

Vietnam: Deepening Reforms for Rapid Export Growth¹

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1. Introduction

One of the most important successes of Vietnam's doi moi (renovation) policy has been a rapid 22 percent annual average growth in the country's exports since 1985. This export growth has been a key driving force for rapid economic growth, job-creation and exceptional reduction in poverty, giving the government the resources to tackle the important tasks on its political and social agenda. Prospects for continuing rapid export growth are bright, given its natural resources, its dedicated and educated labor force, and the government's strong commitment to exports, growth and poverty-reduction.

Nevertheless, Vietnam is at something of a crossroads. It has had an extremely successful performance so far, but unless it breathes new life into its strategy for promoting exports, it will not be able to achieve the targets of its Ten-Year Socio-Economic Development Strategy (SDS), including the employment of the large annual increases in its labor force. In fact it has already fallen behind in 2001 and 2002, averaging export growth of around 7 percent a year, in part because of a difficult global and regional environment.

Vietnam's competitors are not standing still. They are constantly improving their trade regimes, liberalizing their private investment climate, strengthening their financial sector, and improving their logistics, infrastructure, and business services sector. Many countries in the region used the recent crisis to make such improvements. It is thus no longer good enough to show that Vietnam is moving forward; the issue is whether it is moving forward with reforms at a faster pace than its competitors. Vietnam cannot afford to be among the bottom 15 countries in the World Economic Forum's rankings on competitiveness out of 75 economies, if it wants to have one of the fastest export growth in the world.

China's accession into WTO offers has added to those pressures on Vietnam. While China has become an important destination for exports from the region, including Vietnam, it is also a fierce competitor in third country markets. It is also attracting most of the foreign investment coming to the region.

At the same time if Vietnam deepen reforms to liberalize the trade regime, improve the climate for private investment, especially domestic private sector, strengthen financial sector, make state-enterprises more competitive and strengthen infrastructure and business services, exports will grow rapidly. Vietnam accounts for only 0.2 percent of world non-oil exports and only 0.6 percent of developing country non-oil exports. Even a doubling of exports to US\$32 billion will raise its share to 0.4 and 1.2 percent of world and developing country non-oil exports respectively. The constraint on high export growth is unlikely to be external; it lies inside Vietnam and can be addressed by the Vietnamese themselves.

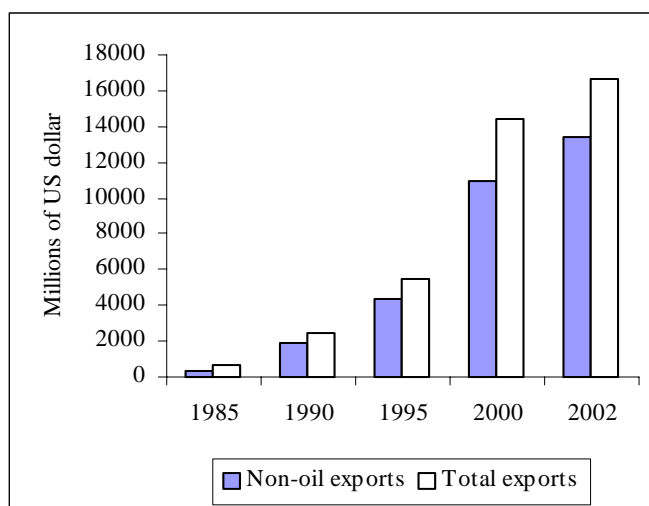
It is therefore encouraging to see Vietnam's efforts at seeking accession to the WTO, at implementing the AFTA and USBTA agreement and at encouraging the domestic private sector and foreign investment.

2. Export Performance

2.1 Overall Export Trends

Vietnam's exports responded strongly to the "doi moi" reforms launched in 1986. Total merchandise exports tripled in dollar terms in five years to reach \$2.4 billion in 1990, surged sevenfold to more than US\$16 billion in 2002². This was commendable performance. Exports from both South Korea and Taiwan passed the \$10 billion mark in 1978, while Malaysia, Indonesia and Thailand passed this threshold in the mid-1980s, and the Philippines only in 1993. Vietnam passed this mark in 1999.

Figure 1. Vietnam's Non-Oil Exports

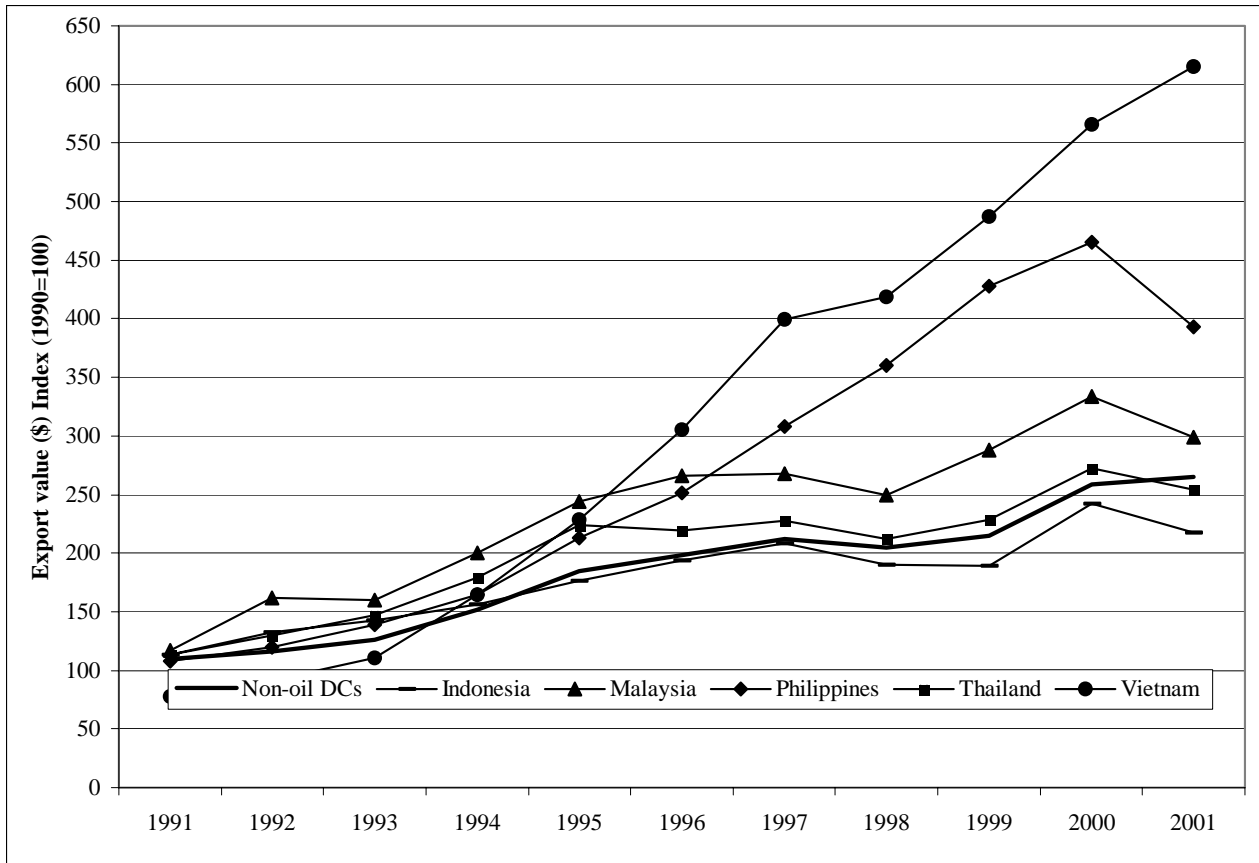


Between 1991 and 2002 the dollar value of non-oil exports from Vietnam grew at an average annual rate of nearly 19 percent, double the average for developing countries as a group. The dollar value index for Vietnam's non-oil exports OSL six fold, twice as much as any other East Asian countries (see Figure 2). In real terms, Vietnam's exports grew at a rate of nearly 17 percent a year in the 1990s, significantly higher than the rate of growth in world exports.

However, there is still considerable room for maintaining these rapid rates of export growth, given the relatively low share of exports in Vietnam's GDP, as well as in world exports. The share of exports in Vietnam's GDP has risen from around 5 percent in the mid-1980s to around 21 percent by the mid-1990s and to 39 percent in 2002. Nevertheless, the fast-growing economies of East Asia, reached more than 60 percent for most countries, with Malaysia's exports accounting for 125 percent of its GDP.

Figure 2. Non-oil Export \$Value Indices*: Vietnam and Selected Countries 1990 to 2001 where 1990 = 100

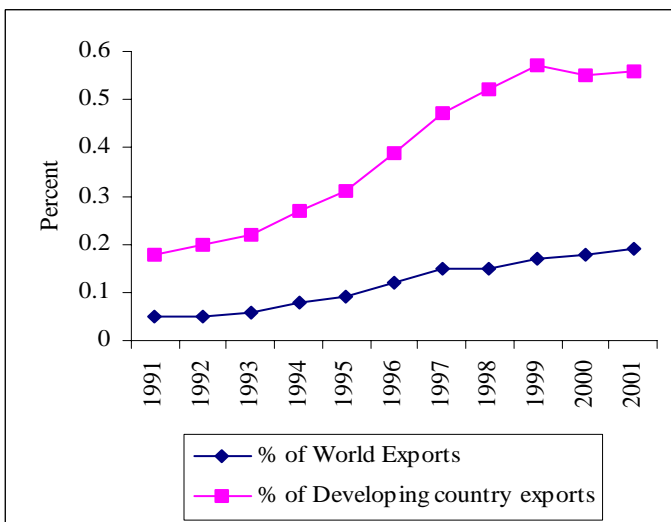
² It is important to note that official trade data up to the late 1980s are believed to understate the level of Vietnam's foreign trade because of the underreporting of barter trade with the communist block countries.



