

The issue of whether it is better for a country to engage in free trade with other countries, or to limit trade through industrial or trade policies has been a contentious one for both economists and policymakers. One counter-argument to the infant industry argument above is that by protecting infant industries, countries are not allocating resources in the short-run on the basis of comparative advantage. The standard neoclassical trade models of trade show that resources will be allocated most efficiently if countries produce those goods in which the before-trade prices are lower than in the rest of the world.

4.2.3 Experiences from East Asian Countries

Although, the East Asia region also suffers from some economic setback such as the lost decade of economic stagnation in Japan (in the 90s) and the Asian Financial Crisis in 1997, it continues to be the best performer in terms of sustained economic growth and poverty reduction in comparison to Latin America or Africa. Many researchers, policy makers and governments have turned to East Asia to explore why East Asian countries are so successful
and if East Asian countries could serve as a model for economic development. These countries have derived great benefits from increasing integration with the international economy, without giving up national autonomy in the economic or cultural spheres, by pursuing decidedly non-neutral policies with respect to the promotion of specific sectors and activities. This chapter addresses a series of questions in an attempt to assess the relevance of their experiences for Vietnam. These questions include:

- Was industrial policy, defined as selectively promoting individual sectors, a major source of growth in these East Asian economies?

- Can these outcomes be duplicated in Vietnam today, or do special circumstances or changes in the international policy environment prevent replication of the East Asian experience?

- Given the revealed costs and benefits, is replication advisable? And, if not, are there other, positive, lessons that Vietnam can take away from the historical experience of the East Asian countries?

According to previous studies (e.g. Crafts 1998; Wong and Ng 2001; World Bank, 2003) the economic growth and development in East Asian countries (Japan and the “Four Tigers” and to some extent Malaysia, Thailand and Indonesia) during the last decades of the last century is a miracle. The income per capita increased more than tenfold in Japan and the “Four Tigers” between 1950 and 1995, and more than doubled in Malaysia, Indonesia and Thailand in the two decades after 1973 (Crafts 1998; Wong and Ng, 2001). In addition, growth was relatively equally distributed, bringing reductions in absolute poverty and improvements in living conditions. The economic take-off and success of China over the last two decades has added to the regional success.

Although the conditions for implementing industrial policies that were adopted by the Asian Tigers have changed as
discussed above, and several authors (Noland and Pack, 2005) have argued that developing countries can no longer implement the successful policies of the Asian Tigers, there are still a number of lessons that can be learnt from the experience of these countries. According to the World Bank (1993), the Asian Tigers all had sound macroeconomic management, a good initial base of human capital and strong export-orientation. They provided stable and predictable incentive frameworks for investment. They had high rates of savings and investments — some of the highest in recent history — which financed investments in the hardware and software of learning. They invested in administrative and institutional capital, both necessary in making markets work better and in mounting effective policies. Their governments had close and continuous dialogue with the private sector, and the granting of privileges was closely monitored and made to depend on export performance. They used “contests” to monitor performance and to ensure that favors were returned, unlike in other countries where privileges were generally granted to industry with no monitoring or performance requirement. Finally, they benefited from their location, being near Japan and what became the world’s most dynamic region. They interacted with, and learned from, each other. They gained from the spillovers of a favorable investment image” (Lall, 2004).

What was ignored by neoclassical analysts was that these common elements went together with striking differences in development “visions,” which shaped crucial elements of their strategies, each involving different kinds and levels of intervention. It is difficult, in fact, to describe their policies as “remedying market failures” in the conventional sense. The Tigers were not trying to make markets work better to achieve some static equilibrium. They were choosing between countless potential equilibria, and bending their resources to obtain the ones they had (more or less clearly) selected. Though there were generic problems they addressed in similar ways (improving the technology infrastructure or providing basic education and training), they used various tools of policy differently to pursue their different visions (Lall, 1996). Since they were all successful (to a greater or lesser extent), because of the
coherence of their policies and good administrative capabilities, it was clear that there are not only “many roads to heaven” but also many heavens. The tools were not that different from those used in less successful economies — the secret lies in the combination of policies and the efficacy of their implementation.

4.2.4 Key Considerations for Successful Government Intervention

There are two types of government intervention, often known under the terms *functional intervention* and *selective intervention*. While functional interventions are designed to remedy generic market failures without favoring one activity over another, selective interventions are designed to remedy market failures for specific activities/sectors/industries/activities. Functional interventions are often preferred to selective interventions because of the risks (of “picking winners”) associated with the latter. It should, however, be noted that economic theory provides valid arguments for selectivity under certain types of market failures. According to the World Bank, in order for national industrial policy to be successful, it is necessary to have three sets of factors viz. incentives, capabilities, and institutions.

**Incentives** as provided by industrial policies will guide the allocation of resources and also the efforts invested in developing competitive capabilities.

**Capabilities** arise from physical investment, infrastructure, human capital development, and technological effort.

**Institutions** of various kinds facilitate capability formation and production where purely market-based forces are deficient.

Successful implementation of industrial policy requires not just one set of factors but also the interplay between these sets of factors. A balance of appropriate incentives, capability development and institutional support is necessary. The nature and balance depend on each country’s endowments, levels of development and inherited structure and institutions.
The above discussion of successful industrial policy rests on the assumption of effective government. In practice governments often lack the skills, knowledge, objectivity, or autonomy to carry out interventions effectively and efficiently. Therefore, consideration of government failures should clearly be an integral part of industrial strategy. Neither markets nor governments can be assumed to be perfect. The examples of highly successful industrial intervention in East Asia (to be discussed in the next section) suggest that under certain circumstances government failures can be minimized and market failures remedied. But many examples of failed government intervention are found in Latin America and Africa. Therefore, the role and capacity of government is critical for successful industrial development.

4.3 A Review of Vietnam’s Industrial policy

4.3.1 A Brief Overview of Economic Reform and Performance

The failure of the centrally planned model that Vietnam followed to develop its national economy after the national reunification in 1975 forced Vietnam to undertake economic reforms, with the first serious reform known as Doi Moi in 1986 and later the even more radical market-oriented reform of 1989 marked a turning point in the history of Vietnam’s economic development. After some initial success, complacency built up and the reform process in general slowed down during the period 1996 - 99, especially after the Asian Crisis. However, since 2000 there have been renewed commitments to reform, with some being achieved especially in the development of private sector and trade liberalization. During the years immediately after the initiation of economic reform, the focus was on macroeconomic stabilization and price liberalization. Several measures to establish market institutions for the economy were introduced including the recognition of a multi-sector economy and property rights.

1. The privatization process has been accelerated when the Government allowed some large and “monopoly” firms in banking, insurance, petroleum, and tele-communication sectors to be privatized since 2006.
Vietnam has substantially liberalized its trade and investment policies since the late 1980s. During the early years of economic reform, Vietnam liberalized its trade regime through signing trade agreement with about 60 countries. It has also implemented preferential trade agreement with the European Union since 1992. Later on, the country actively sought membership of regional and global organizations. Vietnam has become a member of the Association of Southeast Asian Nations (ASEAN) since June 1995 and the Asia Pacific Economic Co-operation (APEC) since 1998. In 2000, Vietnam signed a historic comprehensive trade agreement with the USA to normalize trade relations between the two countries. Recently, Vietnam has also joined regional integration clubs such as ASEAN-China Free Trade Area and ASEAN-Japan Comprehensive Economic Partnership. Most recently, in 2007 Vietnam became the latest member of the World Trade Organization.

Since its 1989 reforms, Vietnam has recorded remarkable achievements in terms of GDP growth, macroeconomic stabilization, export expansion, and poverty reduction. It is now generally recognized that Vietnam is among the best developing countries in terms of achieving relatively high economic growth and reducing poverty incidence. Over the period 1990-2008, Vietnam’s GDP growth rate averaged at over 7 percent per year. Today, Vietnam’s growth rates remain among the highest in the region (second only to China). Figure 4.1 shows that except for the first two years (1990 and 1991) after economic reform where the GDP growth rate was around 5 percent, from 1990 to 1997, the GDP growth rate stayed at around 8 percent per annum on average. The GDP growth rate, however, went down between

2. International integration processes picked up from the early 1990s after the collapse of the Berlin wall and Vietnam lost its traditional markets in Eastern Europe and Soviet Union in the late 1980s. The US trade embargo against Vietnam was only lifted in 1994, and the relationship with the US was normalized in 1995. Another important achievement and event is that since 1993, Vietnam has basically opened development assistance resources (ODA) which have contributed to the substantial increase of financial resources for Vietnam's development investment.
1997 and 1999, partly because of the Asian financial crisis, and partly because of the dissipation of reform effects. Since 2000, the economy has regained its momentum, growing at 7 percent per year, reaching 8.5 percent in 2007, before dropping back to an estimated 6.2 percent in 2008 due to the impact of the Global Financial Crisis. High and continuous GDP growth rates and successful economic development over the period has resulted in overall improvement of people’s welfare and significant poverty reduction. Successive Household Living Standard Surveys of Vietnam shows total poverty incidence to have declined from 58 percent in 1993 to 37 percent in 1998, 29 percent in 2002, 19.5 percent in 2004 and 16 percent in 2006 (SRV, 2003; Nguyen Viet Cuong, 2009). Besides, there are improvements in other dimension of people’s welfare such as the high percentage of literate adults (over 90 percent), higher life expectancy (over 70 years), a lower under-five mortality rate (40 per 1000 live births in 2003).

**Figure 4.1:** Macroeconomic Indicators: GDP Growth, Exports and FDI
As a result, after 20 years of reform, Vietnam has put in place the fundamentals of a market economy and opened up the economy to international flow of capital and trades in goods and services. The emergence of the market-based economy with appropriate institutions, stable macroeconomic environment and the support of the government for business development have allowed Vietnam to (i) unlock the potential of the agriculture sector, turning Vietnam from a food-hunger country to the world third largest rice exporter; (ii) encourage the development of a vibrant domestic private sector; (iii) attract a large amount of foreign investment; (iv) realize its comparative advantages and gain more benefits from international trade. These factors underlie the economic success that Vietnam has achieved since the early 1990s.

4.3.2 Vietnam’s Industrial Structure and Competitiveness

During the course of transition to a market economy, the structure of the economy witnessed gradual changes in sectoral and ownership structure. As tabulated in Table 4.2, during this period, the structure of the economy has shifted towards industrialization and modernization. The proportion of agriculture, forestry and fishery in GDP has declined from 27.4 percent in 1994 and 20.3 percent in 2007. The share of industry and construction in GDP has risen from 28.8 percent in 1995 to 38.1 percent in 2001 and 41.5 percent in 2007. Importantly, the share of the manufacturing sub-sector within the industry and construction sector increased from 15 percent in 1995 to 21 percent in 2008. The share of the services sector remains between 30 percent and 40 percent in recent years.

Table 4.2: GDP Structure by Economic Sector, 1990 – 2008 (Current Prices)
Although Vietnam has witnessed significant changes in the structure of the economy, it is important to investigate its industrial capacity and performance. In its Industrial Development Report series, UNIDO publishes the competitive industrial performance (CIP) index to benchmark industrial national performance in the global economy. In order to assess the overall competitiveness of Vietnam industrial sector, following the UNIDO methodology, we calculate an updated CIP index for Vietnam and a group of benchmarking countries for 2008. The composite index consists of both trade and industry components. Although the industry component is important in reflecting the capacity of the industrial sector, it is the trade component that will reflect the competitiveness of the industrial sector. Instead of calculating the index for all countries in the world, in this section, we focus only on a number of countries. The benchmarking countries (comparators) are selected to reflect the various groups of countries that are comparables to Vietnam in some way, namely neighboring countries, potential competitors, role model countries and large scale countries. As can be seen in Table 4.3, Vietnam ranks 16 out of 17 countries. The ranking positions are stable over time, which confirms that industrial competitiveness is a path-dependent process where economic transformation takes time. The Table indicates that during the last decade, Vietnam although having significantly developed its manufacturing capacity, was not able to improve its ranking, remaining at the 16th place out of 17 countries.

<table>
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<tr>
<th>Industry and Construction</th>
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<th>38.13</th>
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<th>39.47</th>
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<td>37.98</td>
<td>38.01</td>
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<td>38.17</td>
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</table>

Source: GSO statistical data, various years
Table 4.3: Competitive Industrial Performance, Selected Countries

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<thead>
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<th>Economies</th>
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<th>2008</th>
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<th></th>
<th></th>
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</thead>
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<td></td>
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<td>Industry Index</td>
<td>CIP</td>
<td>Ranking</td>
<td>Trade Index</td>
<td>Industry Index</td>
<td>CIP</td>
</tr>
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<td>0.2099</td>
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<td>0.1223</td>
<td>0.1784</td>
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<td>0.1110</td>
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<td>14</td>
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<td>0.0312</td>
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<td>0.4777</td>
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<td>0.0649</td>
<td>16</td>
<td>0.1144</td>
<td>0.0904</td>
<td>0.1024</td>
</tr>
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</table>

Sources: Calculations based on UN Comtrade data, World Bank’s World Development Indicators, and Key Indicators

Although the composite index (Table 4.3) gives an overall picture of competitiveness, it is important to investigate various aspects of the industrial competitiveness for Vietnam. First,
Manufacturing value added (MVA) is the basic indicator for industrial performance. MVA growth in Vietnam over the last years has been impressive – MVA increases 2.4 times in only eight years from US$5.8 billion in 2000 to US$14.0 in 2008 (see Table 4.4 below). Only MVA growth rates in China is comparable to that of Vietnam for the period. Although the growth rate of Vietnam is high, Vietnam started from a very low base, which allowed Vietnam to grow fast during the last decade. The question is really whether Vietnam can keep up such impressive growth levels as its MVA base expands. Like the case of Cambodia, Vietnam is fast growing but from a very small manufacturing base, which calls for caution when reading growth rates. Putting this in perspective, Vietnam’s MVA base is still half of that of the Philippines, and more than 5 times smaller than that of Thailand, a country with almost 20 million fewer inhabitants than Vietnam. In light of the positive signs of industrial progress, it is important to note that Vietnam’s share of global MVA is 0.18 per cent, up from 0.1 per cent in 2000. If we adjust for the size of the economy, then it is even clearer that Vietnam is still far behind the best industrial performers in the region. Although Vietnam’s MVA per capita tripled between 2000 and 2008, this has not affected its position in the regional MVA per capita ranking where it is barely ahead of Cambodia and US$100 behind the Philippines (see Table 4.4 below).

**Table 4.4:** Manufacturing Value Added for Vietnam and Comparators, 2000-2008

<table>
<thead>
<tr>
<th>Economies</th>
<th>MVA (US$ billion constant 2000 prices)</th>
<th>Global MVA share (%)</th>
<th>Annual Growth Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>96.2</td>
<td>111.0</td>
<td>121.2</td>
</tr>
<tr>
<td>Chile</td>
<td>13.3</td>
<td>15.9</td>
<td>17.7</td>
</tr>
<tr>
<td>China</td>
<td>384.9</td>
<td>630.8</td>
<td>920.3</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>3.7</td>
<td>4.3</td>
<td>4.9</td>
</tr>
<tr>
<td>India</td>
<td>65.8</td>
<td>91.0</td>
<td>114.6</td>
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</table>
Another dimension of competitiveness of the industrial sector is the export of manufactured goods. Table 4.5 shows that Vietnam is among the highest growth countries in terms of annual growth rate, over 20 percent per year during the last decade. Exports of manufactures grew at 23.59 percent per year from US$6.8 billion in 2000 to US$36.94 billion in 2008. This impressive rate has made Vietnam the country with the second highest export growth rate in the world, only behind China. In spite of its fast growth rates, Vietnam’s manufactured export volume is quite small compared with other countries in the study. Vietnam’s export share accounts for only a small proportion in world markets, only 0.74 percent of world trade for manufactures in 2008. In terms of manufacturing capacity in relation to exports, as indicated in Table 4.6, the value of manufactured exports per capita of Vietnam has increased from US$87 billion in 2000 to US$429 billion in 2008. However, Vietnam still fares poorly compared to other countries, standing on the 16th place out of 17 countries in the survey sample.

