

## Chapter 1

### Current Status and Future Possibilities

#### *From liberalization to capital inflows*

The Vietnamese economy has grown rapidly with the average growth rate of 7.5% in 1991-2007. Vietnam has transformed itself from an agro-based poor country in international isolation whose industrial production was dominated by SOEs and collectives to a globally integrated country fueled by FDI and private investment.

The continued high growth has elevated Vietnam's international standing, albeit from a very low base. In 1990, Vietnam was among the world's poorest countries with GDP per capita of \$98 (ADB data). By 2007, with the GDP per capita estimate of \$833, Vietnam is quickly approaching the status of a lower middle income country by the World Bank's standard<sup>1</sup>. Unless an unanticipated severe shock occurs, the official target of graduating from low income status by 2010 is likely to be met. The export base also shifted from primary commodities toward manufactured goods such as electronics, garment and footwear. The ratio of manufactured export to total export, which hovered around 28% in the second half of 1980s, increased to approximately 50% by 2007. Sustained rapid growth is generating new social phenomena, both positive and negative, such as higher living standards, westernization, labor mobility, urbanization, income gaps, pollution, traffic problems and social evils.

Vietnam's growth mechanism changed significantly in the middle of the 1990s. Prior to that, growth impetus came mainly from the incentive effects of internal economic liberalization. A series of reforms undertaken in the 1980s and the early 1990s, including agricultural reform, initiation of *doimoi*, the end of rationing, price liberalization, approval of private commercial activities and the first wave of SOE reform, unleashed private dynamism which had been suppressed under economic planning. After the mid 1990s, growth further accelerated thanks to large inflows of foreign capital and transfers. After a mild setback in 1998-99, inflows of foreign fund resumed strongly in the 2000s and generated the symptoms of overheating such as construction and consumption booms, rising inflation, and land and stock market bubbles.

Growth statistics are also consistent with the above view as in Tab.1-1. Until the mid 1990s, the incremental capital-output ratio (ICOR) was low and contribution of total factor productivity (TFP) to growth was high, which indicates that growth was achieved through improving efficiency without large investment<sup>2</sup>. In the latter period, ICOR rose, and TFP's contribution to growth declined while capital's contribution increased significantly. That is an indication of investment-driven growth.

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<sup>1</sup> The World Bank revises country classification annually. Based on the World Bank's 2006 GNI per capita data, the current classification is as follows: low income countries (\$905 or less); lower middle income countries (\$906-\$3,595), upper middle income countries (\$3,596-\$11,115); and high income countries (\$11,116 or more). Separately, the World Bank defines IDA-only countries to be those with per capita income of less than \$1,065 (using 2006 data) and lacking the financial ability to borrow from IBRD. IDA loans are deeply concessional but IBRD loans are non-concessional.

<sup>2</sup> ICOR is computed as investment ratio (I/Y) divided by real growth (Y/Y). The higher the ICOR, the more capital formation is required for growth (i.e., investment is less efficient). TFP is a broad definition of productivity calculated as residual growth after accounting for the impact of increases in factor inputs such as labor and capital.

**Tab. 1-1 Summary of Growth Performance**

	Population (mil)	GDP (USD bil)	GDP per capita (USD)	Economic size relative to ASEAN4	Real GDP growth (%)	Growth accounting (%)			ICOR
						Capital	Labor	TFP	
1990	66.0	6.5	98	2.2%	5.1	6.6	43.9	49.5	3.31
1991	67.2	7.6	114	2.4%	5.8	8.4	16.9	74.7	2.92
1992	68.5	9.9	144	2.7%	8.7	13.0	14.5	72.5	2.23
1993	69.6	13.2	189	3.3%	8.1	41.5	21.6	36.9	3.25
1994	70.8	16.3	230	3.5%	8.8	39.0	18.5	42.5	3.14
1995	72.0	20.7	288	3.9%	9.5	39.9	16.2	43.9	3.12
1996	73.2	24.7	337	4.2%	9.3	36.4	1.5	62.1	3.34
1997	74.3	26.8	361	4.9%	8.2	54.9	16.0	29.1	3.80
1998	75.5	27.2	361	7.9%	5.8	64.1	18.6	17.3	5.59
1999	76.6	28.7	374	6.9%	4.8	62.2	17.4	20.4	6.59
2000	77.6	31.2	402	6.8%	6.8	47.4	13.8	38.8	4.80
2001	78.7	32.7	415	7.4%	6.9	59.9	20.6	19.4	4.89
2002	79.7	35.1	440	7.0%	7.1	44.2	27.7	28.2	5.01
2003	80.9	39.6	489	7.0%	7.3	72.1	43.7	-15.8	5.09
2004	82.0	45.4	554	7.2%	7.8	61.5	21.9	16.6	4.91
2005	83.1	52.9	637	7.6%	8.4	...	...	...	4.68
2006	84.2	60.9	723	7.2%	8.2	...	...	...	4.88
<b>2007p</b>	<b>85.2</b>	<b>70.3</b>	<b>833</b>	...	<b>8.4</b>	...	...	...	...