Source: Based on data compiled from Asia Recovery Information Database, Asian Development Bank (<www.aric.adb.org>), and IMF, International Financial Statistics database (for non-oil exports from DCs) .

With rapid export growth, Vietnam has raised its share of world non-oil exports to 0.2 percent and of developing countries' non-oil exports to 0.6 percent now.

Figure 3. Vietnam's Export as percent of World Exports and Developing Country Exports



By comparison, the Philippines, a weaker performer compared to other middle income countries of East Asia, has a bigger share, as much as three times of Vietnam's. There is thus huge potential for further

export growth. Even a doubling of Vietnam exports to \$32 billion, would only raise Vietnam's share in world non-oil exports to 0.4% and in non-oil exports of developing countries to only 1.2 percent, still a relatively insignificant share.

2.2 Changing Composition of Exports

Until 1992, Vietnam's export expansion was dominated by crude petroleum exports³, but its share declined in 2001 to only 20 percent, with non-oil exports exceeding \$11 billion. This was initially due to a rapid expansion in Vietnam's agricultural exports, especially rice, coffee, rubber, cashew and so on, which grew very rapidly in both volume and value.

Box 1. A Typology of Export Opportunities

Experience of exporters around the world including East-Asia suggests three types of exports based on varying factor intensities.

- (1) Resource-based manufactures
- (2) Labor-intensive low technology consumer goods
- (3) Medium technology labor intensive component manufactures for assembly
- (4) High technology capital intensive differentiated products

Given Vietnam's resource endowment and stage of development, opportunities for export growth are in the first three types of products. Exports of high technology capital intensive differentiated goods (Category 4), originate almost exclusively from developed market economies or advanced newly industrializing countries (NICs), because labor costs are less important than the availability of high-quality operators, with high technical skills and capital.

In the first category, potential for export expansion depends mainly on the availability of natural resources and on attracting capital to process them (i.e. mineral and chemical industries). Processed food offers good potential for Vietnam given its rich agricultural resource base.

The potential export of labor intensive light manufactures and low technology (category 2) and labor-intensive medium-technology component production for assembly (category 3) is now well recognized. The growing ability of modern industry to 'slice up the value chain' of goods traditionally viewed as skill-, capital-, or technology-intensive and to shift the labor-intensive slices to low-wage locations like Vietnam has been a boom to East Asia's sustained growth of regional trade. Electronics, semi-conductors, computers, electrical appliances, automotive parts, electrical machinery and optical products are all subject to this trend. The evidence is that from the mid-1980s exports of components from East Asian countries as a group have grown faster than any another major product group.

The share of manufactures began to increase from the mid-1990s and by the turn of the century, manufactured goods accounted for two-thirds of total merchandise exports.⁴

Manufactured exports were initially concentrated in resource-based products, especially fish, semi-processed rubber, furniture and processed foods (Table 1). From the mid 1990s, standard labor-intensive goods, notably garments and footwear, started to overtake resource-based products. Component assembly began to gain some ground only in the last two years and it remains relatively small as a share of total manufactured exports.

³ Virtually all of Vietnam's oil production is exported, as the country has no major refinery.

⁴ SITC = Standards International Trade Classification; based on the standard SITC definition.

Within resource-based manufactures, exports of processed food, especially fish, have grown faster than other items. Given the country’s agricultural resources and the growing world demand for seafood, canned fruits, vegetables and meat, Vietnam has considerable untapped potential for further export expansion in processed food. In 1999, seafood exports from Thailand and Indonesia were \$7.1 billion and \$4 billion respectively, but Vietnam exported a mere \$900 million of seafood. This figure nearly doubled in the next two years, showing that there is unfulfilled potential.

Table 1. Shifting Composition of Manufactured Exports*, 1985-2000

	(% Share)			Growth Rate (%)		
	1985		2000	1985-90	1990-95	1995-2000
(1) Resource Based Manufactures	74		17.6	21	23	5
(2) Labor Intensive low technology plus medium technology components assembly	21.7		77	34.3	102	20
(3) High Technology capital intensive differentiated products	3.9		5.4	40	622	2.4
Total	100		100	23	67	14

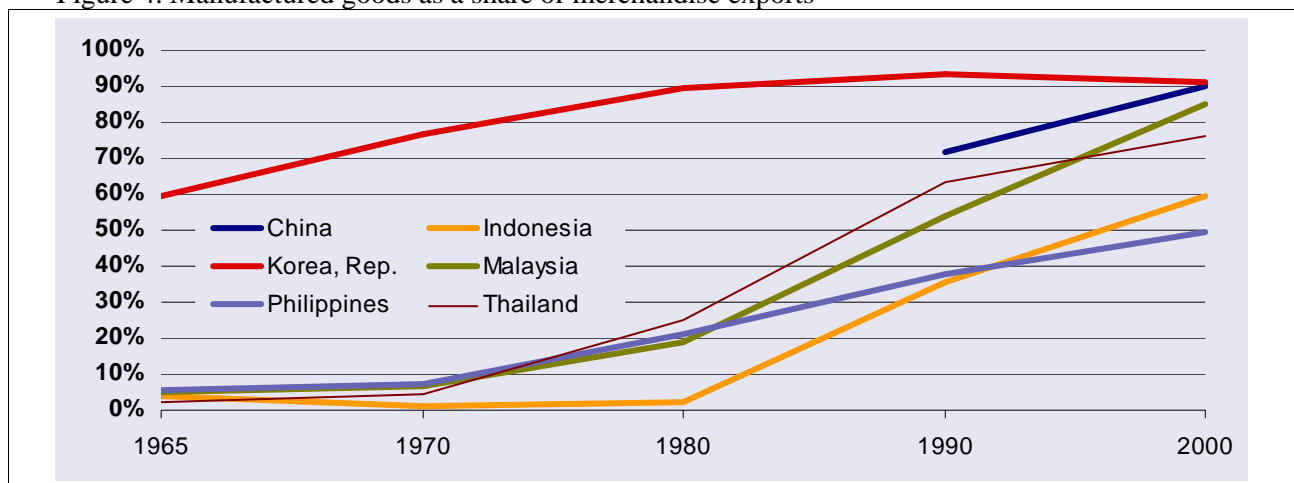
*Classified by factor intensity of manufacturing
 Source: Annex: Vietnam’s Export Pricing and Performance.

2.3 Evolution of East Asian Export Composition

In sum, changes in the export composition in Vietnam is moving in line with the experience of other East Asian exporters that came before Vietnam. Rapid growth of exports in South Korea, Malaysia, Thailand, Indonesia and the Philippines was accompanied by two types of shifts in the composition of total merchandise exports. First manufactures rose sharply as a share of total exports and second, within manufactures, there was a shift towards more technology intensive, but labor-using, exports.

This evolution was common to all successful exporters and high performing economies of the region.

Figure 4. Manufactured goods as a share of merchandise exports



Note: Data unavailable for China prior to 1990.
 Data source: World Bank Development Indicators, ADB (2003)

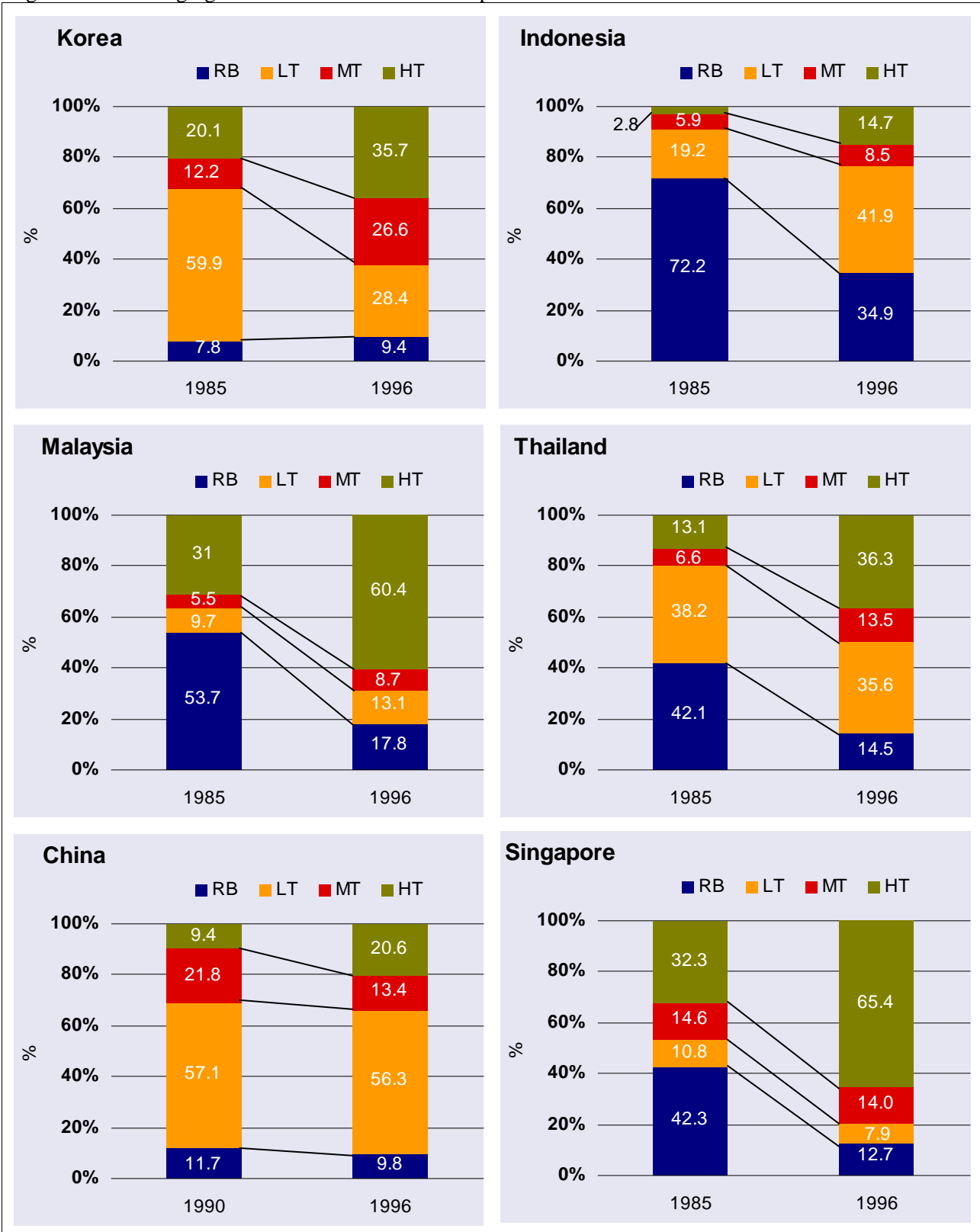
Manufactured exports climbed from under 10 per cent in the 1960s to as much as 90 per cent in 2000, as shown in the figure below. The rapid growth in manufacturing exports was accompanied by a dramatic