<table>
<thead>
<tr>
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<tr>
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<td>0,53</td>
<td>0,49</td>
<td>4,63</td>
<td>3,79</td>
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<td>11,71</td>
<td>11,67</td>
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Sources: UNSTATS and World Bank’s World Development Indicators (2000-2008).
### Table 4.5: Manufactured Exports for Vietnam and Comparators, 2000-2008

<table>
<thead>
<tr>
<th>Country</th>
<th>Value of manufactured exports (US$ billion)</th>
<th>World market share (%)</th>
<th>Annual growth rate (%)</th>
</tr>
</thead>
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<tr>
<td>Brazil</td>
<td>45.79</td>
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<tr>
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<td>China</td>
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<tr>
<td>Costa Rica</td>
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<td>5.38</td>
<td>7.31</td>
</tr>
<tr>
<td>Indonesia</td>
<td>42.61</td>
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</tr>
<tr>
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<td>157.45</td>
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<tr>
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<td>139.70</td>
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*Source: UN Comtrade database.*
Table 4.6: Manufactured Exports per capita for Vietnam and Comparators, US$, 2000-2008

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<tr>
<th>Ranking</th>
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<tr>
<td>5</td>
<td>Mexico</td>
<td>2157</td>
</tr>
<tr>
<td>6</td>
<td>Chile</td>
<td>1976</td>
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<tr>
<td>7</td>
<td>Costa Rica</td>
<td>1617</td>
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<tr>
<td>8</td>
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<td>9</td>
<td>South Africa</td>
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<tr>
<td>10</td>
<td>China</td>
<td>1033</td>
</tr>
<tr>
<td>11</td>
<td>Taiwan</td>
<td>960</td>
</tr>
<tr>
<td>12</td>
<td>Brazil</td>
<td>717</td>
</tr>
<tr>
<td>13</td>
<td>Philippines</td>
<td>501</td>
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<tr>
<td>14</td>
<td>Morocco</td>
<td>489</td>
</tr>
<tr>
<td>15</td>
<td>Vietnam</td>
<td>429</td>
</tr>
<tr>
<td>16</td>
<td>Indonesia</td>
<td>363</td>
</tr>
<tr>
<td>17</td>
<td>India</td>
<td>138</td>
</tr>
</tbody>
</table>

Source: UN Comtrade database.

The share of manufactured exports in total exports shows the industrial structure of a country. The higher the share of a country’s manufactured exports in total exports, the more industrialized
that country becomes. Figure 4.2 shows the quick industrializing process in Vietnam; its share of manufactured exports had risen from 47 percent in 2000 to about 60 percent in 2008. However, Vietnam still lags behind all other comparators, except Chile. Although decreasing slightly, the share of manufactured exports in total exports of other regional comparators (except Indonesia) is much higher than Vietnam, especially the Philippines (above 92 percent). There is no much difference between Vietnam and other resource-based countries (in this group and for all comparators, Chile is the bottom country).

**Figure 4.2:** Share of Manufactured Exports in Total Exports, Selected Countries (Percent)

The technology content of Vietnam’s exports has not been discussed so far, which is an essential element of industrial capacity and competitiveness. In order to analyze the evolution of the technology content of Vietnam’s manufactured exports, the technological classification of UNCTAD has been adopted, which groups traded commodities into high-tech, medium-tech, low-tech and resource-based. Table 4.7 shows the structure of manufactured export of Vietnam and comparators in 2000 and 2008.
From Table 4.7, it is clear that Vietnam has the largest share of low-tech products in manufactured exports. From 2000 to 2008, low-tech exports are still above 65 percent of total manufactured exports. The shares of high-tech and resource-based exports also fell slightly while that of medium-tech exports rose from 10 percent in 2000 to 15 percent in 2008. Overall, Vietnam’s export structure in 2008 is still rather similar to that in 2000. Given structures are difficult to change because they reflect slow and incremental learning processes that result from resource endowments, capabilities and technological activity, it is still a good sign that the share of medium-tech exports is gradually increasing while that of resource-based exports is falling. The actual value of Vietnam’s manufactured exports also confirms this. The value of medium-tech exports in 2008 increased more than 8 times in comparison with that of year 2000. High-tech and low-tech exports increased more slowly, about 5 times, while resource based exports increased less than 5 times. In fact, Vietnam is one of three countries, the others being China and India, that had dramatic increases of actual value for manufactured exports. Tunisia also had impressive increase of high and medium tech, in terms of actual value.

**Table 4.7:** Technological Structure of Manufactured Exports, 2000 and 2008 (Percent)

<table>
<thead>
<tr>
<th>Country</th>
<th>2000</th>
<th></th>
<th></th>
<th></th>
<th>2008</th>
<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td></td>
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<td>MT</td>
<td>LT</td>
<td>RB</td>
<td>HT</td>
<td>MT</td>
<td>LT</td>
<td>RB</td>
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<tr>
<td>Vietnam</td>
<td>11</td>
<td>10</td>
<td>65</td>
<td>14</td>
<td>15</td>
<td>67</td>
<td>8</td>
<td></td>
</tr>
<tr>
<td>China</td>
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<td>24</td>
<td>45</td>
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</tr>
<tr>
<td>India</td>
<td>5</td>
<td>13</td>
<td>47</td>
<td>34</td>
<td>8</td>
<td>20</td>
<td>27</td>
<td>45</td>
</tr>
<tr>
<td>Brazil</td>
<td>15</td>
<td>33</td>
<td>17</td>
<td>35</td>
<td>10</td>
<td>37</td>
<td>11</td>
<td>43</td>
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<tr>
<td>Chile</td>
<td>1</td>
<td>13</td>
<td>6</td>
<td>80</td>
<td>1</td>
<td>10</td>
<td>3</td>
<td>86</td>
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<tr>
<td>South Africa</td>
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<td>35</td>
<td>17</td>
<td>43</td>
<td>4</td>
<td>47</td>
<td>11</td>
<td>38</td>
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<tr>
<td>Indonesia</td>
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<td>34</td>
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<td>4</td>
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</tr>
<tr>
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<td>10</td>
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<tr>
<td>Philippines</td>
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<td>12</td>
<td>7</td>
<td>62</td>
<td>16</td>
<td>8</td>
<td>14</td>
</tr>
<tr>
<td>Thailand</td>
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<td>27</td>
<td>22</td>
<td>19</td>
<td>23</td>
<td>38</td>
<td>16</td>
<td>24</td>
</tr>
<tr>
<td>Korea</td>
<td>35</td>
<td>35</td>
<td>18</td>
<td>12</td>
<td>28</td>
<td>44</td>
<td>12</td>
<td>16</td>
</tr>
<tr>
<td>Singapore</td>
<td>59</td>
<td>21</td>
<td>7</td>
<td>13</td>
<td>45</td>
<td>22</td>
<td>7</td>
<td>27</td>
</tr>
<tr>
<td>Taiwan</td>
<td>43</td>
<td>28</td>
<td>24</td>
<td>4</td>
<td>36</td>
<td>32</td>
<td>19</td>
<td>13</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>47</td>
<td>20</td>
<td>19</td>
<td>14</td>
<td>36</td>
<td>25</td>
<td>19</td>
<td>21</td>
</tr>
<tr>
<td>Mexico</td>
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<td>52</td>
<td>18</td>
<td>6</td>
<td>19</td>
<td>58</td>
<td>13</td>
<td>10</td>
</tr>
<tr>
<td>Morocco</td>
<td>10</td>
<td>13</td>
<td>50</td>
<td>27</td>
<td>6</td>
<td>26</td>
<td>30</td>
<td>38</td>
</tr>
<tr>
<td>Tunisia</td>
<td>3</td>
<td>22</td>
<td>58</td>
<td>17</td>
<td>5</td>
<td>34</td>
<td>39</td>
<td>22</td>
</tr>
</tbody>
</table>

Source: UN Comtrade database.

Figure 4.3 presents the world’s manufactured export structure and that of Vietnam during the period 2000-2008. It is important to note that the export structures in both graphs do not vary much within these years; thus, aligning the export structure of Vietnam to that of the world will surely be a time-consuming and difficult process. Another point worth noticing is the rapid rise of the world’s resource-based exports. Until 2003, this product group still had the lowest share among the four in the world’s export structure. However, it has surpassed low-tech exports in 2004 and later high-tech exports in 2008 to become the second most-demanded product group globally. On the Vietnam side, the notable change in export structure occurred in 2006 when medium-tech exports exceeded resource-based exports to have the second highest share among the four groups.
**Figure 4.4:** Manufactured Export Structure, Vietnam and World, 2000-2008

*Source: UN Comtrade*
4.3.3 Vietnam’s Industrialization Policy

It has been widely commented that even after nearly two decades of reforms, many of the interventionist policies of the old command system have not been totally dismantled in the country. Vietnam’s industrial policymakers remain stuck to a significant degree in strategies based on import substitution and continued state dominance of all but the peripheral small firms and those controlled or managed by foreign investors (Perkin 2001). Vietnam’s Socio-economic Development Strategy for the period 2001-2010 has set the target for Vietnam to “become an industrialized and modern country by 2020”. To achieve this target, specific measures were spelt out; amongst which, state sector reform and development of import-substituting industries continues to be of high priority. According to the 2001-2010 strategy, “the leading role of the State economic sector is to be enhanced, governing key domains of the economy; State enterprises are to be renewed and developed, ensuring production and business efficiency”. It also puts a clear emphasis on the “rapid development of industries which can make the best use of Vietnam’s competitive advantages, control the domestic markets and push up exports”, as well as “selective construction of some heavy-industry manufacturing units”. In this section, we review the development of relevant industrial policy to assess if such policy could deliver the expected outcomes as envisioned above.

Trade Policy

Trade policy is one of the most often used instruments to implement industrial policies. However, the policy formulation and implementation of trade policies of Vietnam seem to serve other objectives besides industrial development. Before joining the WTO in 2007, Vietnam’s trade policy can be described as a mixture of import-substitution and export promotion. Products and sectors that were protected include the agricultural sector, some labor-intensive products such as textiles, garments, furniture and some technology-intensive products such as
automobiles. Maximum tariff levels were imposed on alcohol, petroleum products, automobiles, motorcycles, cosmetics, glass, and glass products.¹ Low or minimum tariff rates were levied on raw material inputs, machinery, and equipment; especially those not manufactured by Vietnam. Products like sugar, petroleum products, cement and clinker, some common chemicals, chemical fertilizer, paint, tubes and tires, paper, silk, construction ceramic, construction glass, construction steel, some types of engines, automobiles, motorcycles, bicycles and parts, and ships and vessels were subject to quantitative restrictions on imports. The prevalence of and inconsistent application of protection followed by Vietnam has led Athukorala (2006) to conclude that “Vietnam has a tendency to protect any industrial sector but do not have the focused protection policy for the sectors which most influence the economy”.

**Figure 4.5:** Vietnam’s Nominal and Effective Rates of Protection, 2005 – 2009

<table>
<thead>
<tr>
<th>Whole economy</th>
<th>Manufacturing sector</th>
</tr>
</thead>
<tbody>
<tr>
<td><img src="chart1.png" alt="" /></td>
<td><img src="chart2.png" alt="" /></td>
</tr>
</tbody>
</table>

*Source: Adapted from Trinh (2010).*

1. It should also be noted that import tax collection is still a major source of revenue for the government. This in part will limit the effectiveness of the industrial policy. There are, however, unintended effects of such policies on economic efficiency and consumer welfare, which need to be balanced. High tariffs, import restrictions and non-tariff barriers against imports are intended to protect domestic producers of similar products. But protection is also a form of subsidy whose costs are borne by domestic consumers. When protection is given to industrial goods, for example steel, cement, or plastics, the price is paid by other downstream producers, which makes protection self-defeating.
Vietnam is now committed to creating a more open and competitive economy through implementation of the AFTA agreements, the US-Vietnam Bilateral Trade Agreement (BTA). Most recently, the WTO accession in 2007 has changed the rules for industrial policy. Protection will no longer be easily available for Vietnam's enterprises, and their products will have to compete with more competitive imported products. Trade policy may no longer be an instrument of broader industrial development strategies and any discrimination against imported products or foreign producers can trigger sanctions by other countries against Vietnam. The commitments of Vietnam under various bilateral and multilateral arrangements and agreements have led to serious reduction in the effective rate of protection for Vietnam. In a recent study, Bui Trinh (2010) has shown that both nominal and effective rate of protection for Vietnam in general and the industrial sector in particular has dropped significantly. In summary, trade policy can make little contribution to the implementation of industrial policy of Vietnam. This is partly due to the global trend in reducing trade barriers but also due to the poor co-ordination between policies and agencies.

*Policy towards the Business Sector*

An important structural shift, reflecting the important shift in economic policy, is the change in the ownership structure of the economy. The shift in the GDP structure in terms of ownership remains slow as reflected by the relatively stable and significant share in GDP by the state-owned sector, partly because of the slow progress of the SOE equitization program. Table 4.8 shows that the share of the state-own sector has decreased from over 40 percent in 1995 to 34 percent in 2008. The FDI sector has continuously increased its share from 6.3 percent in 1995 to 18.6 percent in 2008, demonstrating its greater role as the economy integrates into the world economy. The private sector has also increased its role, accounting for nearly 10 percent of the economy. The business sector remains an important sector of the economy, accounting for 30 percent of GDP.
Table 4.8: GDP Share and Growth Rate by Ownership, 1995 – 2008 (Percent)

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>GDP (Current prices)</td>
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<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
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<td>100.0</td>
<td>100.0</td>
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<tr>
<td>State sector</td>
<td>40.18</td>
<td>38.52</td>
<td>38.40</td>
<td>38.38</td>
<td>39.08</td>
<td>39.10</td>
<td>38.40</td>
<td>37.39</td>
<td>35.93</td>
<td>34.35</td>
</tr>
<tr>
<td>Non-state sector</td>
<td>53.51</td>
<td>48.20</td>
<td>47.84</td>
<td>47.86</td>
<td>46.45</td>
<td>45.76</td>
<td>45.61</td>
<td>45.63</td>
<td>46.12</td>
<td>46.97</td>
</tr>
<tr>
<td>Collective sector</td>
<td>10.06</td>
<td>8.58</td>
<td>8.06</td>
<td>7.99</td>
<td>7.49</td>
<td>7.09</td>
<td>6.82</td>
<td>6.53</td>
<td>6.21</td>
<td>6.02</td>
</tr>
<tr>
<td>Private sector</td>
<td>7.44</td>
<td>7.31</td>
<td>7.95</td>
<td>8.30</td>
<td>8.23</td>
<td>8.49</td>
<td>8.89</td>
<td>9.41</td>
<td>10.19</td>
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</tr>
<tr>
<td>Household sector</td>
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<td>32.31</td>
<td>31.84</td>
<td>31.57</td>
<td>30.73</td>
<td>30.19</td>
<td>29.91</td>
<td>29.69</td>
<td>29.72</td>
<td>30.14</td>
</tr>
</tbody>
</table>

Source: GSO and calculations by authors.

The emergence of the private enterprise sector since the reforms is an important development. The 1990s also saw the emergence of the private sector, thanks to first the introduction of the company law and private enterprise law in 1991 (later amended in 1994). These two laws together with the adoption of the new land law in 1993 and the labor code in 1994 provided an important stimulus for the development of the private sector. However, the most significant reform in the development of the private business sector came in 2000 with the new Enterprises law. During 2000-2004, about 90,000 private enterprises were registered under the new Law, (doubling the number of companies registered during the 9 years of the two previous laws) with the total capital equivalent to about US$13 billion. This sector is making rapid gains in terms of both its contribution to output growth and its growing freedom from the restrictions placed on it under central planning.  

1. Some evidence suggests that the private sector may not be quite as healthy and robust as the numbers imply. See the paper by IFC “Beyond the Headline Numbers: Business Registration and Startup in Vietnam”. http://www.ifc.org/
The government continued its import-substitution policy to protect those SOEs, which are mostly capital-intensive: producing steel, motorcycle, and industrial equipment. Investment poured into this sector, instead of moving toward developing a stronger private sector. The most important incentive is the perception that SOEs will not be allowed to fail. SOEs are protected by a variety of methods, including tariffs and non-tariff barriers, which shield them from import protection. The strong government commitment to the survival of SOEs, together with the SOEs’ alliances with powerful ministries, forms a potent shield that protects the SOEs against competitive market forces. Rhetoric about private sector development notwithstanding, a level playing field for all is yet to be firmly established in Vietnam’s economy. However, despite having gone through many rounds of reforms and receiving numerous incentives from the State, the SOEs in Vietnam remain a pampered, yet less competitive sector of the economy.