Sources: ADB *Key Indicators* (2007); GSO (for ICOR); Tran Tho Dat, Nguyen Quang Thang and Chu Quang Khoi, "Sources of Vietnam's Economic Growth 1986-2004," mimeo, National Economics University (2005).

### *East Asian growth pattern*

For latecomer countries, economic development and international integration are inseparable. Today's development process is characterized by a continuous inflow of foreign products, ideas, technology, and systems into the country. To enhance domestic capability and generate growth, foreign factors must be adopted selectively and with modifications to suit local needs. Integration policy and development policy must be combined into one and managed by the central government, rather than left to market forces or foreign organizations, to minimize macroeconomic and social risks.

The development-integration nexus takes a very special form in East Asia. Growth has been attained through the very existence of the East Asian region as an arena for economic interaction among its members. One by one, countries in different development stages initiate economic growth by participating in the dynamic production network spanned by private firms. Linked by trade and investment, an international division of labor with clear order and structure has emerged in the region. Industrialization has proceeded through geographic spreading on the one hand and structural deepening within each country on the other. The term *flying geese* referred to these systematic supply-side developments<sup>3</sup>. To understand this mechanism, evaluating the policies of individual countries is not enough; it is necessary to

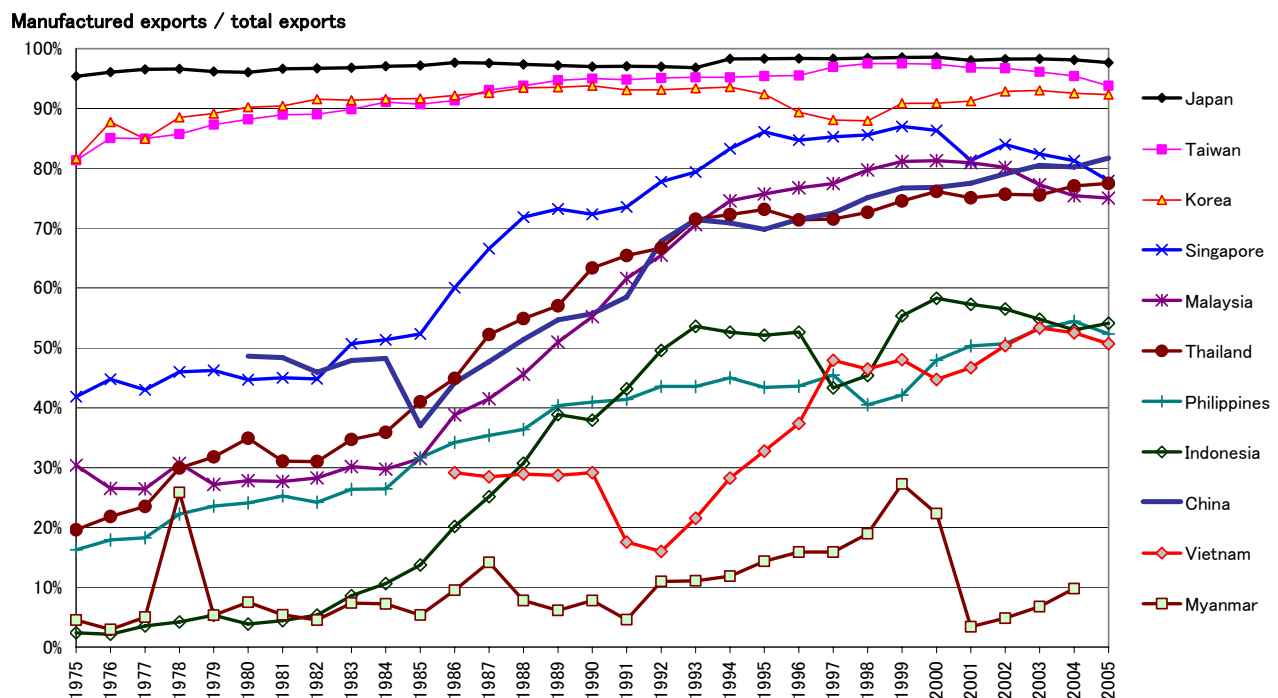
<sup>3</sup> Some argue that the flying geese pattern no longer exists as latecomers catch up with forerunners and "high-tech" goods are produced in low-income countries. However, if we interpret the flying geese hypothesis more flexibly and allow changes in relative competitiveness and production allocation, a clear order and structure is still visible at any point in time. The reality in East Asia is far from random acrobatic flight.