shift away from resource based low technology exports (such as processed foods, tobacco, simple wood products, rubber products etc) toward more technology-intensive products (such as complex, fast moving technologies such as fine chemicals, complex electrical and electronic equipment, precision instruments, some automotive parts and integrated circuits etc) as shown in figure below (see Lall 1998).

This trend might, at first glance, seem inconsistent with the comparative advantage and the endowments of these economies. But in fact, it is quite consistent when the fragmentation of manufacturing processes and the emergence of production platforms assembling various components, are taken into account (Lall, 1998). Labor-intensive final assembly activities have come to be located in countries where labor tends to be cheaper, and the complex, technology intensive core production processes and design remains in the more developed economies.

All successful developing country exporters, especially those in the region appear to have gone through this process, using the technologically sophisticated foreign investors as key players in this evolution. The figures below show this evolution for successful exporters in the region like S. Korea, Indonesia, Malaysia, Thailand, China and Singapore – moving away from resource-based to labor intensive low technology to medium-technology but labor intensive components production for assembly in more developed economies. Indonesia reduced its share of resource-based and low technology labor intensive manufactured exports from 91.4 percent in 1985 to 76.8 percent, because of the growth of other types of export. The same has been true of Malaysia, Thailand and Singapore.

Figure 5. The changing structure of manufactured exports in selected East Asian economies



Note: RB denotes resources based exports, LT denotes low technology exports, MT denotes medium technology exports and HT denotes high technology exports. See Lall (1998) for definitions of these categories.

2.4 Upgrading of Export Structure

Vietnam is still at an early stage in its exports of labor intensive low-technology manufactures like garments, textiles, footwear⁵, leather goods, wood products, plastic products, processed food and so on. Its labor cost advantage remains significant even at lower niches of these markets. There is thus still a huge potential for continued growth in this type of exports over the next decade.

But Vietnam can start exploiting its potential in the medium-technology products which involves production of labor-intensive value-slices, i.e. components of those products assembled somewhere else. There are embryonic exports of this already by a few foreign invested enterprises.

However multinational companies (MNCs) from industrialized countries are the key actors in worldwide and regional offshore assembly operations. While MNCs from the US dominated the scene at the formative stage of global spread of assembly activities in the late 1960s, the involvement of Japanese and Western European MNCs also has been gaining importance since the late 1970s. More recently MNCs from more advanced developing countries, notably those from the East Asian NICs have also joined this process of internationalization of production. In response to rapid domestic wage increases, firms in electronic industry and other durable consumer goods industries in NIEs in East Asia have begun to produce components and sub-assemblies in neighboring countries where labor costs are still low.

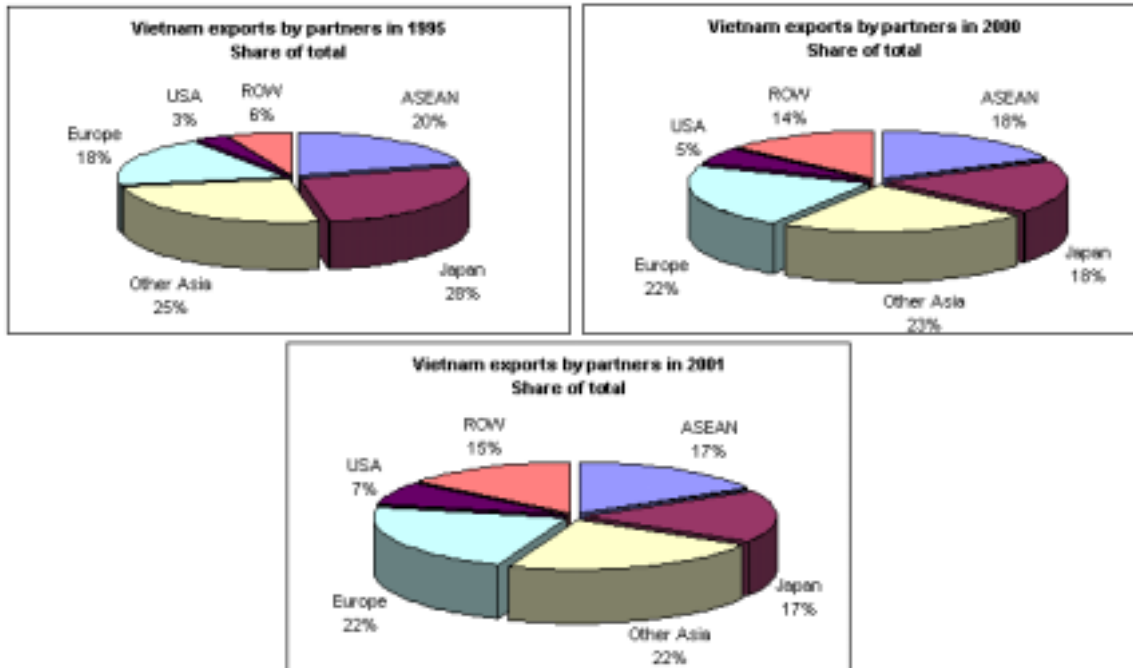
A striking feature of MNE operations in East Asia in assembly activities is the emergence and growing importance of cross-border multi-plant operations within the region (Dobson and Chia 1997; Petri 1993; Athukorala and Menon 1997). MNE affiliates in high-tech industries located in countries like Hong Kong, Singapore and Taiwan, faced with intensifying competition emanating from deregulation and falling trade barriers, have begun to relocate some segments of the production process to neighbouring countries. This process has created a new regional division of labour, based on skill differences, differential factor prices (especially wages) and superior communication facilities. Production is thus dispersed within the region, leading to intensified intra-regional trade in the context of a global industrial network.

If Vietnam has to take a slice of this export business, it must make the domestic climate for doing business in general, more friendly and hospitable. But as countries like Indonesia and India are demonstrating, it is possible to get a miniscule share of world exports of these medium-technology products – which will imply a huge increase in Vietnam's exports.

2.5 Geographic Composition of Exports

Vietnam's export expansion has been underpinned by big changes in the geographic profile of exports, a combined outcome of the reaction of state trading companies to the collapse of the CMEA market and the creation of new markets through foreign direct investment in the country. Exports to CMEA markets declined persistently from the late 1980s to just 2 percent by 2001. Exports to China have expanded more rapidly than to any other regional market. From less than 1 percent of non-oil exports at the start of the 1990s, China took almost 10 percent in 2001.

⁵ Even with the surge in garments and footwear exports, they totaled \$2 billion and \$1.5 billion respectively in 2001 (out of total merchandise exports of \$15 billion). This does not yet put Vietnam into the major leagues in those items.



The geographic profile of Vietnam's exports is unique in Asia because of the small share of the world's single largest market, the US. Entry of Vietnamese products to the US remained virtually barred by the trade embargo, only lifted in 1994, since when exports have taken off and sales to the US reached 7 percent of Vietnam's total exports in 2001. Entry concessions under the recent US-Vietnam bilateral trading agreement should see exports to the US grow rapidly. If the experience of the rest of southeast Asia is a guide, the current US share of Vietnamese exports could increase threefold.

3. Foreign Direct Investment & Exports

Like other East Asian countries, Vietnam's exports grew on the back of rapid increases in foreign investment inflows. Initially, most of this investment came in the form of joint-ventures with SOEs to supply the domestic market. Most of this came into real estate, hotels and heavy industries like cars, steel and cement, largely due to the protected domestic market. But as foreign investment rules were further liberalized, import protection was reduced and export promotion was more firmly entrenched, which came about in the late 1990s following the East Asian crisis, most of the FDI came as wholly-foreign owned ventures into light manufacturing.