The Law on FDI was first promulgated in 1987 and later amended in 1990, 1992, 1996 and 2000. This law helped Vietnam to attract a large volume of foreign capital when domestic savings were not enough to meet investment needs. In 1987, the private sector virtually did not exist in Vietnam. By allowing foreign direct investment, Vietnam in effect imported/implanted the private sector for the first time after the unification of the country. Since then, FDI has indeed become an integrated part of the Vietnamese economy and an important factor in Vietnam’s economic growth during the 1990s. In order to create a more level playing field and to ensure that its laws allowed for national treatment for FDI enterprises prior to Vietnam’s 2006 accession to the World Trade Organization, Vietnam promulgated, in 2006, two important laws, the Investment Law and the new Enterprise Law,\(^1\) creating

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1. Specifically, on November 29, 2005, the National Assembly of Vietnam adopted the Law on Investment No. 59/2005/QH11 (“New LOI”) and Law on Enterprises No. 60/2005/QH11 (“New LOE”) which applies to all enterprises established by domestic and/or foreign investors.
a corporate law regime that applies to both foreign and domestic enterprises.¹

In 2006, of the three economic sectors, the state sector was still the most important source of investment in the country. State investment is made either directly into public infrastructure or through loans to SOEs, or in the form of grants to municipalities and private enterprises. But the state’s share in investment has declined from 60 percent in 2001, to 29 percent in 2008 as private domestic investment increases and the inflow of foreign direct investment (FDI) increases. The recent decline in the state’s share is due more to the increased private investment than to new inflows of foreign investment. The domestic non-state sector recorded a continuous upward trend as a significant source of investment. Private sector investment has increased from 27.6 percent in 1995 to 40 percent by 2008.² Both continued with state involvement, and increased savings and investments by Vietnam’s private sector have contributed to continuing high rates of economic growth.

During the 1990s and early 2000s, FDI’s share of total investment declined somewhat. FDI accounted for 30 percent of investment in the mid-1990s, but fell to 20 percent in the wake of the Asian Financial Crisis. Since then, the share of FDI in total investment kept falling until 2006. Very recently, new large FDI inflows have been recorded, in part as a result of reforms committed to as part of WTO accession that relaxed rules restricting FDI and hence making Vietnam a more attractive FDI destination. In 2007 and 2008, FDI became the most important source of investment.

¹. Besides FDI, Vietnam also started to receive ODA from international donors since 1993 and the amount committed and disbursed has been increasing since then. These capital sources contributed to infrastructural construction such as transport and communication, information, agricultural and rural development, public health, education and training, administrative reform, legislation, and structural reform.

². Jensen and Tarp (2006) point out that private savings to fund private sector investment comes as much from retained earnings of firms as from savings by households. Reinvestment of corporate profits appears to be an important mechanism to maintain high rates of investment and growth.
investment. The sudden increases in the share of FDI during 2007-2008 can be partly explained by the WTO accession of Vietnam which created expectations among international investors about the good prospects of Vietnam.\(^1\) Although Vietnam has been successful in attracting FDI in recent years, the real benefits from FDI still seem controversial. Previous studies have found little evidence of technical spillover from FDI-related enterprises to local counterparts (Nguyen et al., 2008). In addition, the country has become heavily dependent on FDI as an important source of input to sustain economic growth.

**Sectoral Interventionist Policies**

The economic reform implemented by Vietnam has created a large and increasingly important non-state sector. The economic reform to transform its economy from a command economy to a market-based economy is characterized by its use of market-creating measures. However, since the inception of economic reform, Vietnam has also attempted a number of active interventionist policies toward selected industries. Examples include preferential treatment (i.e. tax holiday, reduced land rent etc.) toward FDI in some sectors which later have also been extended to the domestic private sectors (i.e. industrial zones). However, the results are mixed. For the motor bike industry, the government has been successful with its policy of imposing local content and the motor bike sector of Vietnam has been gaining some regional prominence. The success of the industry is in large part due to Vietnam’s large domestic market. However, for the automobile sector, it can be characterized as a failed industrial policy attempt. Given its small domestic market, the government granted investment licenses to11 car-makers. As a result, the local content policy for the automobile companies has not been successful.

**Other Policies: Education, Innovation, Science and Technology**

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1. Vietnam requires registration of intended FDI, and not all of those registrations are implemented.
Industrial policy and trade policy are not stand-alone policies (Valila, 2009). They have to interact with other policies being formulated and implemented. How do these policies interact with each other and how do they influence the possibility of attaining industrial policy objectives? For industrialization to be realized, at least two other policies, namely; education policy and Science and Technology (S&T) policy have to play important roles. Although there has been great improvement during the last 10 years, the S&T and education policies have not yet contributed adequately to the success of Vietnam's industrial policy. In order for industrial policy to be successful and for the industrial base to develop to the point that it can be self-sustained, Vietnam needs to have good domestic capacity to develop the industrial base. However, the investment by the country into R&D, innovation and higher education does not seem to complement other interventionist industrial policies and support the development of the industrial base. Although Vietnam has spent 2 percent of its state spending on science and technology equivalent to 0.5 percent of GDP since 2001, in absolute amount the figure is modest as compared to other countries. In particular, investment in R&D was nearly $400 million in 2007 only.¹ The non-state sector invests around another 0.1 percent of GDP in S&T thus increasing national investment in S&T to a total of 0.6 percent of GDP. To put these figures in perspective, the EU invests 1.95 percent of its GDP, Japan 3.15 percent, China 1.31 percent, the US 2.59 percent, and South Korea nearly 5 percent. In terms of capacity, Vietnam invests around US$5 (2007) per capita while China invests US$20 in 2004 and South Korea US$1,000 in 2007. In addition, this tiny amount of S&T investment is spread thinly among central and local government agencies. This would in turn render the S&T and innovation policies ineffective. To increase the investment for S&T activities, the government is looking to the private sector with the hope that the ratio of public to private investment in R&D would be 1:2 by 2010. However, due to its public nature and risks associated with S&T policies and investment, it would be difficult to achieve this target.

¹ http://english.vietnamnet.vn/reports/2008/11/811926/
Table 4.9: Composition of Graduates from Vietnam’s Higher Education System

<table>
<thead>
<tr>
<th>Year</th>
<th>2005</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Graduates in general programmes (%)</td>
<td>2.99</td>
<td>3.36</td>
<td>3.60</td>
</tr>
<tr>
<td>Graduates in education (%)</td>
<td>34.18</td>
<td>37.22</td>
<td>33.22</td>
</tr>
<tr>
<td>Graduates in humanities and arts (%)</td>
<td>4.34</td>
<td>3.22</td>
<td>3.93</td>
</tr>
<tr>
<td>Graduates in social sciences, business and law (%)</td>
<td>29.71</td>
<td>27.64</td>
<td>27.29</td>
</tr>
<tr>
<td>Graduates in science (%)</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>Graduates in engineering, manufacturing and construction (%)</td>
<td>21.25</td>
<td>20.46</td>
<td>19.76</td>
</tr>
<tr>
<td>Graduates in agriculture (%)</td>
<td>4.78</td>
<td>4.86</td>
<td>5.02</td>
</tr>
<tr>
<td>Graduates in health and welfare</td>
<td>2.74</td>
<td>3.24</td>
<td>3.19</td>
</tr>
<tr>
<td>Graduates in services</td>
<td>0.00</td>
<td>0.00</td>
<td>3.99</td>
</tr>
<tr>
<td>Total graduates in all programmes</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: UNESCO

Table 4.9 shows the structure of Vietnam’s recent higher education graduates. As can be seen, the number of graduates in engineering accounts only for 20 percent of total graduates, which is much lower when reference is made to the remarkable number of graduates in Singapore when the country was industrializing. A large number of graduates are from the social sciences and business studies. This structure to some extent reflects the current incentives/enumeration between sectors of the economy. As such the structure does not seem to fit with the purpose of promoting and developing the industrial base for the country.

4.3.4 Lessons from the East Asian Policy Experience

The experience of high and equitable growth in East Asia has been the topic of extensive research during the last few decades. One of the most hotly debated questions in the economic
literature is the exact nature of government intervention in East Asia. Following the influential World Bank report The East Asian Miracle in 1993, there has been general agreement that governments intervened extensively in most East Asian economies, with the exception of Hong Kong. Still, heated debate exists over the exact nature of the contribution of industrial policy to growth in East Asia and the desirability of following similar policies particularly in developing countries. The goal in this section is to make sense of what is relevant to the current challenges faced by Vietnam in light of the East Asian experience, and to evaluate if and which of the industrial policies should be recommended.

The economic literature points out that the experience of the East Asian is very diverse. The selection and implementation of policies varied enormously and was highly dependent of the conditions facing each country. However, there is a general consensus about the ability of the most successful East Asian countries to get the fundamentals right. In particular, the World Bank’s East Asian Miracle report in 1993 acknowledged the important role played by governments in Japan, Korea, Taiwan and other Asian economies, not only by getting the fundamentals right, but also through active interventions to promote exports and encourage savings and investment. With some exceptions, they enjoyed macroeconomic stability, promoted education at all levels, invested heavily in infrastructure, and possessed good institutions and civil services committed to development, and oriented toward export sectors. Indeed, government intervention played an important role in mobilizing savings, promoting exports or creating a skilled workforce. The political context made it possible for governments to play such an extensive role, while keeping pressure on them to focus on development and thus build legitimacy. Efforts to promote industrial sectors, without having the fundamentals in place have been unsuccessful (for example, in the Philippines). Governments intervened extensively, but in a “market friendly” way, avoiding major distortions. However, it is hard to find conclusive evidence that the promotion of specific sectors contributed to
growth. The World Bank report and other studies did not find a direct link between selective promotion of individual sectors and productivity-based growth. With a few exceptions, there is no clear evidence that selective promotion of specific was the main driver for growth in East Asia. Where selective policies worked, governments attached discipline to the incentives in order to monitor performance and retired support to firms to firms that did not meet the goals – something that was lacking in the Latin American development experience. Also, East Asian governments showed pragmatism and modified policies, compared to other countries where the direct public support to firms has been more persistent and difficult to dismantle.

Policies have also evolved over time, as the domestic and international context changed. There are a number of notable developments recently. First, East Asian countries have interestingly liberalized their economies, lowered their trade barriers, and changed their regulations to promote competition and a more efficient use of resources. Currently, governments are more focused on creating a good investment climate for private firms. Secondly, the paradigm of industrial policy has also evolved. The emphasis is less on direct government selection of promising sectors, and more on the use of indirect mechanisms to promote technological upgrading, by means of attracting FDI and developing local technological capabilities. Third, the world’s production and trade patterns have changed. As global

1. It should be noted that East Asia was not the only region in which governments intervened with the goal of promoting industrialization and growth. In 20th century, Latin America and in some countries such as Brazil at the end of the 70s pursued a similar strategy. However, as the pace of technological change accelerated Latin American countries were not able to adapt fast enough. Several reasons exists to explain the difference between Latin America and East Asia: poor macroeconomic management, falling investment in education at all levels, technology policies that failed to create incentives in firms to innovate, and the lack of discipline in government support to firms. The East Asian Miracle ultimately recommended the path followed by Thailand, Malaysia and Indonesia that relied more on FDI and less on directed credit, as a suitable model for developing countries.
integration increases it becomes more difficult for governments to predict the best sectors of an economy for which a country can produce with relative advantage. As an example, the initial success of the software industry in India was facilitated in part by the easing of government intervention. New production patterns put governments willing to promote individual sectors in a difficult position. This is true even for sectors with simpler technologies, such as apparel, as production chains become increasingly dispersed and the most labor-intensive tasks are rapidly relocated based on trade preferences. The fast-paced technological change and knowledge flows around the world also present advantages and disadvantages for developing countries. Countries can gain better access to technologies, but they also have to compete with each other for access to markets, technologies and investment.

In order to assist policy makers and researchers to assess Vietnam’s current industrial policy in comparison with policies adopted by other East Asian countries during their implementation of industrial policies, we compile various industrial policy measures and compare them in Table 4.10. As can be seen, although there are some selective industrial policies, Vietnam does not seem to have a coherent set of policy to develop the industrial sector.

**Table 4.10: Comparing Vietnam’s Industrial Policy with East Asian Miracle Countries**

<table>
<thead>
<tr>
<th>East Asia Miracle Countries</th>
<th>Vietnam</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Fundamental Characteristics and Policies</strong></td>
<td></td>
</tr>
<tr>
<td>High investment rates/ high saving and investment rates</td>
<td>High investment but low saving</td>
</tr>
<tr>
<td>Responsible tax and expenditure policies – no large deficits leading to inflation.</td>
<td>Large budget deficit and current account deficit</td>
</tr>
<tr>
<td>Stable macroeconomic environment/ Macroeconomic stability - Free from high inflation or major economic slumps</td>
<td>Bumpy economic development – inflation and slump in the last few years</td>
</tr>
<tr>
<td>Realistic exchange rate policy to ensure that it was profitable to export</td>
<td>Fixed and unrealistic exchange rate for promoting export</td>
</tr>
<tr>
<td>Limited price distortions</td>
<td>Price control on some commodities</td>
</tr>
<tr>
<td>Agricultural development</td>
<td>Promotes agricultural development, but requires significant improvement</td>
</tr>
<tr>
<td>High share of trade in GDP</td>
<td>Similar</td>
</tr>
<tr>
<td>Stable and secure financial systems</td>
<td>Developed financial system is yet to be developed</td>
</tr>
<tr>
<td>Improved education/ high investments in human capital</td>
<td>Not really – big problem in higher education and vocational training system</td>
</tr>
<tr>
<td>Policies to obtain maximum benefit from investment and education</td>
<td>Unclear</td>
</tr>
<tr>
<td>Openness to foreign technology /encouragement of technological borrowing - technology licensing - Japan, Korea, Taiwan (China)</td>
<td>Mixed</td>
</tr>
<tr>
<td>Emphasis on exporting which provided a spur to productivity enhancing efforts including:</td>
<td>Similar</td>
</tr>
<tr>
<td>Direct Foreign Investment – Singapore – model for Special Economic Zones in China.</td>
<td>Limited evidence of spillover effects</td>
</tr>
<tr>
<td></td>
<td>Distorted model of economic zones into industrial zones in Vietnam (Vo Dai Luoc)</td>
</tr>
<tr>
<td>Imports of equipment and intermediates embodying new technology</td>
<td>Similar, but luxury consumption imports</td>
</tr>
<tr>
<td>Knowledge transfers from purchasers of exports</td>
<td>Similar, but limited</td>
</tr>
</tbody>
</table>

| Specific Policies |  |
| Mild financial repression | Absent |
| Export-push trade policies | Available, but liberalized to fast and limited domestic market protection |
| Selective industrial promotion | YES - but … |
| Directed credit | Available, but to the benefit of SOEs |

Complied by authors
PART II – LARGE ECONOMIC GROUPS

4.4 Large Economic Groups and Industrial Policy

A long-time industrial policy objective in Vietnam has been to build up internationally competitive conglomerates (i.e. large corporations and large economic groups) to be the flag-carriers/national champions of the Vietnam’s economy. In Vietnam, economic and business groups come in all forms and types, including state-owned and private ones. The questions relating to large economic groups, especially the state-owned groups are drawing increasing attention after the near-collapse of one of the biggest state-owned economic groups in Vietnam – Vinashin, the biggest shipbuilder and a large economic group. This section investigates whether large economic groups, especially state-owned large economic groups could be used as an effective tool to implement industrial policy for national economic development. This is because if Vietnam is willing to let the market to run its course, it may take too long for the industrial base to develop and catch up with other countries. Thus, large economic groups in general and large SOEs may be used in a strategic sense to meet a strategic target.