analyze East Asia as a whole with its production structure, intra-regional trade, and investment flows.

For countries in East Asia, development has been tantamount to jumping into this regional production network and becoming one crucial dynamic link in it. Each country is under constant pressure from the countries moving ahead of it as well as behind it, which compels it to continuously climb the ladders of development. What drives them are the desire for material well-being and the pursuit of national pride in the context of this regional competition, not policy matrices introduced by international organizations.

Fig. 1-1 shows how the East Asian geese have been flying as measured by the ratio of manufactured goods in total exports. The top economies including Japan, Taiwan and Korea have long exported manufactured goods. The second tier of economies such as Singapore, Malaysia, Thailand, and especially China, have caught up very fast. They are followed by the third group of economies such as Indonesia, Philippines and Vietnam. By contrast, Myanmar and economies not shown here such as Cambodia, Laos and North Korea have not even entered the race.

**Figure 1-1 Manufactured Exports**



Sources: Asian Development Bank, Key Indicators of Developing Asian and Pacific Countries, 1993 & 2006; Statistical Bureau, Ministry of Internal Affairs and Communications, Japan Statistical Yearbook 2007.

Industries are constantly passed from the first-tier countries to the second-tier countries, then onto the third-tier countries, and so on. Since this industrial passing occurs mainly through FDI, countries wishing to strengthen their positions court FDI vigorously. Japanese corporations have been the chief architect of the East Asian production network, together with EU and US multinationals. The extensive business networks of Taiwan, Hong Kong, and overseas Chinese as well as bold business moves by Korean *chaebols* have also invigorated this region. Since the 1990s, the emergence of China as an active producer and

investor became the new important factor. No other developing region has formed such an organic and dynamic interdependence as East Asia.

Vietnam is the latest comer to the East Asian production network. In the last fifteen years, Vietnam's economic performance has been quite remarkable. The country took decisive steps in regional and global integration, received substantial FDI and ODA, liberalized trade and investment in steps, and introduced competitive pressures and systemic reforms. Despite these achievements, however, Vietnam is still a tiny player in terms of absolute size and the level of technology.

In the years to come, East Asian catch-up type industrialization, as described above, will continue to be basically applicable to Vietnam. Vietnam is expected to meet the challenges that were faced by Asian NIEs (Singapore, Hong Kong, Taiwan, and Korea) and ASEAN4 (Malaysia, Thailand, Indonesia, and the Philippines) in the past. By overcoming these challenges, which will be discussed in detail below, Vietnam should become one of the key players in the East Asian value chain and supply chain.