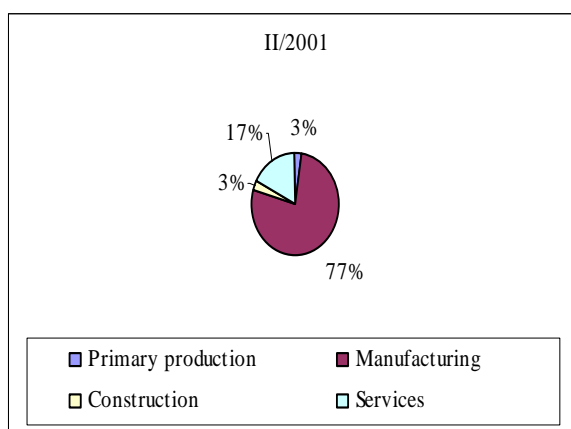
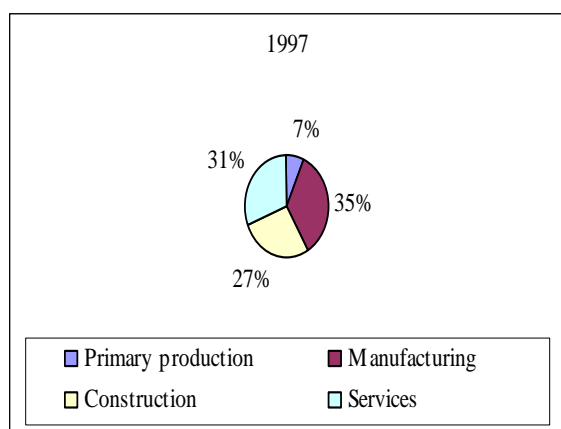
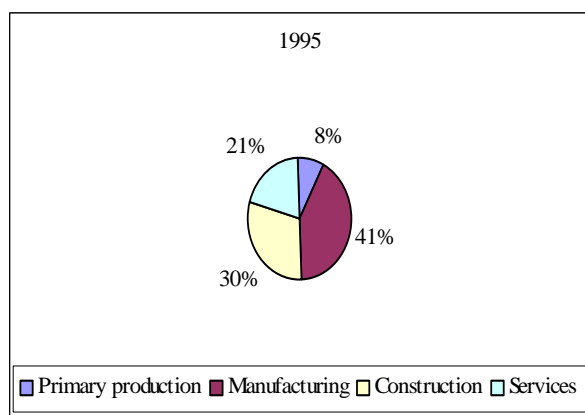
The trend in foreign investment (FDI) flows to Vietnam over the past one-and-a-half decades has by and large reflected changes in the domestic investment climate as also global trends. And as a latecomer on the global scene and having a relatively difficult environment for private sector development, Vietnam attracted mainly the foreign investors from the region. This was due to three factors, two of which related to the global conditions. First, labour-intensive export products from their home countries were not competitive as a result of rising real wages. Second, the imposition and gradual tightening of quantitative import restrictions (QRs) under the Multifibre Arrangement (MFA) made them subject to quotas. Third, unlike firms from developed countries, East Asian firms were more familiar with and more easily adaptable to the more difficult business conditions (eg. poor infrastructure, bureaucratic red tape, unpredictable policy settings) in latecomers like Vietnam. As a result nearly 70 percent of FDI flows came from Asia, in contrast to rest of Asia where developed countries have 70 percent of total FDI inflows.

FDI inflows began to gain momentum from 1991 and reached its peak at around US\$ 2 billion in 1997. The East Asian crisis led to a precipitous fall in the total FDI inflows and it was not until 2001 that it began to recover to \$1 billion mark. However, there have been very significant changes in the type and sectoral focus of FDI flows in recent years, which make them more beneficial for export growth.

As the climate for foreign investment improved in Vietnam, the contribution of foreign invested enterprises (FIEs) to non-oil exports increased. FIEs' share of total non-oil exports rose from 6 percent in 1991-95 to 34 percent by 2000 and their share in manufactured exports rose from 19 percent to 50 percent during the same period. This still means that wholly-Government-owned SOEs and the domestic private SMEs supply nearly half of manufactured exports, with domestic private SMEs dominating garments, footwear, processed food (especially shrimps), leather goods and plastic products.

Changes in sectoral composition of FDI. In line with the changing incentives, there have been changes in the sectors where foreign investment flows have come in. As protection of the domestic market fell in late 1990s and profits in real estate and hotels came down following the regional crisis, FDI flows fell and its composition shifted towards light manufactures and export industries between 1995, 1997 and 2000, as is evident in the figures below. Manufactures initially accounted for a fifth of foreign investments, but by 2001 the share was nearly three-quarters. The share of labor-intensive consumer goods and component production rose significantly within foreign investment in manufacturing. In electronics, unlike neighboring countries where large multinationals predominated, most of Vietnam's foreign investment in assembly plants came from small and medium-sized investors except for two (i.e.Hitachi and Fujitsu);

Figure 6. Sectoral Share of Registered FDI



Changes in type of FDI. There were also changes in the corporate form of FDI as investment rules were further liberalized. Three quarters of foreign investment was in the form of joint-ventures during 1988-94 (71% in 1995 showing some downward trend), but by 2001 less than a sixth were joint ventures and *two-thirds* were fully foreign-owned. What is very different from other East Asian countries experience including China, is that Vietnam has virtually no joint ventures with foreign investors, because it is not encouraged. The result is that the domestic private sector is deprived of the process of learning export marketing and technology of production, as also the capacity to grow bigger and become independent sources of export dynamism.

Figure 7. Type of Registered FDI 1995

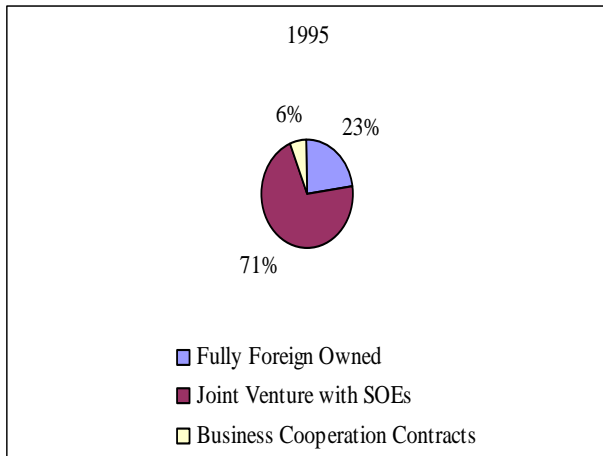
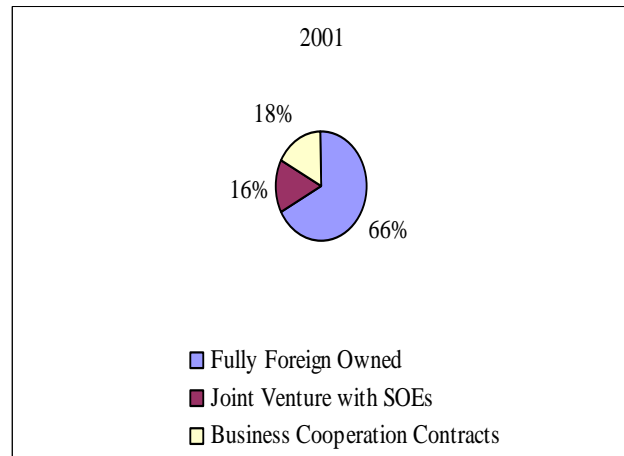


Figure 8. Type of Registered FDI 2001



Role of EPZs. Of the six EPZs set up in Vietnam since the mid-1990s only three are currently in operation, Linh Trung, and Tan Thuan (both in Ho Chi Minh City) and Nomura in the North (Hai Pong). The other three have been converted into industrial zones because of the poor response from export-producing foreign investors.

This mixed performance does not mean that such zones have no “special” role in Vietnam’s promotion of export-oriented FDI. On the contrary, the record of the two Southern zones suggests that export-oriented investors prefer to locate in these zones and the export performance of firms located there has been superior to that of the country as a whole.

Investment in the two zones, both in the number of new firms and the value of committed investment, has increased continuously over the past seven years, despite the decline in total FDI inflows to the country. Exports from the two EPZs have increased much faster than total manufactured exports by FIEs. Their share in total non-oil manufactured exports increased from 11 percent in 1995 to more than 22 percent in 2001. By end of September 2001 total employment stood at 70,000, compared with 15,000 in all 10 industrial zones in the South. The two zones accounted for about 24 percent of total FIE employment in the country by 2000.

The other EPZs have failed not because of the irrelevance of EPZs as a “special” (of course second best) tool of export promotion though FDI but because of implementation problems. Nomura Zone has a high quality infrastructure including port facilities, but it has suffered from a shortage of labor because of its remote location. Other failed zones too were located according to a determination to develop poor and remote regions, rather than to see that the zones operated efficiently. Both southern zones are well

located with easy access to port facilities and urban infrastructure. Moreover, the local administration in HCM City has made use of the administrative flexibility under the decentralized FDI administration mechanism to provide a more favorable business environment (including speedy import clearances) for firms located in the zones.

The contribution of FIEs to employment has not matched their significant contribution to growth in GDP and industrial output. By 2001, total employment in FIEs had reached 420,000 or less than 1 percent of formal (non-household) employment in the economy. Employment in manufacturing FIEs amounted to 322,000 or 4.7 percent of total manufacturing employment.⁸ This lackluster employment record probably reflects the capital intensity bias infused into FIE production by the distorted trade policy regime.