Traditionally in economic literature, business groups are generally considered economically inefficient. However, recent research has provided a new understanding of the importance

\[1\] 'Large Economic Group' is a word for word translation from Vietnamese into English. In the literature, this form of organization is commonly known as business group. In this chapter, large economic group and business group are used interchangeably. In 1994, the Prime Minister issued Decision 90/TTg and Decision 91/TTg, to group about half of the SOEs under a number of large-size umbrella companies known as General Corporations (GC). Decision 90 (issued on March 7, 1994) created 76 GCs, usually called GC90, each with at least 5 voluntary members and minimum legal capital of VND100bn, and Decision 91 called for much larger corporations with at least 7 SOEs members and a minimum capital of VND1000bn, resulted in only 17 GCs, which are called GC91. All 17 GC91 and 76 GC90 combined have a total members of 1,392 SOEs, accounting for 24 of all SOEs in terms of number and 66 and 55 in terms of capital and employees, respectively.
of this organizational form (Ghemawat and Khanna, 1998; Granovetter, 1994; Guillen, 2000; Khanna and Palepu, 1997). These studies suggest that business groups act as substitutes for imperfect capital, labor, and product markets in many countries, thereby enjoying competitive advantages that are not available to independent firms (Leff, 1978). These groups have typically been viewed through a transaction cost economics perspective where they are perceived as responses to inefficiencies in the market. Moreover, the recent literature on Chinese business groups is also reviewed here to shed light on the issues relevant for Vietnam.

4.4.1 A Snapshot of Vietnam’s Large Economic Groups

Defining Large Economic Groups in Vietnam

Defining a business group is not a simple task since group definition varies substantially across countries (Khanna, 2000). As pointed out by Chang (2002), the exact features of business groups differ from one country to another because of distinct economic, social, and cultural environments. However, they have important similarities, and the most notable is that “business groups pursue unrelated diversification under centralized control”.¹ In most countries, group membership is typically informal and Chile is one of the few countries in which groups are legally defined entities (Khanna and Palepu, 1999). There are a number of business group definitions in the literature. Leff (1978)

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¹ Khanna and Yafeh (2005) describe several types of business groups. “In some, equity ties play a central role: among these, there are vertically-controlled groups (“pyramids”), and there are horizontally-linked groups, where cross shareholdings are important. In other business groups, in addition to formal (for example, equity) ties, informal ties are important: group firms can be related to each other through family and social ties, a common sense of identity, trade relations, and other dimensions. In certain countries, business groups are a politically important force; in others less so. And some groups are deeply involved in banking and financial services, whereas others are not. Nevertheless, operation across a large number of (often unrelated) industries (diversification), and family ownership combined with varying degrees of participation by outside investors are common characteristics of many business groups around the world.”
refers to a business groups as “a group of companies that does business in different markets under a common administrative or financial control” and states that group members are “linked by relations of interpersonal trust, on the basis of a similar personal, ethnic or commercial background”. Granovetter (1994) defines a business group as “a collection of firms bound together in some formal and/or informal ways”. Khanna and Rivkin (2001) state that a business group is a “set of firms which, though legally independent, are bound together by a constellation of formal and informal ties and are accustomed to taking coordinated action.” There are still other definitions of a business group in country-specific studies.

Defining large economic groups or business groups in Vietnam is even more difficult due to the existence of both state-owned and large private economic groups. In Vietnam, there are two kinds of business group: (i) State-owned economic group; and (ii) private economic group. At the moment, the state-owned economic group is officially defined by law. According to the current laws and regulations, state-owned economic groups will be established according to the Decree No. 101/2009/NĐ-CP on the pilot implementation of establishment of economic group, dated 5 November 2009, a state-owned economic group is a large-scale group of companies associated with each other under the parent-affiliate structure, creating a consortium of enterprises bonded by economic, technology, market and other business services (Article 4.1).

As at June 2010, there are 12 large state-owned economic groups and 11 large state-owned corporations.¹ Most of the 12 state-owned economic groups are established from large state-owned corporations. The structure of the state-owned economic groups is mostly of a parent-affiliate structure with a 100 percent state-owned parent company and a number of affiliate firms. The ownership of affiliate firms may vary and the parent company in

many cases owned up to 100 percent equity. In contrast to the state-owned economic group, the laws and regulations on the legal form and establishment of private economic group have not yet been issued although private economic groups may/do exist informally or are under the process of formation and this is consistent with natural progression and international practices.\(^1\) Besides the state-owned large economic groups, recently there has been the emergence of large private economic groups such as Viet-A; Sunfat, Hoa Phat, and Nam Cuong.Dong Tam, FPT, Hoanh Anh Gia Lai, Kinh Do, Hoang Long, and T&T.\(^2\)

**Large Economic Groups: Origin and Economic Power in Vietnam**

The concept of economic group is new to Vietnam. The first reference to the concept of economic group was in the Enterprise Law which came into effect in 2006. However, the definition of such an economic organization was only vaguely defined.\(^3\) Only with the Decree No. 101/2009/NĐ-CP issued by the government on the pilot implementation of establishment of state-owned economic groups, dated 5 November 2009, did the concept of state-owned economic groups become clearer. Still, it leaves the concept of private economic groups undefined. To fully understand the evolution of the state-owned economic groups in Vietnam it is necessary to relate it to the course of state-owned enterprise reform.

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Like the SOE sectors in other former socialist countries, the SOEs in Vietnam are often associated with inefficiency, corruption, and unfair competition against the private sector. In Vietnam, SOEs are being given many advantages and preferential treatment as compared to private enterprises in terms of access to credit, land use rights, trade protection, etc. Despite these advantages, their performance has been disappointing.\(^1\) Attempts to reform Vietnam’s state-owned enterprise sector, i.e. equitizing state-owned enterprises — or converting them into joint stock/limited liability companies, began as early as mid-1992, but progress was very slow.\(^2\) According to the latest data from the Ministry of Finance (MOF), as of 31 December 2009, 5112 SOEs had been converted/equitized. By 2010, the Government has plans to convert the remaining 1,500 SOEs, of which 948 are proposed for equitization. The equitization process of Vietnam is characterized by slow progress as is evident in Table 4.11 and by July 2010 Vietnam would not meet the target that it set for itself. Most of the SOEs equitized up to 2006 were small, with 46 percent having capital of less than VND5 billion, though the size increased marginally over time. The state has often retained a share of more than 50 percent in equitized SOEs.\(^3\)

\(^1\) Their failures were attributed to such factors as the lack of management autonomy and entrepreneurship (director or managers of SOEs typically behave as bureaucrats rather than entrepreneurs), soft budget constraints, self-sufficiency and also in many cases, the lack of competition. Reform of SOEs became essential (Tran Van Tho 2002).

\(^2\) After 5 years of reform by the end of 1997, only 17 enterprises had been equitized.

\(^3\) Different from the equitization in China, there are few outside investors in Vietnam’s equitized SOEs. Early equitization was primarily internal, with employees acquiring more than half the shares in the equitized SOE. The government and employees together held almost 80% of the shares. Very few outsiders such as strategic investors were involved. Over time, the stake of employees declined modestly while that of company outsiders increased, reflecting in part the introduction of Decree 187 in 2004, which required equitized SOEs to auction shares to the public.
Table 4.11: State-owned Enterprise Conversions, Cumulative and Planned, 2007–2010

<table>
<thead>
<tr>
<th>Item</th>
<th>SOEs converted</th>
<th>Of which equitized</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cumulative until 31 December 2007</td>
<td>4,979</td>
<td>3,369</td>
</tr>
<tr>
<td>Year 2005</td>
<td></td>
<td>724</td>
</tr>
<tr>
<td>Year 2006</td>
<td></td>
<td>640</td>
</tr>
<tr>
<td>Year 2007</td>
<td></td>
<td>150</td>
</tr>
<tr>
<td>Planned 2008–2010</td>
<td>1,535</td>
<td>948</td>
</tr>
<tr>
<td>Year 2008</td>
<td></td>
<td>73</td>
</tr>
<tr>
<td>Year 2009</td>
<td></td>
<td>60</td>
</tr>
<tr>
<td>Remaining to be converted/equitized until July 2010</td>
<td>1500 including 8 large economic groups and 80 state general corporation</td>
<td></td>
</tr>
</tbody>
</table>

Sources: Ministry of Finance, Government of Vietnam, 2008 and various public media sources.

In response to the slow progress in reforming the SOE sector, the government started to establish large state-owned economic groups in an attempt to speed up and revitalize the momentum of the state-owned enterprise reform. The state-owned economic groups are sometime considered as a new bottle for an old wine of large corporations 90 and 91. These corporations were established in 1990 and 1991 as a measure to reform the SOE sector and often referred to as corporations 90 and corporations 91.¹

In East Asia, business groups are playing important roles in the national economy. The top 30 business groups accounted for 40 percent of Korea’s output in the mining and manufacturing

¹. See http://www.vnn.vn/kinhte/2005/06/460353/
sectors and 14 percent of GNP in 1996. Similarly, business groups that were listed on the stock exchange accounted for the following exchanges in total market capitalization in 2002; 24.3 percent in Thailand, 24.9 percent in Malaysia, 39.6 percent in Singapore and 56.2 percent in Taiwan (Chang, 2002). A natural question to ask in Vietnam is the importance of economic groups for the national economy. Unfortunately, there is no systematic data on the economic groups in Vietnam. As such, this section draws on the available data to sketch a picture about Vietnam’s SOE sectors and the large economic groups.

As can be seen in Table 4.12, the number of SOEs has decreased markedly. Since 2000 the SOE sector has seen its significance reduced in both absolute and relative terms. In 2000, the SOEs account for 13.6 percent of the total number of enterprises. In 2007, this figure dropped to merely 2.2 percent. Since 1998, a series of reforms, including small SOE privatization, liquidation of insolvent companies and equitization, has contributed to this reduction.

**Table 4.12: Vietnam Enterprises by Ownership during 2000-2007**

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of enterprise</td>
<td>42288</td>
<td>51680</td>
<td>62908</td>
<td>72012</td>
<td>91756</td>
<td>112950</td>
<td>131318</td>
<td>155771</td>
</tr>
<tr>
<td>State owned enterprise</td>
<td>5759</td>
<td>5355</td>
<td>5363</td>
<td>4845</td>
<td>4597</td>
<td>4086</td>
<td>3706</td>
<td>3494</td>
</tr>
<tr>
<td>Non State owned enterprise</td>
<td>35004</td>
<td>44314</td>
<td>55237</td>
<td>64526</td>
<td>84003</td>
<td>105167</td>
<td>123392</td>
<td>147316</td>
</tr>
<tr>
<td>FDI</td>
<td>1525</td>
<td>2011</td>
<td>2308</td>
<td>2641</td>
<td>3156</td>
<td>3697</td>
<td>4220</td>
<td>4961</td>
</tr>
</tbody>
</table>

<p>| | | | | | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of enterprise</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>State owned enterprise</td>
<td>13.6</td>
<td>10.4</td>
<td>8.5</td>
<td>6.7</td>
<td>5.0</td>
<td>3.6</td>
<td>2.8</td>
<td>2.2</td>
</tr>
</tbody>
</table>
The reduction in number of enterprises is also reflected in the decreasing share of the state-owned sectors in industrial output (Figure 4.5). By 2007, the SOEs still account for around 20 percent of total industrial output. This reflects the concentration of economic power in the hand of SOEs, i.e. only 2.2 percent of enterprises accounting for 20 percent of total industrial output.

**Figure 4.6:** Shares of Industrial Output by Ownership

Tables 4.13 and 4.14 highlight further the concentration of economic power in a few SOEs. As indicated by Tables 4.12 and 4.13, the SOEs account for 38 percent of the largest 889 enterprises in terms of capital (with registered capital more than VND500 billion) and 86 enterprises in terms of the number of employees (over 5000 employees). Figure 4.6 indicates that among the 200 largest firms in Vietnam, 122 are SOEs of which 19 are economic groups.
### Table 4.13: Distribution of Enterprises by capital and ownership 2007

<table>
<thead>
<tr>
<th>Capital (VND billion)</th>
<th>Total</th>
<th>&lt;0.5</th>
<th>0.5-1.0</th>
<th>1-5</th>
<th>5-10</th>
<th>10-50</th>
<th>50-200</th>
<th>200-500</th>
<th>Over 500</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of enterprises</td>
<td>155771</td>
<td>18646</td>
<td>23631</td>
<td>72342</td>
<td>17269</td>
<td>16353</td>
<td>5286</td>
<td>1355</td>
<td>889</td>
</tr>
<tr>
<td>State-owned enterprises %</td>
<td>2.2</td>
<td>0.1</td>
<td>0.1</td>
<td>0.4</td>
<td>1.9</td>
<td>6.6</td>
<td>18.8</td>
<td>32.3</td>
<td>38.0</td>
</tr>
<tr>
<td>Non-State-owned enterprises %</td>
<td>94.6</td>
<td>99.2</td>
<td>99.4</td>
<td>98.7</td>
<td>94.9</td>
<td>82.8</td>
<td>59.5</td>
<td>41.8</td>
<td>33.0</td>
</tr>
<tr>
<td>FDI %</td>
<td>3.2</td>
<td>0.7</td>
<td>0.5</td>
<td>0.9</td>
<td>3.2</td>
<td>10.6</td>
<td>21.7</td>
<td>25.9</td>
<td>29.0</td>
</tr>
</tbody>
</table>

*Source: GSO statistical data, various years*

### Table 4.14: Distribution of Enterprises by Number of Employees and Ownership 2007

<table>
<thead>
<tr>
<th>No. of Employees</th>
<th>Total</th>
<th>Under 5 employees</th>
<th>9-May</th>
<th>Oct-49</th>
<th>50-199</th>
<th>200-299</th>
<th>300-499</th>
<th>500-999</th>
<th>1000-4999</th>
<th>over 5000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of enterprise</td>
<td>155,771</td>
<td>34,856</td>
<td>51,041</td>
<td>50,588</td>
<td>13,333</td>
<td>1,962</td>
<td>1,694</td>
<td>1,283</td>
<td>928</td>
<td>86</td>
</tr>
<tr>
<td>State-owned enterprise %</td>
<td>2.2</td>
<td>0.0</td>
<td>0.1</td>
<td>1.2</td>
<td>9.4</td>
<td>20.6</td>
<td>25.9</td>
<td>27.8</td>
<td>34.7</td>
<td>43.0</td>
</tr>
<tr>
<td>Non-State-owned enterprise %</td>
<td>94.6</td>
<td>99.4</td>
<td>99.3</td>
<td>95.9</td>
<td>79.1</td>
<td>60.0</td>
<td>51.4</td>
<td>43.5</td>
<td>31.3</td>
<td>14.0</td>
</tr>
<tr>
<td>FDI %</td>
<td>3.2</td>
<td>0.5</td>
<td>0.6</td>
<td>2.8</td>
<td>11.5</td>
<td>19.3</td>
<td>22.8</td>
<td>28.7</td>
<td>34.1</td>
<td>43.0</td>
</tr>
</tbody>
</table>

*Source: GSO statistical data, various years*
Vietnam’s Economic Groups in Comparison with other Countries

Business groups exist throughout the world; we can find conglomerates in the West, “keiretsu” in Japan, Chaebol in Korea, “grupos economicos” in South American countries, and “business houses” in India. Business groups also emerged in the former socialist European countries as a result of rapid privatization of state-owned enterprises (Khanna and Yafeh, 2005). In this section we compare Vietnam’s large economic groups with groups in other countries, especially in Korea and China. In Vietnam it has been argued that the Vietnamese government has admired the success of Chaebol in Korea’s economic development and recently looked to China’s large business groups and national champion as a role model for Vietnam economic group. A key feature of China’s SOE reform is the state’s firm grip on large-scale, state-owned enterprises (SOEs). Similarly, Vietnam’s intention is to develop

1. It would be safe to state that Vietnam would imitate policy actions by Chinese government.

http://www.soas.ac.uk/economics/research/workingpapers/file28835.pdf
large economic groups in order for the Party and the Government to control and lead the economy toward socialism. In particular, the Party, the State and the Government make it clear that the state-owned economic sector will play a leading and dominant role in the economy. Therefore, it is of great value to investigate the development of large Chinese SOEs.