#### *Avoiding the middle income trap*

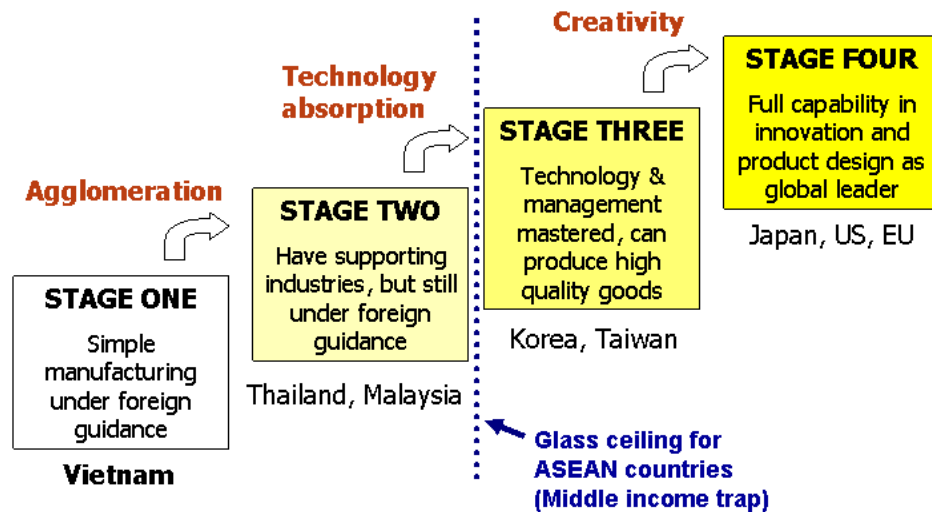
Industrialization in latecomer countries usually starts with simple assembly or processing of light industry products for export such as foodstuff, handicrafts, garment and footwear. Electronic products and parts may also be produced this way. In this early stage, design, technology, production and marketing are directed by foreigners, key materials and parts are imported, and the country contributes only unskilled labor. While this generates jobs and income for the poor, internally created value is small and foreign created value dominates. Vietnam's industrialization up to now is basically characterized by this situation.

In the second stage, as FDI rises and production expands, the domestic supply of parts begins to increase. This is realized partly by the inflow of FDI suppliers and partly by the emergence of local suppliers. As the domestic supply of parts increases and their quality improves, assembly industries can enhance competitiveness and expand further. A virtuous circle between assemblers and suppliers sets in. This is the stage where the industry grows *quantitatively* through the increased domestic availability of physical inputs. Domestic value has increased, but production basically remains under foreign management and guidance. Thailand and Malaysia have already reached this stage.

The next challenge is to internalize skill and knowledge by accumulating industrial human capital. Locals must replace foreigners in all areas of production including management, technology, design, parts and components, factory operation, logistics, and marketing. As foreign dependence is reduced, domestic value creation expands dramatically and the country emerges as a dynamic producer in the global economy. Korea and Taiwan are such producers.

In the final stage, the country is equipped with the capability to create new products in addition to the capability to produce existing products with high quality and low cost. It becomes a global innovator who leads market trends. Japan, the US, and some of the EU countries are such industrial leaders.

**Figure 1-2 Stages of Catching-up Industrialization**



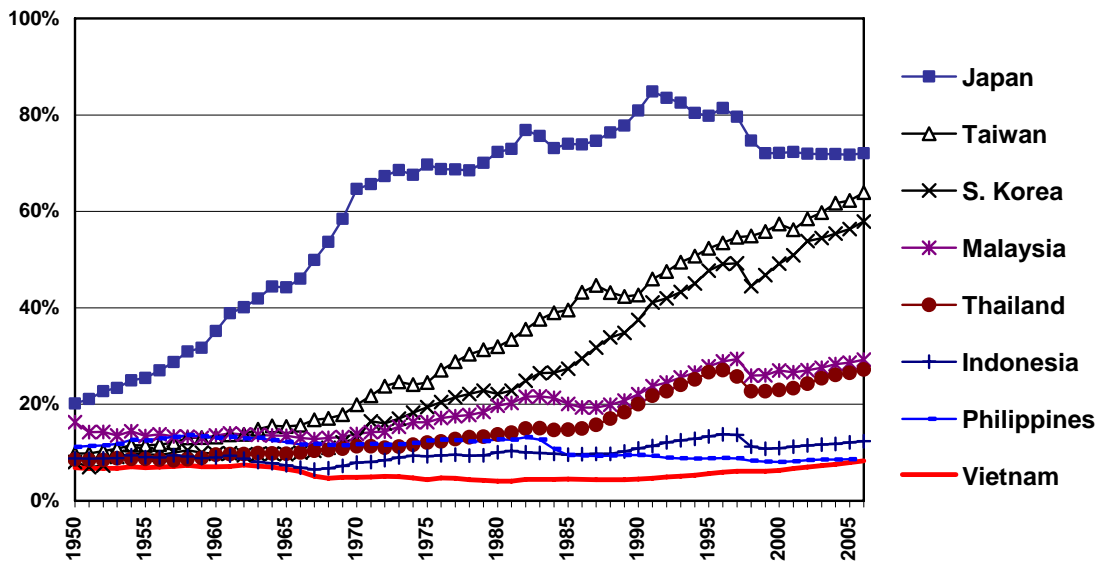
However, progress is not guaranteed for all. A large number of countries that receive too little FDI cannot even enter the first stage. Even after the first stage is reached, climbing up the ladders becomes increasingly difficult. Another group of countries are stuck in the second stage because they fail to upgrade human capital. It is noteworthy that none of the ASEAN countries, including Thailand and Malaysia, has succeeded in breaking through the invisible “glass ceiling” in manufacturing between the second and the third stage. A majority of Latin American countries remain middle income even though they had achieved relatively high income as early as in the 19th century. Countries in the middle income trap continue to remain at a moderate level of industrialization and cannot join the high income club.