4. Domestic Policy Context

Vietnam's constraint in continuing to grow their exports as fast as possible is to be found in its domestic policy. It has such a small world market share, that external constraints are minimal. Future export success therefore depends crucially on the country's ability to address critical supply side issues. This section examines the domestic policy context for export expansion, focusing first on macroeconomic policy and the overall incentives, the trade policy regime on the incentives for exports, domestic regulatory impediments to private investment, especially domestic private sector, and in that respect the functioning of the banking system and state-enterprises as also the state of logistics and infrastructure and the service sector.

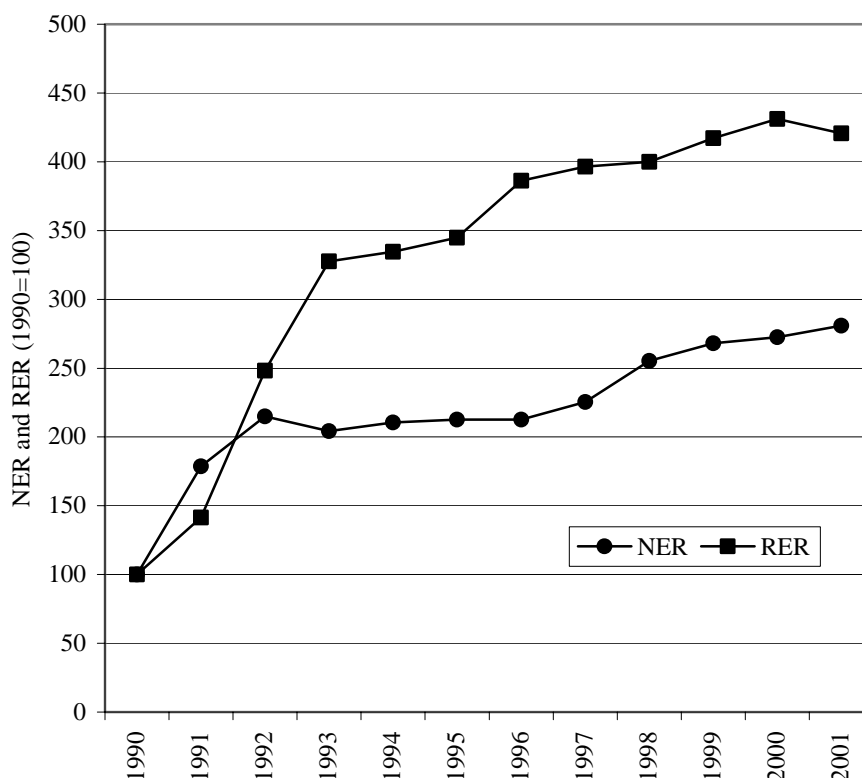
4.1 Macroeconomic Policy Regime and the Real Exchange Rate

Vietnam has an excellent track record of maintaining a stable macroeconomic environment since the start of the reform program in 1989. This, coupled with periodic downward adjustment of the nominal exchange rate by the State Bank of Vietnam (the central bank), have helped avert real exchange rate appreciation (Figure 9). In addition, the nature of foreign capital flows, in the form of FDI rather than portfolio capital, and the restrictive trade regime, has kept imports in line with export earnings. Macroeconomic management may become more of a challenge as commodity and financial markets get more integrated in the context of the AFTA and USBTA.

Competitive real exchange rates are important given that the suppliers of similar products, for example, those in ASEAN, have allowed their the exchange rates to move together with differential inflation rates. From the mid-1990s, the dong moved closely with the US dollar, giving improved competitiveness with China and to a lesser extent with the US since the mid 1990s, but a loss in competitiveness vis-à-vis the EU as the euro weakened against the dollar.

⁸ Total (economy-wide) employment figures used in these calculations come from General Statistical Office, Statistical Data of Vietnam Socio-Economy, 1975-2001, Hanoi: Statistical Publishing House.

Figure 9. Nominal and Real Exchange Rate Indices, 1990-2001 (1990=100)



Note: NER Nominal exchange rate. Trade-weighted bilateral exchange rate indices of the major trading partner countries.
 RER NER adjusted for relative price levels measured in terms of the consumer price index (CPI). An increase in the index reflect a depreciation (improvement in competitiveness.)

4.2 Trade Policy Regime and Export Incentives

Vietnam has come a long way in liberalizing trade and in reducing import protection. Trade reforms gained momentum between late 1980s and early 1990s, stalled during the 1995-97 period and picked up steam again, from 1998. Like so many other countries, Vietnam sought to encourage rapid export growth, side by side with a highly protected domestic market, and it succeeded, through duty drawbacks and export processing zones. But this will be increasingly difficult to do as a growing share of Vietnam’s production and exports is conducted by the private sector and as labor markets become more integrated. A highly protected domestic market will increasingly constrain future export growth.

Most of Vietnam’s import protection has been provided by non-tariff import restrictions, especially until 1998. Initially, only state-trading firms and state-owned industries could import subject to discretionary approvals of quantities by the relevant ministries. Product-specific import quotas and import licensing (or variable quotas), were introduced in 1994. Nearly 19 commodity groups were subject to those restrictions in 1997 and this fell to 12 in 1998 and to 2 in early 2002. Estimates available suggest that coverage of quantitative import restrictions fell from nearly ... of imports and ... of domestic production in 1998 to 13 and 4 percent of imports and production, respectively in 2002. However, other non-tariff restrictions, like special-authority regulations, as well as inflexible customs procedures, continue to restrict imports, and needs to be reduced.

Import tariffs, introduced only in 1988⁶, are increasingly becoming the main source of protection for the domestic market and going forward, tariff reductions will be important in reducing bias against exports. They have been biased in favor of the manufacturing sectors, and products produced predominantly by the SOEs. Subsequent fine-tuning of tariffs during the late 1990s reflected selective protection of consumer goods (cosmetics, some categories of food products including sugar), upstream activities related to textiles and garments (silk, cotton, and certain fibers) and some specific intermediate goods (metal products, cements, glass). Only machinery and equipment and a sub-set of processed food products experienced falling average import tariffs and thus falling protection (CIE 1997).

The average import tariff is down to around 16 percent in 2002, and with it has fallen the dispersion in tariffs. There are only 15 tariff bands now, down from 35 in 1997, and the maximum tariff rate was reduced from 200% to 120% over the same period. Only 1% of total tariff lines (i.e. 71 out of 6296 lines) have rates above 50%.⁷ The dispersion in tariffs, as measured by the coefficient of variation (CV), remains high, though it has come down from 131 to 116 over the same period.

The tariff structure is a cascading one, like in so many other countries. The import tariffs are particularly high for processed food and processed agricultural products as also consumer goods like garments, footwear, ceramic products, leather and cosmetics. Intermediate goods and raw materials, taxed at zero or relatively low rates. Not surprisingly, most of the zero- or low-tariff rates are on items predominantly used by SOEs as inputs in their production, whereas some inputs like woven and knitted fabrics, using also by private firms, are taxed at a relatively high rate.

Vietnam does not compare very favorably with its neighbors, in terms of average import tariffs and their dispersion. The average tariff rate in Vietnam (both in terms of simple average and import weighted terms) is comparable with that of China and Thailand, but is significantly higher than that of the other three countries in the region. This is true also for primary and manufactured imports. Vietnam shows the highest degree of dispersion (variability around the average tariff level) relative to all five countries. Vietnam has lowered its coverage of quantitative import restrictions and other NTBs, but it is higher than all others.

Table 2. Nominal Tariff Rates & Dispersion in Selected East Asian Countries, 2000

	Tariff measure [*]	All products	Primary products	Manufacturing
China	Mean	15	14	15
	CV	71	102	59
	Weighted mean	20	19	16
	Maximum	121		
Indonesia	Mean	8	7	16
	CV	128	159	119
	Weighted mean	11	5	26
	Maximum	170		

⁶ The Law on Import and Export Duties came into effect on 1 January 1988, and a harmonised system (HS) of tariff nomenclature was introduced in 1992

⁷ These tariff rates are concentrated in three HS Chapter: HS 22 (Beverages, spirit and vinegar); HS 24: (tobacco and manufactured tobacco), HS 87 (Vehicles, other than railway).