Korea’s Experience with Chaebols

As discussed in Lee (1997), Chaebols are the large, conglomerate family-controlled firms of South Korea characterized by strong ties with government agencies. These government-favored Chaebols had enjoyed special privileges and grew large. By 1996, the 30 largest Chaebols accounted for 40 percent of Korea’s total output (Ungson, Steers and Park, 1997). ¹ A question that needs to be addressed is how the Chaebols grew large and how the Korean government used these Chaebols for its industrialization purposes? In the early phase of Korean economic development, Chaebols were used as an effective tool for economic development due to their ability to transfer and share financial resources, human resources, and management know-how across subsidiaries when external markets were poorly developed. Industrialization in Korea started with the launching of the first five-year economic development plan in 1962. Lacking adequate resources, experience, and market institutions, the government opted to seek rapid growth by pursuing initiatives to jump-start the industrialization process. The government

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2. Chaebol refers to business association. There were family-owned enterprises in Korea in the period before 1961 but the particular state-corporate alliance came into being with the regime of Park Chung Hee (1961-1979). From being small/medium size firms which were founded by indigenous entrepreneurs during the Japanese colonial period, Chaebols have grown rapidly with the strategic support of the state, bestowed in the course of an unprecedented economic development and the export-oriented industrialization policy adopted by Park Chung Hee (1961-1979) regime. Leading Chaebols, such as Samsung, Hyundai, LG, and Daewoo, had over 80 affiliated companies each participating in a wide range of industries, including semiconductors, consumer electronics, construction, shipbuilding, automobiles, trading, and financial services. Like many other business groups around the world, each Chaebol owned a complete complement of companies spanning many industries.
designated “strategic sectors” for the concentration of scarce resources. Firms that diversified into strategic sectors in response to the government’s initiative could readily secure funds, diversify and renew their business portfolios, and emerge as Chaebols (Korea Economic Research Institute, 1995). On the Chaebols’ side, in the early period of development, Chaebols took advantage of the abundance of new business opportunities while exploiting their ability to overcome factor market imperfections through internal markets. In the early period of industrialization with abundant new business opportunities, the basis of competition was the ability to overcome factor market imperfections. With internal markets for capital, labor, and intermediate products, business groups were able to organize necessary resources and seize new market opportunities rapidly.

By successfully transforming from exporters of cheap products to major global players in the past two decades, Chaebols have been regarded as drivers behind the unprecedented success of the Korean economy (Amsden, 1989; Chang and Hong, 2000). However, the perception of such large and diverse business groups has changed quite dramatically in the more recent period. Since the Asian Financial Crisis in 1997, Chaebols in Korea have been described as excessively diversified and poorly managed organizations and accordingly, seen as globally non-competitive.

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1. The government of South Korea also used many measures to protect its domestic market from foreign competition. Only until the 1980s when the domestic heavy industries experienced serious financial problems, which invoked skepticism about the government’s capability of leading economic development and under the pressure by major trading partners to liberalize its market, cut import tariff and reduce the government’s support to industry sectors; the South Korean government shifted the government’s role from a “development” to a “regulatory” approach.

2. It is safe to argue in some cases that Chaebols grew not because they were profitable but merely because they could borrow vast funds as the government used preferential loans with low interest rates as an inducement for companies to invest in strategic sectors. Such loans had been the dominant source of capital for companies. For instance, government policy loans to these strategic sectors accounted for 63 percent of total bank loans and constituted a majority of the investments in heavy industries (Kim, 1997).
As a result, some scholars argued for the break-up of Chaebols to improve national competitiveness. The government forced many Chaebols to restructure their business portfolios. In fact, the 1997 Financial Crisis has brought vast changes to many Chaebols. Of the largest 30 Chaebols in 1996, about half of them have gone through bankruptcy proceedings or bank-sponsored restructuring programs. Some Chaebols have also voluntarily taken their own restructuring efforts, often on a large scale.

*Chinese Policy towards Large State-owned Enterprises*

Like Vietnam, state-owned enterprises (SOEs) played an important role in the economy of China. The reform of state-owned enterprises occurred contemporaneously with the rapid growth of the Chinese economy and contributed to raise the overall competitiveness of the Chinese economy. This reform brought about a drastic change in China’s corporate structure, with the weight of SOEs in the Chinese economy declining. In its move towards privatization, the state had a specific interest in the development of large companies and the creation of business conglomerates. At the 5th Plenary Session of the 14th Central Committee of the Communist Party in 1995, China adopted the “Zhuada Fangxiao” policy which means “keep the large and let the small go.” This policy aimed for the full privatization of small companies, which comprise the majority, and the transformation of mid- and large-sized SOEs (via structural reform) into public limited companies, with the state only playing the role of shareholder. China also formulated a blueprint aimed at advancing three to five Chinese SOEs into the world’s top 500 rankings by 2000. China also made a concerted effort to cultivate its own business conglomerates. By

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1. Within the industrial sector, the share of SOEs in the total number of companies stood at 6.1% in 2007, a sharp decline from 39.2% in 1998, with its share in total employment plunging to 22.1% in 2007 from 56.1% in 1998. In contrast, total assets of SOEs registered a relatively mild decline to 44.8% in 2007 from 68.8% in 1998, indicating that SOEs still play a major role in the industrial sector. In terms of total output, SOEs saw their share fall to 29.5% in 2007 from 49.6% in 1998, indicating that SOE reform has not yet been completed with high shares of output.
benchmarking the industrial policies of Japan and Korea and their highly efficient and competitive business groups, China aimed at creating “National Champion” companies that could compare favorably with their rivals in Korea and Japan. This brought about vertical integration throughout major industries, which had also occurred in Japan and Korea. Mergers proved to be an effective way of fostering these business groups. In 1997 alone, as many as 3,000 firms were merged, and 15.5 billion Yuan worth of national assets were re-distributed. It was during this period that large-scale business groups were created through mergers in the areas of petrochemicals, steel and air transportation.¹

Comparison between Vietnam’s Economic Groups and Other Asian Counterparts

There are a number of differences and similarities between Vietnam’s economic groups and their counterparts in China and Korea. First, the control system of economic groups in Vietnam is different somewhat from that of Chaebols and similar to their Chinese cousins. In Korea, the Chaebols are controlled by founder families (Chung, 2004). While in Vietnam like China, the pyramid structure guarantees centralized control over the entire group.

Second, while the large business groups in other countries became formidable due to their innate competitiveness, the large

¹ In a recent paper published by the Wharton Business School in 2006 entitled “China: Reform from the Outside In”, the author described a recent wave of foreign purchase of equity in China’s biggest SOEs and has pointed out that by letting foreign ownership in Chinese SOEs, the Chinese Government intends to encourage foreign ownership to bring in new management approaches, better incentive systems, greater transparency, and a whole new level of corporate governance. The article points out the large foreign reserve by the Chinese government as evidence that the Chinese does not need investment capital. Rather, what they are after is ‘business expertise’, with a primary intention to move state-owned firms to sound commercial footing. By making the SOEs become a shareholding company rather than a wholly state-owned enterprise, the Chinese government subjects them to Chinese securities law which require to install directors and corporate governance systems, which in turn helps to increase transparency and help companies become competitive in an open market.
economic groups in Vietnam were established mechanically through administrative fiat.

Third, while the ultimate goal of large business groups in other countries is to serve the interest of the shareholders by providing profit orientation, there is a confusion of goals and roles in the large economic groups in Vietnam.

4.4.2 Vietnam’s State-owned Large Economic Groups as Industrial Policy

Since the promulgation of the government plan to establish large state-owned economic groups using large corporations, the policy has been under public scrutiny. The rationale for establishing such large economic groups has been questioned from the very beginning.¹ More recently, with the near-collapse of one of the largest economic groups, the supposed Vietnam’s flagship shipbuilder VINASHIN, the problems of large economic groups have been hotly debated in Vietnam.² Despite the popular perception of the economic groups being problem-ridden, there is yet no conclusive verdict on the economic roles played by business groups around the world (Khanna and Yafeh, 2007). The value and the role of business groups depend on the institutional contexts in which they are embedded (Khanna and Rivkin, 2001). It is therefore useful to review the rationale, roles and dangers of large economic groups for national economic development and industrialization in Vietnam.

Market Failures and Institutional Voids

The existence of so many business groups around the world, especially in developing countries, points to the important role of large economic groups. Economic theory has it that the emergence and existence of business groups is due to the underdeveloped


². See http://vnr500.vietnamnet.vn/content.aspx?id=707
nature of the market mechanism in developing countries (see Leff, 1978; Goto, 1982). The theoretical literature attempts to explain why business groups would deviate from the norm of specialization in core competences. The market failure argument explains business groups as a logical response to technology borrowing and economies of scope, capital and managerial scarcity, and other kinds of informational and institutional voids (Amsden, 2001; Leff, 1978; Khanna and Palepu, 1997). According to Khanna and Palepu (1997), unlike developed countries where capital markets are efficient; labor markets are well functioning, and product markets are driven by reliable enforcement of liability laws, efficient flow of information and proactive consumers; developing countries are characterized by inefficient capital markets, lack of well-trained business people in the labor market, and lack of information and transactions-related institutions in the product market.

In contrast to the advanced countries where rule of law is enforced, in addition to a competitive environment relatively free of corruption, and a system of predictable contract enforcement; the governments in developing countries, including Vietnam, are highly bureaucratic and hence, intervene in business extensively. In such a situation, business groups can have superior access to capital markets and to internal labor and product markets. Vietnam is making its transition to the market economy only in the last 20 years, and market institutions are only emerging. In this context, the emergence of large economic/business groups (both private and state-owned) could be viewed as an appropriate response to inadequate market institutions. The internal markets (i.e. capital, labor and product) allow affiliate members of such business groups to overcome the market failures in developing countries.

In addition to the typical institutional voids identified above, there is a peculiar type of institutional void that exists in China and Vietnam (and other transition economies), the ownership void. Ma et al. (2006) argue that the ownership void exists due to the lack of unambiguously specified ownership of state-assets in transition economy. They argue that the role of business groups is
to facilitate economic reform and corporatization of state-owned enterprises. In China SOEs are owned by the State and hence, belong to all citizens. But in reality, these owners do not have the right to manage, control, use, transfer or sell the property. It is this particular situation that leads to an ownership void. Instead, these enterprises are run and managed by state agents who claim to act in the interest of the owners (citizens) but in many cases pursue their own private benefit at the expense of the owners. It is this ownership void that is the root cause for the widespread poor performance of SOEs in China (and also in Vietnam). Under this situation, the economic groups are created to fill the ownership void. These business groups are “created to serve as the second-order but direct owners of Chinese SOEs in the institutional transition and ownership transformation process” (Mat et al., 2006, p. 472).

*Large Economic Groups as a Device for Industrial Policy and Economic Catch-up*

Can large economic groups in general and state-owned groups in particular be developed for the purpose of national economic industrialization and catch-up? Despite its potential problems, economic/business groups in general can be used for economic catch-up, i.e. implementing industrial policy. The Korean case, discussed above, is a good example. When Korea started its industrialization in the early 1960s, it was evident that its growth potential was seriously constrained by limited financial resources. To overcome such constraints, it was a reasonable solution to pool the capital into just a few big businesses. In other words, the Korean government promoted a small number of big businesses to expedite economic growth. Therefore, the spectacular economic performance achieved in Korea has often been attributed to the growth of big business groups. More recently, it is China, another catching-up economy, that has been successful in promoting the development of the big business groups for national economic catch-up, while there bottom-up, the SME sector has also played an important role (Lee and Woo, 2002). For the case of China,
Keister (1998) is the first to conduct an in depth study to analyze how and why Chinese business groups were formed and what impact their formation has had on economic performance. She suggests that the formation of Chinese business group was a strategy of the government to reform SOEs and she described how the government actively encouraged the formation of business groups in China and protected them from competition.

How could state-owned economic groups be drivers of economic growth and development despite the popular perception that the larger the SOE sector the less efficient and dynamic they are? As pointed out by Chang (2007), there is no clear theoretical case either for or against SOEs – the performance of private sector firms will only be superior to SOEs only under restrictive condition as shown by the Sappington-Stiglitz fundamentals of privatization theorem and that the problems faced by large SOEs and large private enterprises are the same. There can be successful large SOEs as well as failures.1 In terms of real case evidence, there are evidences from East Asian and European countries2 that it is not simply that their SOE sectors are big, but they have been most dynamic, and have led the modernization of their industries. Taiwan has one of the largest public enterprise sectors in the non-oil-producing world. The Taiwanese SOEs were mostly in the upstream sectors producing intermediate inputs, and their efficiency has contributed to the competitiveness of the country’s downstream industries which use their products as inputs (Wade, 1990). The Taiwanese government also started some risky, high-technology SOEs and spun off private sector firms from them, with some of the leading semi-conductor firms in the country were created in this way. Examples of successful and efficient large

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1. The government can implement industrial policy through large SOEs in such cases as (i) natural monopoly; (ii) market failure (capital, labor); (iii) externality and (iv) equity. The reasons that may underscore SOEs failure include; free-rider problem, principle-agency problem, and soft-budget constraints.

2. According to Chang (2006) many of the countries which actively practiced industrial policies have used state-owned enterprises extensively. France, Austria, and Norway all had large SOE sectors
SOEs can be found in many countries around the world and in the region, i.e. POSCO, the steel producer in Korea, Singapore Airlines in Singapore, and Thai Airways in Thailand.

Problems Associated with Large Economic Groups for Vietnam

Agency problems and costs: Like any formal business, large economic groups have to deal with the agency problems. The agency cost here could be shareholder-manager agency costs, the debtor-manager agency costs, and employment agency costs. Depending on whether the economic group is privately owned or state-owned, the agency costs may vary. The agency problem arises when there is a separation between owners and managers of a business as the managers would seek to fulfill their own objectives rather than those of owners. This type of agency cost problem is inherent not only in state-owned large economic groups but also in private owned (including publicly owned) firms and business groups. In Vietnam, the public held business group is relatively few in number. For the state-owned large economic groups in Vietnam, they also suffer from the agency problem of separation between ownership and control. But the problem for state-owned group is even worse due to the ownership void briefly discussed above. The owners are citizens but the groups are controlled and run by politicians or managers appointed by politicians. As a result, state-owned large economic groups and corporations are charged with tasks such as macroeconomic stabilization that have little business value. And this complicates the issue of accountability.

3. Of course, this is not to suggest that an effective industrial policy regime requires a large SOE sector. Japan is an important exception to this pattern that proves this point. While Japan’s SOE sector is not exceptionally small, it is not very large either, and in manufacturing industries, the role of SOEs has been minimal.

http://www.tin247.com/thu_tuong_trieu_tap_lanh_dao_cac_tap_doan%2C_tong_cong_ty_nha_nuoc_ban_giai_phap_kiem_che_lam_phat-3-66307.html
Further, the separation of ownership and control may also lead to the pursuit of other objective such as empire-building rather than profit making, i.e. focusing on growth.¹

In addition, large economic groups are not disciplined by market forces because the politicians that run them have the power to regulate the industry, or the state-owned large economic groups that have political connections and power that allow them to ignore regulations. In Vietnam, this problem is even worse as many people have questioned whether the government agencies and ministries have any power over large economic groups.² Another problem associated with large state-owned economic groups is the soft budget constraint (Kornai, 1986).

Restructuring the State-owned Enterprises and Large Economic Groups – The Way Forward

The analysis and review of the literature above have shown that large economic groups could potentially play an important role for Vietnam’s economic development. However, evidence has also shown that using such large economic groups as an instrument for implementing industrial policy is not an easy task. The recent near-collapse of Vinashin highlights the potential risks, challenges, problems and costs associated with establishing, managing, controlling and using large economic groups. It also calls for a more systematic, more disciplined and more innovative approach in the governance of large economic groups. Although a systematic and comprehensive analysis is beyond the scope of this chapter, however attempts have been made to review the recent literature on state-owned corporate governance in China in order to shed some light on the problems that Vietnam is facing. A number of points are worth noting:

Khanna and Palepu (1999) point out that by simply dismantling the large and diversified large economic groups

¹. See http://vnexpress.net/GL/Kinh-doanh/2010/07/3BA1DF1E/.
in order to reduce the huge debt problem, reduce inefficiency, promote entrepreneurship, and to create more focus and efficient enterprises may not work due to the institutional void discussed above. Instead, these authors suggest a number of alternatives. At a more general level, they suggest building a market infrastructure, especially soft infrastructure. At a more specific level, they suggest reforming business practices – accountability and corporate governance.