Starting from a very low level, Vietnam is currently in the first stage of industrialization trying to reach the second. Large FDI inflow, required to realize this transition, is already happening. Neighboring ASEAN countries even fret about losing FDI to Vietnam. While Vietnam’s short-term goal is the attainment of physical expansion of the industrial base, it should also simultaneously prepare to avoid the middle income trap in the future. For this, front-loaded and well-targeted policy actions for upgrading industrial human resources is the key.

Without breaking the glass ceiling, middle income may be achievable but high income cannot be reached. Figure 1-3 shows per capita real income of selected East Asian economies relative to the US level. Until the mid 1960s, these economies (except Japan) showed no clear sign of catching up. However, Taiwan and Korea, which started from equally low levels, took off in the late 1960s and have improved income dramatically. In comparison, the catching up of Malaysia and Thailand looks less impressive, and Indonesia and the Philippines failed to improve their relative positions. Although the negative impacts of financial crises and recessions are visible in this diagram, long-term trends are indisputable.

**Figure 1-3 Different Speed of Catching Up**

(Percent of US real income)



Sources: Angus Maddison, *The World Economy: A Millennium Perspective*, OECD Development Centre, 2001; the Central Bank of the Republic of China; and IMF *International Financial Statistics* (for updating 1998-2006). Note: Per capita real income relative to US as measured by the 1990 international Geary-Khamis dollars.

### *Vietnam's unique features*

Vietnam's development strategy cannot be the same as those of other ASEAN countries, even if international lessons are useful. Vietnam must find a path most suitable for its own circumstances. Vietnam's unique features are many, but the following should be particularly noted in forging Vietnam's dynamic comparative advantage.

First, Vietnam's international integration must proceed faster and at an earlier development stage than experienced by ASEAN4. This means that strategy of receiving a large amount of FDI while removing trade and investment barriers only slowly, over a few decades, is no longer available to Vietnam.

Second, Vietnam's current industrial dynamism is fueled mainly by private investment and consumption. Very strong private demand is generated by a large inflow of external funds—Viet Kieu remittances, workers' remittances, FDI, ODA, tourism receipts, security investments—and accelerated further by active public spending for building infrastructure. The Vietnamese economy is booming and even overheating.

Third, foreign investors are attracted by Vietnam's advantages which are mainly given and not policy-created, such as good location and good workers. Vietnam is luckily situated in the heart of East Asia with a long coastal line. Moreover, Vietnam's workers are reputed to be skillful and diligent *provided* that they receive proper managerial direction and technical training. These advantages should be the principal sources of Vietnam's industrial competitiveness in the future, but they remain largely unexploited at present.

Fourth, on the negative side, Vietnam's policies and institutions are weak not only by the standard of East Asian high performers but even by the general standard of developing countries. Superiority in policies and institutions is not the reason for the current high growth. This is so even though the Government has made great effort in the last two decades. If Vietnam wishes to achieve high-quality growth, the policy framework must be reformed even more so that they will no longer be the obstacles of development<sup>4</sup>.

These unique features should be fully reflected in designing Vietnam's policies for breaking the glass ceiling, catching up steadily to a high income level, coping with the China challenge, and achieving the national goal of industrialization and modernization by 2020.

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<sup>4</sup> The JBIC's *Vietnam's Investment Climate 2006*, a handbook for Japanese SMEs considering investment in Vietnam, lists the following strengths: (i) good workers, (ii) political stability, (iii) rapidly improving FDI climate, (iv) good location in East Asia, and (v) large population; while weaknesses include (i) unstable policy and law, (ii) poor infrastructure, (iii) irregular business practices, (iv) corruption, (v) lack of supporting industries, (vi) shortages of skilled engineers and middle-level managers, and (vii) possible negative impact of integration.