Malaysia	Mean	10	5	15
	CV	200	181	172
	Weighted mean	13	12	16
	Maximum	300		
Philippines	Mean	8	6	8
	CV	94	57	19
	Weighted mean	7	5	9
	Maximum	60		
Thailand	Mean	18	16	19
	CV	84	48	55
	Weighted mean	17	14	18
	Maximum	80		
Vietnam (2002)	Mean	16	19	14
	CV	113	124	102
	Weighted mean	15	17	13
	Maximum	120.0	120.0	50.0

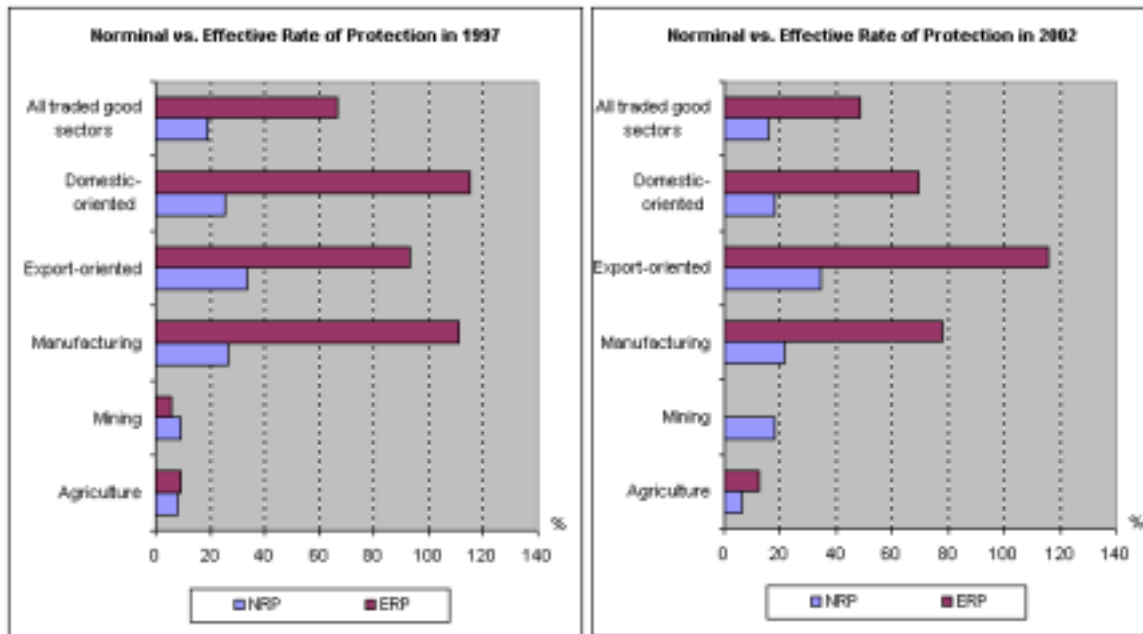
Notes*: In all countries the minimum tariff rate is 0; CV is coefficient of variation (standard deviation as a percentage of the average)

Source: Compiled from individual country tariff schedules available from the Asia Pacific Economic Cooperation (APEC) Secretariat online data base, www.apectariff.org.

Effective protection for production for domestic market. Effective protection, which shows the full assistance provided to producers by both output and input protection (tariffs & QRs), has been falling, as tariffs and QRs have been reduced between 1997 and 2002, but they still remain very high compared to other countries in the region. The estimates of effective protection suggest the following:

- Effective protection is significantly higher than nominal protection due to the cascading tariff structure;
- Manufacturing is significantly more protected than agriculture, largely because SOEs have been more effective than farmers in obtaining such protection;
- Manufacturing protection has fallen from an average of 121 percent (116 excluding vehicles) to 96 percent (91 excluding vehicles), but remains much higher than countries in the region;
- Motor vehicles, sugar and garments/apparel have the three highest effective protection rates;
- Overall dispersion in effective protection rates are high, with the consequent resource misallocation potential even for production for domestic market;
- Other labor intensive products like leather products, carpets, plastic products also have high effective protection.

Figure 10. Nominal and Effective Protection Rates by Sectors: 1997 and 2002



Source: Annex: Trade Policy Reform and the Incentive Structure

Vietnam's trade regime has to reduce the extent of effective protection it provides to its producers if it is to reap the benefits of import competition. Such competition has promoted significant gains in efficiency and productivity in other countries' protected sectors. In fact, the extent of protection provided to manufacturing by Vietnam in 2002, exceeds those provided by South Korea in the late 1960s, as is evident in the Table below.

Table 3. Effective Rate of Protection in Manufacturing in Selected East Asian Countries

	Year	ERP	Source**
Indonesia**	1975	74	World Bank (1993)
	1987	70	Fane and Condon (1996)
	1990	59	World Bank (1993)
	1995	25	Fane and Condon (1996)
South Korea	1975	55	World Bank (1993)
	1980	67	World Bank (1993)
	1988	28	Panagariya (1994)
	1990	27	PECC (1995)
Malaysia	1979/80	31	Salleh and Meyanadan (1993)
	1988	23	Panagariya (1994)
	1991	15	PECC (1995)
	1995	13	Alavi (1996)
Philippines	1992	32	Panagariya (1994)
	1995	28	PECC (1995)
	1999	10	WTO (1999)*

Taiwan	1989	57	PECC (1995)
Thailand	1981	74	World Bank (1993)
	1988	51	Panagariya (1994)
	1997*	72 (33)	Warr (2000)
Taiwan	1989	57	PECC (1995)
Vietnam	1997	116	This study
	2002	91	This study

Notes: ERP estimate for total manufacturing (72) has been influenced by abnormally high ERP for the motor vehicle industry (497), which account for only 8% of total manufacturing value added. When this sector is excluded, the estimates drops to 33.

**For complete references see Annex: Trade Policy Reform and the Incentive Structure.

Policies to offset bias against exports

Vietnam, from the early days, has been conscious of the need to offset the bias against exports. While there have been no direct export subsidies, efforts have always been made to reduce the costs for exporters wherever possible. While it has never used export subsidies as an explicit tool, it introduced import duty exemptions, duty drawbacks and export processing zones as early as in 1992, in order to provide exporters with duty-free access to imported inputs and to facilitate customs processing. Vietnam had also permitted exporting without license, much before importing, and more recently allowed VAT exemptions for exports, and made approval of foreign investment for exports more automatic.

Import-tariff exemption of inputs for exporters Duty exemption and refunds for imports used to produce exports were made a central part of the policy regime since the early 1990's. Under the law⁸, raw material and intermediate goods for processing and re-export, done in accordance with a contract entered into with a foreign party, have been exempt from import duties. The law, following amendments in the mid and late 1990s, also allowed producers, who do not enter into export processing contracts with foreign parties, to receive offsets in export activities, by granting them refunds of import duties that were paid on imported materials, whenever they can show that they have used them for the production of exports.

Export producers are required to execute the production contract and export within a specified period of time – 270 days according to the 1998 Amendment to Article 17 – in order to be exempt from import duties. In some exceptional cases, the tax payment time might be extended to suit the enterprises' production cycles and materials as well as raw material reserves⁹. Companies that fail to export their production within 270 days are required to pay duties on the imported materials and apply for refund after they export their output.

Vietnam's duty drawback system, unlike China's until recently, apply to exporters at any location and to both direct and indirect exporters, thereby avoiding the bias towards shallow export processing

⁸ The Law on Export and Import Duties of 1991, and its amendments of 1993 and 1998, provide the legal framework that governs import duty collection and export processing in Vietnam.

⁹ Source: Gazette, The Law Amending and supplementing a number of articles of the law on export tax and import tax, No. 4/1998/QH10 of May 20, 1998

supply chains. All companies, state-owned or private, can benefit from the duty drawback system regardless of the location¹⁰. This incentive to off-set input tariffs, are extended not only to direct exporters, but also to suppliers of companies that produce exports. These suppliers receive preferential treatment which often means zero or near zero tariffs on imported materials¹¹.

However, the process of Custom clearance of export processing contracts is quite complex and consists of multiple steps. Export producers must fill in registration forms and go through the clearance process for each production contract. For some apparel producers this means repeating the process 3 to 4 times a week and for large companies the frequency is likely much higher. Custom officials examine the forms and the goods at the port of entry and verify that the tariffs in the documents correspond to the official tariffs for these goods. Custom officials also verify the IO coefficients which determine the quantity of imports required for each production contract. According to export producers the clearance process is most difficult for new products. Once a production contract clears Customs, it becomes easier to repeat the procedure.

Also, the operation of the duty drawback scheme shows arbitrariness and sometimes subject to corruption and unofficial taxation of exporters. The time taken to process duty rebate claims has been reduced to three to five weeks, instead of the three months as it used to take, with increasing experience of customs officials. But firms that export only part of their output or newcomers to exporting still face problems. Customs officers often take a long time, in deciding the proportion exported out of total output produced and the input-output ratios to be applied – for calculating the inputs which may be imported duty free. Currently the estimation of inputs utilized relies on an “used-up ratio” declared and guaranteed by the importer. This practice works well for firms which import on a continuing basis, but problems arise when new and different cases have to be dealt with.

There is clearly a need to shift from the current ‘discretionary’ system of duty drawback which is time-consuming and costly to exporters to an *automatic* system based on pre-announced input-export ratios that could be applied for reimbursement of paid import duties, as it has been done in Korea (see Rhee et al, 1985), Taiwan (China), Mauritius, Sri Lanka (see Navaratnarajah, 1982) and so on. This would avoid abuse of duty exemption facility, minimize corruption and reduce administrative delays. It will also leave room for exporters to claim duty-rebate at the “published” rate, even if they are substituting local material for imported inputs over time; this will then work as an incentive for promoting backward linkages of export production, provided such linkages are cost-effective. As a first step, introduce reimbursement of import duties based on “published rates” for a selected list of ‘established’ and potential export products (e.g. garments and textile, plastics goods, footwear, leather goods, electronics, etc) while continuing parallel with current shipment-by-shipment assessment for all other products.

Exemption from domestic taxes Exporters are exempted from the Value added tax (VAT) and the special sales tax¹², as is appropriate, and exporting firms receive profits tax rates that are concessionary

¹⁰ Source: Article 15 of the Law on Export and Import Duties (1993) and interviews with business leaders: Mr. Vu Manh Cuong, Director, Hanoi Leather and Shoes Company, Hanshoes and Ms. Troung Thanh Huong, Vice Director of Import export activities, Dong A Co.,Ltd

¹¹ Interviews with Mr. Nguyen Huu Luc, Deputy Director, Department of Import and Export Duties, General Department of Finance, Ministry of Finance, Vietnam and Mr. Yong Kyu Oh, General Manager, Sales Department, Orion Hanel Picture Tube Co., Ltd.