4.5 Conclusions and Future Directions for Research
As pointed out earlier, Vietnam is now at the critical juncture of its economic development as the country moves from a low-income country to a lower-middle-income country. During the last few decades, the government has implemented many economic reforms successfully. However, the new global economic environment and the new middle income context pose the question if Vietnam could continue its current course of economic development and avoid the middle-income trap. This chapter closely examines the empirical concept of industrial policy and its relevance for Vietnam’s economic development. Review of relevant sources shows that Vietnam has not had a consistent and well-defined industrial policy/strategy. The last few decades of Vietnam’s economic development policy can be more characterized as market-development reform (including institution building measures) rather than selective interventionist policy of the Korean, Malaysia, Taiwan types, although the government did have some ad hoc interventionist policies. In the new global economic environment, Vietnam may not have all the selective industrial policies that were available to other countries. Instead, one of the very important tools for Vietnam to implement its industrial policy is the large economic groups, especially the large SOEs. However, they are a double-edged sword that can only be used effectively and safely in the hand of a good master.
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Chapter 5

SOME “DEVELOPMENTAL BREAKTHROUGHS” FOR THE COMING DECADE: FREE ECONOMIC ZONE (FEZ) MODEL AS INSTITUTIONAL INNOVATION EXPERIMENT IN VIETNAM

Bui Truong Giang

5.1 Conceptual Evolution of “Free Economic Zones” (FEZs)

The first Free Economic Zones (FEZs) were Free Ports (FP). These were established in the 16th Century, with the main function to serve the trade relations among nations. Until the mid-20th Century, most of the FEZs in the world were trade-related. In recent decades, FEZs have evolved into multi-functional economic zones, and more comprehensive ones have emerged since the 1990s. Those free zones or FEZs are the products of increasingly international and regional economic interactions. These FEZs, however, are defined geographically within a country, or between neighboring countries. Due to various FEZ modalities, particularly in terms of areas, scope and levels of ‘freedom’, it is pertinent that there is no single definition for an FEZ. But the most common feature is that a FEZ is a defined economic area with a more “liberal” environment for businesses and investment than in the rest of the economy. Meng (2003) has listed 66 terms to indicate free zones or special zones. “Special Economic Zone” is used to describe various functional and comprehensive FEZs in FIAS (2008). In this Chapter, the term “Free Economic Zone” or
FEZ is chosen to cover all types of free or special zones, unless otherwise specified.

5.1.1 The “Old” Concepts of FEZs

A variety of terminologies related to FEZs have been introduced since the 16th Century, with even greater diversity during the last four decades, such as the Free Port, Free City, Free Zone, Free Trade Zone, Free Enterprise Zone, and Export Processing Zone. The definition of a free zone by the World Customs Organization (WCO) in 1973 is contained in the 1999 Revised Kyoto Convention of the WCO, which defines a free zone as “part of the territory of a Contracting Party where any goods introduced are generally regarded, insofar as import duties and taxes are concerned, as being outside the Customs territory …..and not subject to the usual Customs control”.

According to Grubel (1984), a free economic zone is “a geographically defined area within which certain types of economic activities take place without some of the government taxation and regulation that applied to them in the rest of the economy”. This definition highlights the two key components of a FEZ, which are (a) a geographically defined area and (b) without some taxation and regulation.

In a study of FEZs in West Asia in 1995, the United Nations Economic and Social Committee for West Asia (UN-ESCWA) adopted the following definition: “Free Economic Zones are designated areas free of customs duties and import controls that provide and attractive environment for investment, technology, and promotion of exports and employment opportunities” (UNESCWA, 1995). This FEZ concept defines another type of free zone, in which the host governments does not apply special

consumption tax, customs duties or other restrictive measures to foreign trade and other economic activities between the zone and foreign territories.

The International Finance Corporation (IFC), in its report on special economic zones, defined SEZs as: “geographically delimited areas administered by a single body, offering certain incentives (generally duty-free importing and streamlined customs procedures, for instance) to businesses which physically locate within the zone”. (FIAS 2008, p. 2). Thus, the IFC has introduced a definition that covers almost all types of free zones which may be categorized as ‘old generation’ FEZs.

In Korea, the Incheon Free Economic Zone Authority (IFEZ) in the late 1990s defined Special Economic Zones (SEZs) “as specific geographical regions that have economic laws different from and more liberal than a country’s typical economic laws. The goal is usually an increase in foreign direct investment (FDI) in the country”.¹ This SEZ concept takes a narrow and specific approach. This is due to the fact that in the aftermath of the 1997-1999 Asian Financial Crisis, the Government of Korea recognized the need to attract new investment resources for post-crisis economic growth. The idea of a “special and free economic zone” was introduced into the Government’s strategic planning in order to enhance the attractiveness of the Korean economy to international investors.

For Russia, according to the 1993 Tax Code of the Russian Federation, “The free economic zone and free storehouse are tax regimes in which foreign goods are stowed and used within corresponding territorial borders or premises (sites) without levying of customs duties, taxes, as well as without application of measures of economic policy to goods mentioned, and the Russian goods are stowed and used on conditions, applied to export in accordance with the customs regime of export, in order defined by the Code” (Sberegaev 2005, pg.75). This definition of FEZ is closer

¹ See http://eng.ifez.go.kr/guide/org/special-economic-zone.asp.
to the concept of Export Processing Zone (EPZ) and compatible with the Special Economic Zone concept of the 1980s-1990s.

In Lithuania, the FEZ is defined as “a territory designed for economic and financial activity, where special economic and legal conditions of functioning set for economic subjects are in effect. No permanent residents can reside in this territory.”¹ Introduced in 1995, this definition reflects the traditional approach on FEZ establishment, which focuses on special privileges in a planned area without any consideration on the labor mobility and natural persons internationally.

However the FEZ is defined (FIAS, 2008, Box 1 & 2), the main contents of any FEZ concept should include:

a) A geographically defined area;

b) A single governance body;

c) Prevailing benefits for firms within the zone areas;

d) Separated customs offices with streamlined procedures.

Thus, the conceptualization for FEZs in the 1980s-1990s should cover the two following core components:

• A delimited and planned territory with legally binding sovereignty;

• A freer space with more liberal business and living environment than that of the whole economy;

These concepts have reflected the levels of international trade and investment liberalization before the 1990s, when global tariff barriers were relatively high and production factor mobility not as liberal and diverse as the WTO era with the booming of various FTA/RTA initiatives.

¹ According to the Law on the Basis of Creation of Free Economic Zones, accepted in Lithuania in June 28, 1995.
5.1.2 The ‘New Generation’ FEZ Concept

To accelerate FEZ development in the face of global competition, the FEZ Planning Office under the Government of Korea (2009) introduced a very concise definition of FEZ “as an area specially designated to provide companies with an optimal environment to engage in global business activities...”. A FEZ by this new definition includes: “[1] A cluster of global companies … formed by providing advanced socio-economic systems and diverse incentives, and [2] world-class cities … built through development of cutting-edge airports, ports and office facilities as well as high quality schools, hospitals and tourist facilities”.1 Thus, this new FEZ concept broadens the FEZ’s mandate to function not only as an economic and business agent but also a place for better livability. It means that the new FEZ model covers also the development of international cities or metropolitan areas.

Meng (2003) expanded the new generation FEZ concept by giving it more comprehensive functions, including political objectives, political zones and cross-border space: “in order to realize certain economic and political objectives, FEZ is geographically defined in an area or zone inside a country or in a cross-border area between several countries where certain economic activities are especially allowed and where free trade and other preferential policies and privileges different from those in the rest of the country are granted. An FEZ ranges from a small size to a large dimension, from a zone inside a country to a cross-border zone between more than two countries and from an economic zone to an economic and administrative zone and furthermore to an economic and political zone” (Meng, 2003, p. 18).2


1. Meng’s (2003) definition follows closely the new development of SEZ models in China, particularly in the case of ShenZhen SEZ, when in 2009, the central Government of China allowed the local government of Shenzhen City to launch the experiment that transformed Shenzhen Special Economic Zone into Shenzhen Special Political Zone (SPZ), a bold step towards broader and deeper political reforms in China in the time to come.
Local FEZ Concept

The FEZ concepts are not limited to the national level, but can also cover the sub-national, i.e. local or regional, levels. It implies that the motivation to establish FEZs can come from both central and local governments in different economic spaces. At first, the local FEZ concept is similar to the national FEZ concept, except for governance structure and mandates. In recent years, the concepts of local FEZ or regional FEZ are becoming more innovative, going beyond the conventional concept of FEZs introduced by the central government. This suggests the notion of FEZs functioning as experimental tools for institutional innovation at sub-national levels before a nation-wide introduction.

Quite a few concepts and definitions have been introduced to reflect the dynamic evolution of FEZ models in the national and global economic development process. The above examination confirms two key determinants of the uniqueness and success among FEZs, which are (1) location and (2) the internationalization of FEZ laws and institutions.

5.1.3 Brief Overview of the Evolution of the FEZ Model

According to a survey by IFC, WEPZA and ILO (2007), there are approximately 3,000 zones in 135 countries today, accounting for over 68 million direct jobs and over US$500 billion of direct trade-related value added within zones, including 2,301 zones in 119 developing and transition countries, clustered mainly in Asia and the Pacific and the Americas. China alone accounts for about 19 percent of these zones. Just over half of them are privately owned and operated. Altogether, these zones account for approximately US$200 billion in gross exports per annum and directly employ some 40 million workers, and indirectly some 60 million. In 1975, in contrast, there were only 79 zones in 25 countries around the world, employing about 800,000 people (ILO, 2003). All were government owned and operated (ILO, 2003).¹

¹. These figures were derived from a database developed by FIAS, World Economic Processing Zones Association (WEPZA), and International Labor Organization (ILO, 2007).
The evolution of FEZs occurred in phases. The very first Free Port was established in the 16th Century (Meng, 2003), with the key function of facilitating trading activities among nations. Until the mid 20th Century, most of FEZs in the world were trade-related FEZs. In recent decades, the FEZ models have been transformed into multi-functional and comprehensive FEZs. Looking back the history of FEZ development in international economic relations, a large numbers of FEZs had emerged, developed and disappeared, but all the remaining FEZs still possess their core advantage as a spatial geography with high concentration of economic agents and activities in the national or global economic system. This is the key to success of any FEZ model. The following is a brief historical review.

From 16th to 18th Century: Free Cities and Free Ports arose along the Mediterranean to promote “free trade” inside the region and with other continents.¹

From 18th Century to mid-20th Century: This period was led by the 1st and the 2nd Industrial Revolution, therefore the free cities and free port models had transformed themselves in to Free Trade Zones (FTZ) or trade-related FEZs to facilitate the economic boom. Singapore (1819) and Hong Kong (1841) were established. The Hamburg model had been prevalent during the Second Industrial Revolution, with Hamburg Port leading the transformation trend from FPs into Free Trade and Manufacturing Zones (FTZs).

The 1940s-1970s: The FTZs had transformed into manufactured-based or service-based FEZs during this period.² Then came the

2. The typical FCs and FPs in the 17th century were Naples, Venice, and Trieste in Italy, Porto in Portugal, Dunkerque in France, Copenhagen in Denmark, Hamburg, Bremen, Luebeck and Rootstock, Gdansk (Danzig) and Koenigsberg in the Germany of that time. Until the early 18th century, there were two primary types of FEZs, namely FC and FP, while FP had evolved from FC, and they spread only in Europe, especially along the Mediterranean and the North and Baltic Seas (Meng, 2003).

2. For example, the birth of various service zones such as Free Banking Zone (FBZ) in Bahrain, Panama, Luxembourg, Cayman and Bahamas islands), Free Insurance (FIZs) like New York and London; Free Tourism Zone like Macao, Monaco, Amsterdam, Hamburg, Nevada and the Atlantic City in US.
Export Processing Zone (EPZ) model\textsuperscript{1} - a new type of FEZs which specialized in export processing activities to implement export-oriented development strategies for industrialization in developing economies, particularly in Asia, with the Taiwanese EPZ model a good example. Free port cities like Genoa, Hamburg, Rotterdam, Singapore or Hong Kong had also transformed into trade hubs and international transit ports in this period. In summary, FEZs experienced a rapid development during this period (Meng, 2003).

With the third industrial revolution and rise of export-oriented developing economies, developed countries have established service-based FEZs for structural change and competitive advantage creation towards service sector, shifting the labor-intensive industries to developing countries. Late in this period, ‘open’ FEZs emerged to better connect with the nation-wide or region-wide economies, rather than function as ‘exclusive zone’ entities, which were particularly successful in South Korea, Singapore, the UK and the US.

\textit{The 1970s-1980s: } With the profound impact from the Third Industrial Revolution and break-through in science and technology, the trade-related, manufacturing- and service-based FEZs were transformed into science and technology-base zones. Various concepts of science-base industrial zones, hi-tech parks and science cities emerged during this period, which were then expanded in to multi-functional or comprehensive FEZs.

\textit{Since the 1990s: } This is the booming period of cross-border and sub-regional FEZs, together with the mushrooming of Free Trade Area/Agreement (FTAs) and Growth Triangle initiatives. Regionalism is the key driver of this “cross-border” trend, along with globalization and localization. While some cross-border FEZs had been established earlier,\textsuperscript{2} this period was marked by a

\begin{itemize}
  \item The first EPZ was established at Shannon Airport in Ireland in 1959. The first two EPZs in Asia were set up at India’s Kandla port and Taiwan’s Kaohsiung port in 1965. The Taiwanese EPZ model was considered as most successful and was scaled up into other economies in Asia, Africa and Latin America.
  \item The 1st cross-border FEZ was established in EEC in 1976.
\end{itemize}
variety of cross-border or trans-national FEZs models, such as the Cross-border Growth Triangle (CGT), Sub-regional Development Triangle, Cross-border Economic Corridors or Border-Gate Economic Zones (BGEZ).

5.2 Theoretical Foundations of FEZ Models

The establishment of FEZs has become a key institutional innovation for developing countries to catch up and avoid the ‘middle-income trap’. Governments have so far relied on FEZs models to experiment with ‘break-throughs’ in infrastructure and institution building to promote growth and integration. What is the theoretical foundation for FEZ development?

5.2.1 Economies of Scale: The Core Concept of FEZ Theory

Major advances in world or national economic development often derive from break-through in development thinking or ideas. If the economic development miracles in the 19th and 20th Centuries were inspired by the ideas of “division of labor” and “the invisible hand”, then in the 21st Century it would be the historical break-through in information and communication technology and life sciences. The 3rd and 4th Science and Technology Revolution have accelerated the glocalization (globalization and localization) process, which is reshaping the development mindset of nations on the road to higher stages of sustained prosperity.

While political leaders are asked for new growth drivers to move up the higher stages of technology-led productivity and knowledge-based competitiveness, economists have been seeking new theoretical foundations for generating growth. Thus far, the concept of division of labor has brought about huge productivity gains, but with diminishing returns to scale, countries would reach their potential production frontier (PPF) sooner or later. In Smith’s classic work *The Wealth of Nations* (1776), there are two important qualifiers: “the gains from dividing labor are limited by market size, and not all activities exhibit increasing returns to scale” (WDR, 2009, pg. 126). The mission of nations is to find ways to
expand the market size(s) through engaging in economic activities with increasing returns to scale, or shifting their PPF upwards to the right.

On scale economies, economists argue that larger scale benefits productive efficiency. But they also distinguish between internal economies and external economies (Box 5.1).

**Box 5.1: The Scale Economies Effects**

- **Internal economies** arise from the larger size of a plant to better exploit fixed costs. A larger steel mill can get volume discounts from suppliers—implying fixed costs of transport and trade—and reap the benefits of dividing labor within the firm.

- **External economies** are synonymous with “agglomeration economies,” which include the benefits of localization (being near other producers of the same commodity or service) and urbanization (being close to producers of a wide range of commodities and services).

- **Localization economies** arise from a larger number of firms in the same industry and the same place. Spatial proximity helps because immediate access to competitors in the same sector allows firms to stay abreast of market information in negotiating with customers and suppliers.

- **Urbanization economies** arise from a larger number of different industries in the same place. A management consulting company can benefit from locating near business schools, financial service providers, and manufacturers.