¹² The special sales tax was introduced in 1990 and amended in 1993 and 1995 and has 10 rates, ranging between 15 and 100 percent.

relative to the standard rates¹³. Firms exporting half to 80 percent of their production are taxed at 20 percent for twelve years, while exporting more than 80 percent are taxed at a rate of only 15 percent for fifteen years. For companies involved in production in the IZ/EPZ, the tax holiday ranges from two to four years, depending on whether they are involved in simple processing or production, their export orientation and technological sophistication.

With the exception of the VAT and sales- tax rebates, all other tax concessions allow for considerable discretion – and some exporters view the final outcome as the result of negotiations rather than law. Going forward, there will be need for greater clarity and transparency in taxation, so that potential exporters, and any other businesses, can predict their tax liabilities.

Estimated Bias Against Exports

Despite considerable import liberalization, Vietnam's trade regime in 2002 remains biased against exports. First, high import protection makes production for the domestic market more profitable than for the export market, because the former permits sales at above world prices; in addition, there is less pressure on domestic producers to enhance efficiency. Second, import protection raises the costs of non-traded goods including labor, which make exports less competitive. Third, imported inputs for exporters in Vietnam cost more than world prices given the tariffs on those imports. Vietnam's offsets remain inadequate, as estimates of bias against exports confirm.

Comparisons of returns to domestic market sales (shown in effective protection rates for import-competing production) with the returns to export sales, will highlight the magnitude of the bias against exports¹⁴ that still exists. On average, the estimates suggest the following:

- With no import tariff exemption for inputs, the regime's bias against exports exceeds 480 percent i.e. selling in the domestic market is nearly five times as profitable as selling in the export market;
- With around four fifths of the import duties paid by exporters refunded, which is what survey results suggest, the bias falls to 137;
- But with a perfectly functioning duty exemption system i.e. with exporters duty-free access to imported inputs, the bias falls to only 55 percent.

It is clear that the Government ought to establish a highly effective and efficient duty exemption and duty drawback system, as part of its export strategy until the import tariffs are reduced further.

There is also large variation in biases against exports among different sub-sectors, ranging from more than 500 percent for sugar to –30 percent for computers, where in the latter case, selling in the export market is more favorable. Assuming that a fully effective and efficient duty exemption system is made operational, Vietnam's tariff structure still imply a high degree of bias against exports as follows:

- Plastic products, confectionary, motor vehicles and motorbikes, and garments face export biases exceeding 300 percent;
- Glass products, detergents, home tools, transport parts, is at 100 percent or greater
- Seafood, ceramics, building materials, including cement, and textile exceed 60 percent;
- Even with fully effective duty exemptions, more than a quarter of the 70 sub-sectors examined will continue to suffer from strong bias against exports.

¹³ There is a three-band profits tax: 25 percent for heavy industries; 35 percent for light industries; and 45 percent for services.

¹⁴

The implication of the above analysis is that the import tariff regime in 2002 remains the dominant source of policy bias against exports. While improving the efficiency of the duty exemption scheme and other tax exemptions will go a long way in reducing that bias, without further reductions in import tariffs, the bias will continue.

The greater the bias against exports, the more it will slow down the pace at which domestic private sector firms (small and medium scale) will enter into export activity. These firms have been powerful vehicle for export expansion in other East Asian countries. Green-field foreign investors in export-oriented production look at the relative attraction of Vietnam as a low-cost production platforms compared to competing locations globally and regionally. But domestic entrepreneurs look at relative opportunities between the domestic market and the international market that faces them.

Further Reductions in Import Tariffs

Vietnam is committed to reducing and rationalizing import tariffs further, in line with its commitments under the AFTA, the USBTA and soon, the WTO when the accession process is completed.

The implementation of the road-map for AFTA will reduce tariffs to a maximum of 20 percent in 2003 and to 5 percent in 2006, in respect of most ASEAN imports except for the few items on the sensitive and exclusion list. Average tariff for ASEAN imports will fall to 8 percent in 2003 and 4 percent in 2006. In terms of sub-sectors, ASEAN imports of textiles, garments and apparel, footwear, food and beverages, furniture, pottery and glass and glass products will face the greatest reductions in tariffs, more than 20 percentage points.

This competition is likely to lower prices and reduce profits of domestic producers selling previously protected products in the domestic market, thereby improving relative profitability of exports, in addition to other important payoffs for the efficiency of the Vietnamese economy. First, domestic users will have access to international markets for intermediate inputs and consumer goods (mainly ASEAN in this case). In case of inputs, this will mean lower price and better quality inputs for other producers using those inputs, thereby enhancing their competitiveness. Second, greater import competition will spur domestic producers to find better ways of producing their goods and services, generating productivity improvements among domestic enterprises¹⁵ and spilling over to exports.

This import liberalization will not only improve relative profitability of exports generally, it will also provide Vietnam with greater access to ASEAN export markets. Vietnam's exports to ASEAN countries are currently concentrated in agriculture and forestry, processed agriculture and coal, oil and gas products, (Fukase and Martin 2001). It has been estimated that its exports to ASEAN countries could expand by around 14 per cent in the aggregate, (Fukase and Martin 2001), with agriculture and processed agricultural products making the larger gains.

Commitment to the implementation of the US BTA will free up trading rights, reduce tariffs on a small number of items multilaterally, strengthen customs and improve transparency of trade policy and other regulations. It will also promote liberalization of key service sectors: banking, non-bank financial sector, insurance, telecommunications and other business sectors like logistics, legal, accounting, engineering, computer-related, and construction areas (see discussion on service sector below)

¹⁵ Lawrence and Weinstein (2001) found that import protection retarded total factor productivity growth in Japan. They also found that data from Japan, Korea and the United States confirmed that imports were an important factor in promoting productivity growth and learning more from examining foreign imports.

4.3 Climate for Private Investment and Exports

Since the “doi moi” began, Vietnam has had a more favorable regime for private foreign investors than for private domestic investors. This was part of Vietnam’s gradual and sequential liberalization. The lifting of controls and restrictions as well as the award of property rights started with farmers and foreign investors, which was followed by micro-household investors and then, private domestic investors, the latter’s real opening was not until the Enterprise Law was implemented in 2000. For each group, liberalization was done step by step, with revisions of the initial law at regular intervals.

The de-collectivization of agriculture and allocation of land titles, and the passing of the Foreign Investment Law occurred in the late 1980s with the approval of Domestic Investment and the Commercial Law coming in the early 1990s. All of these were extraordinarily effective in promoting growth of investment by farmers, foreign investors and households. De-collectivization galvanized the energy of millions of Vietnamese individuals who diversified and expanded their agricultural production rapidly, accounting for most of the exceptional growth in agricultural exports up to 1995. Foreign investment inflows jumped from negligible levels to more than a billion a year in 1995, all of joint-ventures with SOEs in the initial years. Micro-household-enterprises expanded quickly, with 600,000 micro household enterprises operational in manufacturing by 1999. The registered domestic private small and medium-enterprises (SMEs) grew at a very slow pace – 5600 SMEs in manufacturing in 1999 --in part because registration was a very discretionary and difficult process until 2000.

Agricultural production, which was done mainly by private individual farmers, grew by leaps and bounds, with Vietnam moving from a rice-deficit country to the second largest exporter of rice. The private sector – foreign investors and household investors - also made big advances in industry. Industrial output grew at an annual average rate of 10 percent in the 1990s, with the private sector growing at a much faster rate. As a whole, the private sector – mainly household enterprises and foreign-invested enterprises -- increased their total share of the industrial output from 37 percent in 1990 to 58 percent in 2000. This was reflected in the growth of exports described above.

The rapid growth of private SMEs began only after the Enterprise Law was implemented. In 2000, together with the removal of more than 150 restrictions on entry of private firms in different sub-sectors. The revised Law on Promotion of Domestic Investment, passed just before that, also provided new incentives for the domestic private sector. New registrations of SMEs rose from 12,000 a year in 2000, to 18,000 in 2001 and to 24,000 in 2002, compared to only 3000 a year before the Enterprise Law.

Since early 2001, Vietnam has taken further new measures to open the economy further for foreign investors -- the revision of the Foreign Investment Law and the issuance of Decree 24. By permitting foreign investors to set up export-oriented enterprises through simple registration, without waiting for discretionary approvals, the government addressed a major grievance in an important area. By simplifying the process for modifying the corporate structures of existing foreign-invested-enterprises (i.e. for expansion and conversion to wholly foreign owned companies), by lifting restrictions on access to foreign exchange, and by permitting mortgages of land-use rights of foreign-invested-enterprises by all banks in Vietnam, the foreign investment environment has been further liberalized.

Other measures have been taken since to improve the overall climate for the private sector in Vietnam. The National Assembly approved changes to the Constitution to encourage the private sector, recognizing the rights of enterprises and entrepreneurs to determine their forms of business and to

operate in sectors not prohibited. The Fifth Party Plenum, in March 2002, endorsed the private sector as an important contributor to employment creation, income generation and budget revenues, and called on the leaders to encourage their development. Another 50 licenses affecting the setting up or operations of private businesses were removed or modified, and a decree to support and promote the development of private SMEs was issued. The secured transactions registration agency was made operational in both Hanoi and Ho Chi Minh City, facilitating execution of mortgages by the private sector. This improved climate for private sector is reflected in the growth of domestic formally registered private firms.