*Source: WDR (2009, p. 129).*

*Internal economies* can be pecuniary or technological, depending on whether they originate from reduced fixed costs due to increasing scale or from better operation arrangements
through technological investment. Mass production is the typical production approach to exploit internal economies. Most of the market economies have implemented policies to materialize such internal economies to scale for higher economic growth so far.

External economies - or agglomeration economies – reflect externalities which are also sources of increasing returns to scale. This means increasing scale economies could come from outside factors which generate external effects on economic activities. The so-called agglomeration economies provide another way to highlight spatial concentration of economic activities as a dynamic source of increasing returns to scale. Agglomeration economies are in turn divided into localization and urbanization economies.

Localization economies reflect externalities within an industry, and arise from interactions among firms and economic agents in the same industry. Localization economies include externalities from technical and knowledge spillovers (Marshall-Arrow-Romer (MAR) externalities) in a specific industry, when productivity and growth of a firm in a specific industry or defined area can have positive impacts on other firms’ activities in the same industry (van Oort, 2004). Externalities and spillover effects can come from labor market pooling, idea creation from human capital accumulation processes or direct interaction, and the availability of specified services for production activities.

Urbanization economies reflect externalities between industries in a same space, and are transferred to firms of different industries as a result of savings from large scale operation of a city as a whole (van Oort, 2004). Urbanization economies occur if the production cost of an individual firm decreases as the total output of the urban area increases. They differ from localization economies in two ways: First, urbanization economies result from the scale of the entire urban economy, not simply of a particular industry. Second, urbanization economies generate benefits for all firms in the urban area, not just firms in a particular industry.¹ This

¹. Urbanization economies associates with generalized location factors such as
in turn results in diversity of firms and industries, and that is why we see a wide variety of economic sectors in major urbanized or metropolitan areas. It is this spatial agglomeration that shapes the geographical structure patterns of economic activities into cities, industrial clusters and production centers.

**Table 5.1** Recent Theoretical Advances in Recognizing the Importance of Scale Economies

<table>
<thead>
<tr>
<th>Subject</th>
<th>Decade</th>
<th>Publications</th>
<th>Main insights</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrial organization</td>
<td>1970s</td>
<td>Spence 1976; Dixit and Stiglitz 1977</td>
<td>Increasing returns to scale and imperfect competition can be incorporated into formal economic models</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Mills 1972; Diamond and Mirrless 1973; Henderson 1974</td>
<td>External economies within cities and systems of cities; different levels of agglomerations are related to city functions</td>
</tr>
<tr>
<td>International trade</td>
<td>1980s</td>
<td>Krugman 1980, 1981; Ethier 1982; Helpman and Krugman 1985; Grossman and Helpman 1995</td>
<td>Increasing returns and imperfect competition explain intra-industry trade between countries with similar endowments; initial endowments may, through trade and specialization, influence the long-run rate of growth; trade unleashes forces of both convergence and divergence</td>
</tr>
<tr>
<td>Economic geography</td>
<td>1990s</td>
<td>Krugman 1991; Fujita, Krugman, and Venables 1999; Henderson 1999</td>
<td>Increasing returns-to-scale activities are characterized by agglomeration and imperfect competition, while constant returns-to-scale activities remain dispersed and competitive, helping to explain spatial distribution of economic activity and growth of cities</td>
</tr>
</tbody>
</table>

good infrastructure, favorable community attitude, tax credits and subsidies, and favorable socioeconomic factors. These factors are not specific to a particular industry, but favor any kind of industry.
| Endogenous growth | 1980s | Romer 1986; Lucas Jr. 1988 | Perfect competition and knowledge-related or human capital–related externalities imply aggregate increasing returns and explain why growth rates may not fall over time and why wealth levels across countries do not converge |
| Endogenous growth | 1990s | Romer 1990; Grossman and Helpman 1991; Aghion and Howitt 1992 | Imperfect competition explains why the incentive to spend on R&D does not fall, and knowledge spillovers explain why R&D costs fall over time, resulting in more and better products that fuel growth |
| Endogenous growth | 2000s | Aghion and Howitt 2005; Rossi-Hansberg and Wright 2007; Duranton 2007 | Imperfect competition and Schumpeterian entry and exit of firms, with entrants bringing new technologies, explain how a country’s growth and optimal policies vary with distance to the technology frontier; knowledge accumulation in cities leads to growth |


5.2.2 The New Trade Theory (NTT): Broadening Theoretical Foundations for FEZ models

Comparison between the old and new generation FEZ since the 1990s helps us to understand the evolution of FEZ models and to see how the theoretical foundations of FEZs are modified as they evolve. Both the New Trade Theory (NTT) pioneered by Krugman (1986, 1991) and the National Competitive Advantage Concept advocated by Porter (1990) have observed that key assumptions of “comparative advantage”-based trade theory are increasingly irrelevant to the new reality of international economic integration and industrial competition.

The work of Paul Krugman laid the foundations for the NTT in the 1990s.\(^1\) On economies of scale, Krugman (1979) observed that

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1. The New Trade Theory (NTT) is not the focus of this chapter, rather
customers prefer a variety of brands and trademarks and production activities tend to explore gains from scale economies. Going beyond the classical theory on international trade, which is based on comparative advantage and diminishing returns to scale, Krugman proved the presence of increasing returns to scale. Krugman (1996) asserts that international trade economists before him had neglected returns to scale as an explanatory factor in trade, since trade could reflect superior specialization rather than comparative advantage.

But it would be inefficient if enterprises spread out their production activities globally, so the choice is to concentrate such activities into some factories and bases in one or several countries only. This logic explains why a country needs specialization in some brand and trademark of a specific product, rather than produce a variety of products (Krugman, 1991). He argued that if trading activities are promoted mainly by economies to scale, regions with highest concentration of production activities will have higher returns, thus attracting even more production activities. It means that production activities will not be scattered all over the globe, but concentrated in a few countries, regions and cities with increasing population density and higher income levels.

The above arguments also helps to explain the birth of various FEZs in the world as well as their successes or failures, since only FEZ models that satisfy the preconditions of increasing economies to scale; generating sufficient concentration and specialization of economic activities; providing enterprises with strategic market location and facilitating their global strategies could have higher prospects of success.

5.2.3 The New Economic Geography Theory (NEG)

External Increasing Returns: Key Driver for Spatial Economic Agglomeration

The reason why spatial economic agglomeration occurs has
been studied for decades by economists, with a shared view that it is the expectation of *external increasing returns* to scale. Accordingly, urbanization economies will occur with the establishment and expansion of cities, whereas localization economies will be realized during the clustering process of firms and industries within a specific geographical space. It is therefore the external increasing returns to scale or agglomeration economies that drive the process of industrial clustering and city formation.

At the end of the 19th Century, Alfred Marshall (1890) noted that: “Workers with industry-specific skills are attracted to a location where there is a greater concentration”, (WDR, 2009, tr.128). Three key drivers for industry clustering are: (a) input sharing, (b) labor market pooling, and (c) knowledge spillovers. Experimental research by Jaffe et al. (1993), Holmes (1999), and Costa and Kahn (2001) provided evidence supporting Marshall. According to development economists, increasing returns to scale is key to explaining the geographical structure of economic activities. Prior to the NEG theory, they had touched upon agglomeration processes as sources of city establishment, such as the “big push” of Rosenstein–Rodan (1943), the “growth poles” of Perroux (1955), the “circular and cumulative causation” of Myrdal (1957), and the “backward and forward linkages” of Hirshman (1958) (Fujita and Thisse, 2005). For example, according to Myrdal (1957), the circular causation effects in the agglomeration process of firms and workers occur when a variety of goods supply increase workers’ real incomes (forward linkages), or when a large number of consumers attract more firms (backward linkages). Hirshman (1958) goes further in analyzing such linkage effects, as scale economies at the firm level are integrated and synchronized into increasing returns at a region-wide level.

As Marshall (1890, 1920) argued, localization economies accompany the spatial agglomeration process of a specific industry. In addition, Jacobs (1969) introduced the ideas of city size and diversity as sources of urbanization economies. Thus, Marshall’s
and Jacobs’ work are considered foundations for the theoretical advances in the study of scale economies in the past four decades.

*Location Theory from an Agglomeration Economies Perspective*

Why is location so important to an industry and what are the key determinants of location? Brülhart (1998) analyzed three major approaches in location theory, namely (a) the neoclassical approach, (b) the New Trade Theory approach and (c) the New Economic Geography (NEG) approach.¹

According to the neoclassical approach, the location of an industry is determined *exogenously*, or by the so-called “first nature” (Cronon, 1991; Krugman, 1993a), indicating a given spatial distribution of natural endowments, climate, technology, and factors of production. Brülhart (1998) observed that such an approach explained the early stages of economic development, characterized by perfect competition, homogenous products and non-increasing returns to scale.

Recent studies by Kim (1995) and Glaeser et al. (2001) add to Marshall’s and neoclassical arguments on the sources of agglomeration by proving that *natural advantage* is another driver of spatial economic agglomeration. This natural advantage hypothesis is shared by Krugman (1993a), who also argued that many industrial clusters or cities occur by chance rather than as prescribed by location policy.

*The New Economic Geography Theory: Comprehensive Approach to Spatial Economic Agglomeration*

The New Economic Geography (NEG) theory of Krugman (1991); Fujita, Krugman and Venables (1999), Henderson (1999) and others during the 1990s complement the ideas on

1. Though Fujita (1988), Krugman (1991a, 1991b, 1993b), and Venables (1996) are considered pioneers of the NEG, concepts of the NEG theory have been discussed in the work of early economic geographers and location theorists such as von Thünen (1826), Weber (1909), Marshall (1920), and Hoover (1948).
agglomeration externalities pioneered by Marshall (1890) and Jacobs (1969). In the NEG theory, these authors expanded the list of sources for agglomeration process to include (a) the greater availability of consumers in larger cities; (b) natural advantage as an urbanization and localization driver; (c) self-reinforcing agglomeration due to internal economies of scale related to transactions costs. Head and Mayer (2004), Rosenthal and Strange (2001) provided evidence for such predicted effects.

Unlike the Neo-classical and the NTT approaches, the NEG considers location of an industry as endogenous, called the ‘second nature’ by Cronin (1991) and Krugman (1993a), where spatial distribution of economic activities is independent of natural advantage (Ottaviano and Thisse, 2005). It is from the ‘second nature’ that the industrial location theorem was derived. Brülhart (1998) described the ‘second nature’ characteristics as mobility of production factors and/or firms, pecuniary and technical externalities, and input-output linkages, which are also key determinants of location(s) of an industry or a group of industries. The process of location decision is self-reinforcing, as it facilitates the forming of industrial clusters, then leading to higher localization, urbanization.

According to Glaeser et al. (1992); Mills and McDonald (1992); Moulaert and Djellal (1995), economic growth and technology development at the regional level are influenced and stimulated by economies generated by spatial proximity and associated externalities, such as being located near various numbers and types of firms in agglomerations or free economic zones, and a guaranteed quick business access to other service and industrial suppliers (Nam and Radulescu, 2004).

Fujita and Thisse (1996) analyzed four sources of agglomeration or industrial clustering: (a) the existence of scale economies at the firm level, (b) the sharp fall in transportation costs, (c) the size of the population, which decides the urban structure of the economy, and (d) history. The authors observed that there are multiple of equilibria, and the government should try to create conditions for
achieving the “optimal” equilibrium. Recent research by Fujita and Mori (2005) has confirmed the central role of the NEG in the core-periphery model (CPM) introduced by Krugman (1991a). The two authors also outlined the roles of four key elements of the NEG, namely (a) general equilibrium modeling of spatial economy, (b) increasing returns at the level of individual producers leading to imperfect competition, (c) transport costs, a key factor in decision on firm location, and (d) agglomeration economies from locational mobility of producers and consumers.

How is spatial agglomeration shaped, once the geographical distribution of economic activities has been determined? The two contrasting trends of centripetal and centrifugal forces are the answers. Thus, there exists the trade-off relation between scale economies and transportation costs in the market location process. This explains why the spatial agglomeration process would lead to frictions between or dispersion of economic activities into neighboring areas.¹

5.3 Role of FEZs in National Development and Integration

This section focuses on the costs and benefits from FEZ development by host countries. Wall (1993, p. 248) noted that: “...there [are] economies of scale in the development of land and in the provision of common services and utilities [and] ... external economies of agglomeration by having similar industries grouped together. [Furthermore]... governments may wish to impose a geographical limit on the operation of some policies ... and... to restrict certain activities to specific areas”. This observation is consistent with the gradualist approach in economic liberalization and reform in such transition economies as China and Vietnam.

Potential economic effects of FEZs on the national economy are two-fold. Static benefits include: (a) direct employment creation

¹. This also relates to the Fragmentation Theory, but the main focus here directly relates to the theoretical foundations for FEZs, otherwise specified.
and income generation, (b) export growth and diversification, (c) foreign exchange earnings, (d) foreign direct investment, and (e) government revenues. Thought difficult to measure, the dynamic benefits are far more important in the long-run. They include: (a) indirect employment creation, (b) skills upgrading, (c) female employment, (d) technology transfer, (e) demonstration effects from the application of best practices, and (f) regional development. One of the dynamic effects from FEZs is on human development. Besides upgrading labor force and skill development, the “learning by doing” process with knowledge spillovers are positive to human development.

Together with positive and dynamic gains from FEZs, socio-economic challenges could arise: (a) dependence on imported inputs with low value added from exports, (b) being trapped in low skilled and assembly activities, (c) neglect of nationwide reform efforts (World Bank, 1992), (d) attracting low-tech, low-skill and too liberal FDI, (5) discrimination against women through payment of low wages, (f) allowing firms to give in to poor safety and health conditions in factories, and (g) adoption of loose standards on environmental monitoring to attract polluted industries (FIAS 2008, p. 33).

5.3.1 FEZS and the Generation of New National Competitive Advantages

The potential benefit of competitive advantage comes from Porter’s (1990) *The Competitive Advantage of Nations*. The NTT does not explain choices at the micro-level, nor the linkage between macroeconomic policies and firms’ activities in international trade. Porter (1990) argues that the traditional types of comparative advantages are increasingly diminished as sources of national prosperity, while the macro-level explanation on competition is inadequate.

His work was the first to set out a theory of competition based on productivity at both micro-level (firms) and macro-level (nations, regions) by introducing the four-factor *Diamond of
National Advantage - a diamond-shaped diagram as the basis of a framework to illustrate the determinants of national advantage.\(^1\) This diamond represents national playing fields that countries establish for their industries. He argued that a nation can create new advanced factor endowments such as skilled labor, a strong technology and knowledge base, government support, and culture, rather than rely only on the old comparative advantages of natural resources, labor, and the size of the local population in international trade. He also introduced the *industrial cluster* approach as a way for firms to build linkages and institutions and for Governments to create new competitive advantages from spatial geography to achieve increasing returns to scale and productivity-based competitiveness.

This theory of productivity-based (national) competitive advantage provides the rationale for governments and enterprises to decide on ways to create new sources of growth, whether by industrial clustering or larger spatial economic agglomeration. In either case, the FEZ model fits the bill.

5.3.2 FEZs as Creating New Growth Poles for Regional Development

The new generation of FEZs since the mid 1990s has been designed to facilitate more comprehensive liberalization and deeper integration of the national economy into the globalization process, acting as windows of opportunities to absorb best resources from outside to serve national development and global competition. With a lower middle-income economy undergoing industrialization, the establishment of FEZs should aim at creating new growth poles for a catch-up strategy. The Chinese experience in hosting its first major SEZs in the early 1980s and hundreds of national level zones subsequently has successfully created three major growth poles along China’s Eastern and coastal regions.

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1. The four corners of the diamond represent (1) factor conditions; (2) Demand condition; (3) Related and supporting industries; and (4) Firm strategy, structure and rivalry.
5.3.3 FEZs Connects National and Local Economies into Global Value Chains

Attracting Foreign Direct Investment

Studies on FDI and MNCs have implied that the FEZ models with modern governance institution and best practices meet the expectation of international investors and MNCs, thus increasing the chances of a country in competing for foreign investment inflows. Theoretical and empirical studies on the relation between economic geography and international investment agree that market distance and size are crucial determinants of MNCs’ choice of location for their overseas affiliates. One of the key motivations by MNCs is to find out the best business environment with optimum transaction costs so as to have competitive advantages in the global market. Therefore, countries that wish to attract both vertical and horizontal FDI from MNCs can rely on the FEZ model to set up attractive institutional arrangements for MNCs. Once an affiliate is established in certain country, the parent MNC has gained a strategic foothold in the domestic market. A host country aiming to attract FDI through FEZs would be more successful if such FEZs facilitate MNCs to establish strategic position in the host country’s market.

Positioning the National Economy in Global Value Chains

Analyses on factor prices and MNCs’ behavior in affiliate locations point to the importance of the traditional comparative advantage of natural resources, abundant inputs for production, and low labor costs. FEZs that help minimize transport costs and those related to the fragmentation of MNCs’ production activities have a higher chance of being selected as a location for MNC’s affiliates.

Studies by Kuchiki (2005a, 2005b and 2006) looked at ways to understand the “tastes” of international investors, so that a country or region can adjust its domestic policy and institutions accordingly to such tastes, particularly by providing incentives and superior infrastructure and modern institutions within a FEZ. While establishing industrial clusters, it is crucial that the would-be clusters are designed to fit into the targeted MNC’s value chain management strategy.
5.3.4 FEZs as Hubs for Advanced Knowledge and Technologies, Fostering Entrepreneurship and Local Enterprises

By examining the “incubator hypothesis”, Hoover and Vernon, (1959), Leone and Struyk, (1976), and Fagg, (1980) highlighted the role of agglomeration economies in the formation of new manufacturing firms. Studies by Rosenthal and Strange (2003), and Stuart and Sorenson (2003) also explained differences in the entry rates of high-tech firms by reference to agglomeration economies. Romer (1986) and Lucas (1988) argued that investment in knowledge is likely to be associated with spillovers to other agents in the economy. These knowledge spillovers play a fundamental role in determining the rate of technological progress.

On how knowledge spillovers affect growth, there are three major hypotheses (Table 5.2). First, the Marshall (1920) then Arrow (1962) and subsequently, Romer (1986) or MAR hypothesis considers knowledge to be predominantly industry-specific and hence local specialization will foster entrepreneurship. Second, Porter (1990) also supports MAR’s knowledge observation, but highlights the role of competition in innovative firms. Third, Jacobs (1969) agrees with Porter that competition fosters growth, but believes regional diversity in economic activity will also result in higher growth.

Table 5.2: Stylized and Hypothesized Relations of Inter- and Intra-industry Agglomeration Circumstances with Economic Growth

<table>
<thead>
<tr>
<th>Economic activities</th>
<th>MAR</th>
<th>Porter</th>
<th>Jacobs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Concentration</td>
<td>+</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>Diversity</td>
<td>-</td>
<td>-</td>
<td>+</td>
</tr>
<tr>
<td>Competition</td>
<td>-</td>
<td>+</td>
<td>+</td>
</tr>
</tbody>
</table>

As the conceptualization of new FEZ generation have covered the component of “international cities” or “regional hubs”, the FEZ environment is increasingly become the destination for global labor inflows, accompanied by skills, ideas and human interactions among individuals and business communities. Jacob (1969) has observed that most innovation and creative ideas of human-being occur in cities. This would turn FEZs into incubators for new ideas and global best practices, which in turn would benefit the host countries. As FEZs increasingly become “open cities” or global metropolitan hubs, a successful FEZ in the knowledge-based economy must be embedded with “urbanization” and “internationalization” drivers, as the ultimate competition among nations and firms nowadays is thus for knowledge and ideas.

5.3.5 FEZs as an Institutional Innovation Instrument for Developmental Break-Through: Cities as Urbanization Drivers and Growth Engine

As early as 1890, Marshall noted that the concentration of an industry in a city would generate knowledge spillovers among firms, the facilitating growth of the industry or city. In his book, Jacobs stated that: “My purpose is to show that cities are primary economic organs” (Jacobs, 1969, p.6). Quigley then observed that: “…Large cities have been and will continue to be an important source of economic growth…” (Quigley, 1998, p.137). Duranton (2000, pp. 291 – 292) confirmed that “The city is not only the place where growth occurs, but also the engine of growth itself”. Fujita and Thisse (2002, p. 389) also emphasized that “agglomeration can be considered a territorial counterpart of economic growth”. Lucas (1988) considered cities as the engines of economic growth in an economy, together with knowledge and information spillovers.

Recent studies by Duranton (2004, 2008) have provided further evidence of the impact of urbanization and cities on productivity and growth in developing countries, arguing that cities in developing economies promote productive efficiency. His
early work with Puga (2004) also examined the ways in which cities positively facilitated knowledge creation, accumulation and spillovers.¹

Finally, the question for developing countries or those in the middle-income stages is how to attract horizontal FDI from multinational corporations (MNCs) so as to generate endogenous competency to escape from the “middle-income trap”² and becoming a high-income economy. If successful in establishing FEZs as *city-led growth* engines, it would become institutional “break-through” practice for Vietnam to avoid the “Middle Income Country” trap in decades ahead.

### 5.3.6 FEZs as an Experimental Model for Modern Governance

Warr (1989), Jayanthakumaran (2002), and Sinclair (2001) explored the economic effects of FEZ development. Other studies by Madani (1999), Cling and Letilly (2001), and Schrank (2001) examined the relationship between FEZs and economic reform and trade liberalization efforts in developing countries. In terms of policy, FEZs are considered tools of a national economic growth strategy and for enhancing international competitiveness and attracting FDI. In terms of institutions, FEZs provide the governments and authorities with better governance and more efficient monitoring on firm practices, or access to international best practices.

The FEZ model enables the pooling of development resources into a defined space, which will be more feasible and easier for governance, compared to having to strengthen nationwide administration. In this sense, FEZs are “learning windows” to seek and internalize modern governance practices in the world.

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1. Further analyses of human capital externalities and knowledge-spillovers are found in Eaton and Eckstein (1997); Black and Henderson (1999); Glaeser (1999); Bertinelli and Black (2004) and Rossi-Hansberg and Wright (2007).
2. On the middle-income trap, see Robert Wade’s presentation at the *1st High-level Round-Table on Reviewing 20 years of Doi Moi in Vietnam*, UNDP and VASS, Hanoi
5.3.7 FEZ as a “Developed Economy” within a National Economy

Developing FEZs should be complementary to the national socioeconomic development process. The established FEZs should also not become an isolated or separated economic space with poor linkages with the nationwide economy, but act as the engine for national economic growth. In the era of global integration and competition, if a nation follows the step-by-step approach to development, it can take decades to escape the “middle income country” status. This is the reason why a developing and lower middle-income country should experiment with development break-throughs to accelerate the development process. While the whole economy may not be able to shorten the time need to reach a high-income status, some parts can “go first” by creating spatial economic agglomeration to acquire advanced knowledge and cutting-edge economic agents from developed countries and international companies. The FEZ model is the answer. With FEZs’ international best practices and modern institutions for business and livability, a country could establish a modernized and developed economy within its national borders. Such developed local economies will act as growth poles, the impact of which would be gradually spread throughout the economy.

5.4 Keys to the Success of FEZs

5.4.1 Lessons from International Best Practices on FEZs Development

Although the number of FEZs is in the thousands, the number of successful ones is not many, whether measured in terms of static and dynamic effects, contribution to growth and learning by doing. In general, the optimization of FEZ development depends on the level of its integration with the host economy and the trade and investment reform agenda (OECD 2003, FIAS 2008). A FEZ is poorly connected to the national economy if it has the following features (FIAS, 2008):
1. High import dependence of most EPZ activities
2. Impact of certain export market access arrangements
3. Ban against local sales by EPZ enterprises
4. Lack of competitiveness of local firms
5. Preference of global firms to rely on their international suppliers
6. Lack of awareness and information about prospective domestic suppliers

Selecting an FEZ’s location is critical to its future success and contribution to national development. The theoretical analysis in part II has confirmed that such location will have to “optimize” benefits and effects from the spatial economic agglomeration process. The FEZ operation will be sub-optimal with:

1. Uncompetitive fiscal incentives
2. Restrictive controls on zone activity and cumbersome regulations
3. Exclusion of merchandise processed in zones from entry under bilateral and regional trade agreements.
4. Inadequate administrative structures or too many bodies involved in zone administration
5. Poor zone development practices – inappropriately designed or over-designed facilities, inadequate maintenance and promotion practices
6. Zone operation based on subsidized rent and other services
7. Weak coordination between private developers and governments in infrastructure provision

On a FEZ’s contribution to national development, the important message is that “zones cannot and should not be viewed
as a substitute for a country’s larger trade and investment reform efforts.” (FIAS, 2008, p. 51). FEZs should be complementary to national policy and institutional reforms. The role of the government is to establish appropriate regulatory, legal and institutional frameworks for the selected FEZ models.

5.4.2 Modern Governance Models for FEZs: Key Determinant for FEZs’ Success

The emergence of the new generation of comprehensive and cross-border FEZs requires changing zone governance models to bolster FEZ effectiveness, and to better connect with the national, sub-national, regional and the global economy. Despite its name, ‘Free’ does not mean free from national or international regulations or governance. According to FIAS (2008), four typical governance models can be identified from the various types of FEZs in the world:

1. a cross-national level institution is responsible for the cross-national economic, social and political cooperation of FEZs;

2. a national administrative system is responsible for the macro-level decision-making of FEZs such as legislation and supervision;

3. a regional administrative system has a state or province govern and supervise the economic and social affairs of FEZs, and

4. a FEZ authority is responsible for its own economic and social activities.

In the fourth governance model, the FEZ’s authority includes the government- and enterprise-oriented model, the mixed or separated model, the model of an administrative area, and the cross-border administrative model. The key difference is the participation of representatives from the private FEZ developers or investors in the zone governance authority.
In terms of governance organizational framework for FEZ management and development, there are also a variety of models. It could be an independent or autonomous body under the government or established by private investors, or a specialized department under ministries or investment promotion authorities. It could also be a separated management board for a specific FEZ. With an increasing number of private-owned FEZs, the zone governance organizational model has been transformed into an enterprise-based governance model. This model facilitates the divestiture of government activities from the zone’s physical infrastructure development, and the streamlining of the key functions of zone governance into regulation, planning and promotion.

In the past, the governance structures or models were mostly government-led, either by central governments or local authorities. With the rise of private owned FEZs along with the transition to a market-oriented economy, many FEZs governance structures were transformed from the government-oriented to the enterprise-oriented and mixed model, while numerous new FEZs selected the enterprise-oriented and mixed model. From success stories of FEZs, six key governance factors are associated with FEZ success.

1. A high degree of autonomy for the FEZ governance body, in relation to line ministries, with direct reporting to the highest level of government;
2. Sufficient financial resources for zone operation, free of corruption;
3. Customer-oriented and one-stop-shop services;
4. Partnership with strategic private FEZ developers;
5. Service outsourcing from private suppliers; and
6. A focus on regulation and supervision functions, delegating zone operation and development to private developers and investors.
These six institutional determinants emphasize the decisive roles of autonomy and linkages in the success or failure of the new generation of FEZs. Challenges lie in the lack of governing competence of the public sector, which fails to catch up with the demanding governance structure of the new generation FEZ, particularly mega-FEZs like Dubai (UAE), Subic-Clark (the Philippines) and Shenzhen (China). Accounting for increasing shares in the national GDP, budget revenues and exports, this type of mega-FEZs can, on the one hand, have systemic impacts on the national economy, and, on the other, can become the role models or “experimental sites” for introducing any new policy or institution into the national economy. Thus, seeking an optimum governance model for the new generation of comprehensive and trans-border FEZs is among the most challenging tasks for any host government.

5.5 Some Implications for Vietnam’s FEZ Strategy for 2011-2020

5.5.1 Preconditions for Success

The clients of FEZs are foreign investors, firms and individuals. For a FEZ to be successful, it must be attractive enough and satisfactory to the tastes of these clients. Besides the determinants of success outlined above, the overall political, economic, and socio-cultural environment of the host countries should facilitate the dynamic growth and sustainable development of investors and firms in the FEZs.

Political Stability

Political stability is considered the most crucial factor for international investors, particularly FEZ developers, when selecting location for their investment. A nation with low political risks would minimize business uncertainty, particularly during project planning and implementation. Countries with political stability reduce the risks for foreign investors of sudden policy changes or reversals in the host countries. Recent FEZ development
projects involve huge investment capital commitments with long time-frames for return on investment. Hence, political stability is a prerequisite for zone’s success.

**Strong Political Commitment to an Open Economy and FEZs Development**

Most firms investing in FEZs are global companies or multinational corporations, so that the more legal, policy and business environment of the host countries and the FEZs are compatible with international standards and best practices the better. In general, there are hardly any cases of successful FEZs in a closed and non-market economy. In terms of policy, if the government demonstrates strong commitment to an open-door process, FEZs of the host countries would become more attractive to international investors. Furthermore, policies promoting liberalization and integration also mean that the national government would not use policy for market distortion or unfair competition.

**Selection of Strategic Location**

The above analysis has shown the decisive role of location selection in the success of a FEZ. Thus, the location of a FEZ should possess a geographically differentiated advantage or strategic space for the FEZ’s potential customers. At the national level, a FEZ should be located in a place with *geo-strategic superiority*, interfacing large economic hubs, proximity to key foreign markets or on major international sea routes.

**Availability of Skilled Labor Forces with Low Retraining Costs**

Many studies have also shown that a low-wage labor force is no longer the competitive advantage that investors consider for locating in a FEZ. Instead, the availability of skilled workers with low re-training costs is preferred. In an environment of global labor mobility, the availability of skilled labor is not limited to the local labor force pool, but includes foreign workers, expertise or immigrants. This determinant reflects a fundamental change in
FEZ models in the 21st Century, to the extent that unless a FEZ can facilitate international labor mobility, particularly of skilled labors, it has not much chance of success.

*Availability of Modern Infrastructure*

Both soft and hard infrastructure in FEZs are crucial to investors’ selection of investment location, as infrastructure affects overhead costs and hence competitive advantage. A FEZ infrastructure system should go beyond the traditional function of saving costs to enable creating competitive advantages for FEZ firms against their competitors. Hard infrastructure should ensure connectivity of airport, sea-port, warehouse, and other logistic facilities and utilities with national and global systems. Soft infrastructure should ensure a business environment with international best practices, provide top quality telecommunication, financial and other supporting services, as well as a world-class living environment for those who work in a FEZ.

5.5.2 Feasibility and Piloting FEZ Models in Vietnam

At every level of development, each nation can find a suitable FEZ model to adopt. Vietnam is entering a new development period in 2011-2020, with a vision to overcome three key bottlenecks of market institutions, infrastructure and human resources. In our view, the new FEZ model should be introduced as an institutional innovation experiment in Vietnam to create new growth drivers and overcome bottlenecks to high and sustainable development. Two key arguments are:

First, FEZs will become new drivers of growth for Vietnam in the coming decades. The current global economic crisis and internal structural weaknesses have revealed constraints in the current economic growth model of Vietnam, which is factor-driven. Vietnam must shift to technology-driven growth model with new engines of growth. To this end, Vietnam should introduce a FEZ model into the national economic space to create new growth pole(s).
Second, FEZs will act as a laboratory for modern institutional innovation in Vietnam. Transitioning towards a socialist-oriented market economy, Vietnam could introduce the FEZ model as a laboratory for building the necessary socialist-oriented market economy institutions. This “learning by doing” process would produce valuable experience for Vietnam in finding out and justifying the superiority of such socialist-oriented characteristics in the Vietnamese development model.

Since it is not feasible to pilot institutional innovation nationwide, the FEZ model experiment should be undertaken in a limited geographical area to increase their chances of success. To enhance the possibility of success, the piloting and scaling up of the selected FEZ models should be designed according to international best practices. Together with designing FEZ governance institution, planning and management processes must be effectively enforced. According to Hartmann and Linn (2008), key success factors of a piloting and scaling up process include:

1. Leadership, vision and core values;
2. Strong commitment of political system;
3. Supporting policy, programs and projects;
4. Institutions able to adapt to change;
5. Incentive systems and accountability;
6. Effective monitoring and evaluation;
7. Orderly and gradual scaling up.

Drawing on the earlier analysis and the practical lessons from FEZ development in the world, the key message of this paper is that Vietnam should introduce selected FEZ models as a key component of institutional innovation in the 2011-2020 National Development Strategy.
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