Further actions needed to promote the private sector

The experience of the successful East Asian exporters, that have come before Vietnam, show that the domestic private sector has to be strong and dynamic, if rapid export growth is to be sustained for decades. Even foreign investors look at the overall climate for private sector and their potential partners when they are choosing the location of their production platforms. While labor cost is a key consideration for low income countries, the relative state of domestic private sector, of logistics and infrastructure and the transactions cost of setting up and running business are all important considerations.

Growth of the formal domestic private sector in Vietnam is of recent origin. Their sustained overall growth and their participation in export growth will be a function of several things. First, it will depend upon how quickly Vietnam moves to a level playing field between state and private firms. Second, it will depend upon their access to land-use rights and their capacity to use them for collateral and for equity in investment ventures. Third, it will require the banking system to become more friendly towards the domestic private sector, that have difficulty in getting a working capital line of credit or investment financing in general, but also for exports, something other East Asian countries overcame quite quickly. Fourth, it will be a function of how rapidly Vietnam will implement its legal system development strategy that it has adopted where the rule of law will be available to all and private sector will operate increasingly in a rules-based environment.

SOE and banking reform. The above steps, together with measures to expose SOEs to greater competition and discipline, are contributing to a gradual leveling of the playing field between them and the private sector. Ongoing liberalization of trade, the promotion of private sector development (as indicated above) and recent banking reforms have increased competition and financial accountability for SOEs. SOE reforms began during 1989-94, and helped reduce their number from 12,000 in 1990 to around 5,300 in 2000. Equity stakes in about 400 enterprises were sold in 2000 and another 400 have been either equalized, sold, transferred or liquidated since then.

Trade liberalization has been accelerated, but exports are still constrained by the regulatory environment affecting the private sector. In some cases a monopoly in production leads to monopoly in trading as well, as is the case of coal, a major traditional export of Vietnam (Box 2). Monopoly adversely affects the activities of the private sector that use SOE products as inputs for their exports.

Box 2. Monopoly in production leads to monopoly in export

At a trade promotion conference, a director of a Hanoi company complained that his company could not export coal although he had found a foreign customer. The coal producer said it could not sell to the company because coal exports had to go through certain “channels”. The situation is the same for machinery and equipment. Some corporations have a monopoly for production, which they use to extend their power to control exports. (*Vietnam Investment Review*, 6 September 2001).

Box 3. Administrative Barriers

Field interviews for the annex on footwear with businessmen in Ho Chi Minh City revealed that Vietnam retains a large number of import barriers in the form of administrative obstacles. Vietnam ties with Brazil and India in fourth place for the large number of administrative obstacles to imports. Vietnamese authorities currently use 12 of the 22 possible types of administrative obstacles identified. The average for all countries is eight types of barriers.

Access to Credit

East Asian countries widely aided exporting firms by providing them with ready access to institutional credit, both for investment credit and credit for working capital, although the key emphasis of policy was always on the latter. A key lesson from the East Asian Experience (particularly that of Korea and Taiwan) is that, at the take-off stage stages of export-led industrialization, ready-availability of working capital was more important than the availability of investment capital in determining export success. However, as Chapter VIII of the Lessons of the East Asian Experience for Vietnam shows, access to credit is subjugated to industrial policy. It may take months for export loans to be approved in Vietnam, which means that would-be exporters are handicapped in meeting orders at the speed required on the international market place and are likely to be forced to trade with foreign buyers under less favorable terms of payments.

Limited access to institutional credit has been identified as a major constraint on private enterprises not only in export production but also in all areas of economic activity. Provision of working capital loans remains the weakest link in the current policy framework for export promotion. This inference is based on a number of studies (IFS-MDPF 1999a and 1999b, Apoteker 2000, GDI 2000, CIEM 1999), plus interviews with managers of exporting firms and presentations made by private sector participants at the two business forums organized as part of the present study.

Ironically, the recently established Credit Fund for Supporting Exports (CFSE) seems to have wrong lending priorities: its role is limited only to providing long-term (investment) finance for export producers. Even as a source of long-term funding, there are problems.

First, is where it gets its funds. In addition to annual state budget allocations, funds are to come from charges and levies on firms involved in foreign trade. This means that export development measures are to be financed by adding to the anti-export bias in the trade regime – something that does not redress the imbalance of incentives against exports.

Second, funds are to be used for selective export support. Given the lack of any effective way of determining the efficiency of individual exporters, this most likely means that success of an exporter in getting help will depend upon talent to twist laws to his advantage rather than ability and competitiveness. A key lesson from the East Asian success stories is that, given the information problem and the proneness of bureaucratic procedures to manipulation and corruption, equal incentives should be provided to all exporters on an equal footing. This is the application of market principles, which will ensure that the efficient exporters will expand exports at the expense of inefficient ones.

In principle, all domestic firms can access the Development Support Fund established since July 1999. In practice only SOEs have access to this facility. Similarly, although state-owned commercial banks (SOCBs) have excess liquidity and difficulty in finding opportunities for lending, they provide credits mainly to SOEs. Despite the government's policy of export promotion, and a new lending program for

small and medium industry by SOCB, lending to SOE has remained the preferred SOCB policy because the banking system is weak and it calls for less judgment to keep to the SOEs. In this sense, SOEs have crowded out the private sector in credit markets.

Problems are compounded by legal issues related to bank collateral. Currently, apart from a government guarantee, bank credits are based on real estate and plant facilities. Documentary credits require a cash deposit, sometimes up to 100 percent of L/C value. Lending or bank advances based on inventory are absent in SOCB policy because banks have no holding facilities, or are unwilling to set up this facility, or are reportedly unable to control this type of collateral. Some small private banks accept inventories (receipts) as part of collateral, since they have to take riskier lending opportunities and, in the words of a private bank's CEO in Ho Chih Minh City, work harder than SOCBs to survive. Furthermore, the banking system as a whole has not begun to use the rediscount facility of commercial papers. There has been a regulation, but as in other instances, implementation rules take a long time to prepare. Finally, unlike other countries of south east Asia, Vietnam has not developed a policy to assist "indirect exporters", those who supply finished goods to the exporters or supply materials for exporters. To encourage Vietnam's financial institutions to go into financing indirect exporters and using domestic L/C, some technical assistance is recommended.

As a result of all the difficulties to gain access to the formal credit market, small private exporters often have to turn to informal financial markets, including Vietnam's peculiar institution called *Hui*, or *Ho*, a rotating saving/credit system of informal, risky credit cooperatives within small groups, normally of no more than a dozen individuals.

Collateral issues also complicate the difficulties of achieving efficient credit markets. The main problem concerns unsettled issues about using land rights collateral for borrowing/lending. These legal issues are relevant to lending to both SOEs and to the private sector, although they are more of a problem for the latter. To begin with, the laws and regulations on mortgage and secured transactions themselves are complicated and confusing. For example, not all land "assigned" to SOEs can be mortgaged or used for secured transactions or used as bank collateral. Only the land "assigned" to SOEs with fees paid by SOEs to the government is qualified to be used for collateral loans. If the land is assigned to SOEs free of charges, as is often the case, it can not be used for mortgage or bank collateral loans (Art. 27, Law on Transfer of Land Use Rights, June 22, 1994 amended in 1999, application decrees 2000 and 2001; other details on legal framework issues are discussed in *Appendix 6 of the Annex on the Regulatory Environment*). In several cases, banks, which are still learning to cope with changing land laws and regulations, have overlooked this condition.

The second issue involves foreclosure and selling the property pledged as collateral. Although the laws and regulations allow land use rights to be used as collateral for bank credits, in practice, procedures for foreclosure and selling the collateral are either lacking or ineffective. Considerably more work needs to be done to improve the legal system. Unsettled legal framework issues make SOCBs unwilling and private banks reluctant to lend on real estate collateral. SOCBs, in this situation, simply turn to "easy clients", i.e., large SOEs, since they have at least some form of government guarantee. This leaves private exporters to seek help from private banks that can be more dynamic than state banks, but they are small and under-capitalized. Because of difficulties with collateral based on real estate, SOCBs in practice lend to SOEs on the basis of a simple signature (called "faith collateral", or *tin-chap*) of the clients, although they routinely ask the sponsoring agency to sign the loan documents as a guarantee for repayment. To what extent this guarantee can be effective is another issue, but at least it serves to alleviate the responsibility of the SOCB loan officer in question. A survey done for an ongoing study of the textile sub-sector reported a significantly higher percentage of rejection of loan applications made by the private sector compared with SOE applications.

Box 4. Collateral Requirements for Financing

Owners of private companies complain that they are unable to borrow money from foreign banks because they are unable to use land as collateral. In Vietnam the government owns all land; individuals and businesses only have the right to use that land. Collateral requirements do not apply to state-owned companies seeking financing. Business executives said that access to finance and the interest rates charged (between 10 and 11 percent a year in November 2001) do not present an obstacle to their operations.

When firms fail to repay loans, SOCBs treat SOEs and private enterprises differently. If SOEs fail to repay, the bank has some recourse: i) to ask the sponsoring agencies to repay loans; ii) to sell the collateral if possible; iii) to ask the government for a solution to freeze or re-schedule the loan, as often happens (see specific cases in the Annex on Regulatory Environment and Support System). On the other hand, if a private enterprise fails to repay, the bank simply has to sell the collateral, if that is possible.

Foreign Exchange Restrictions

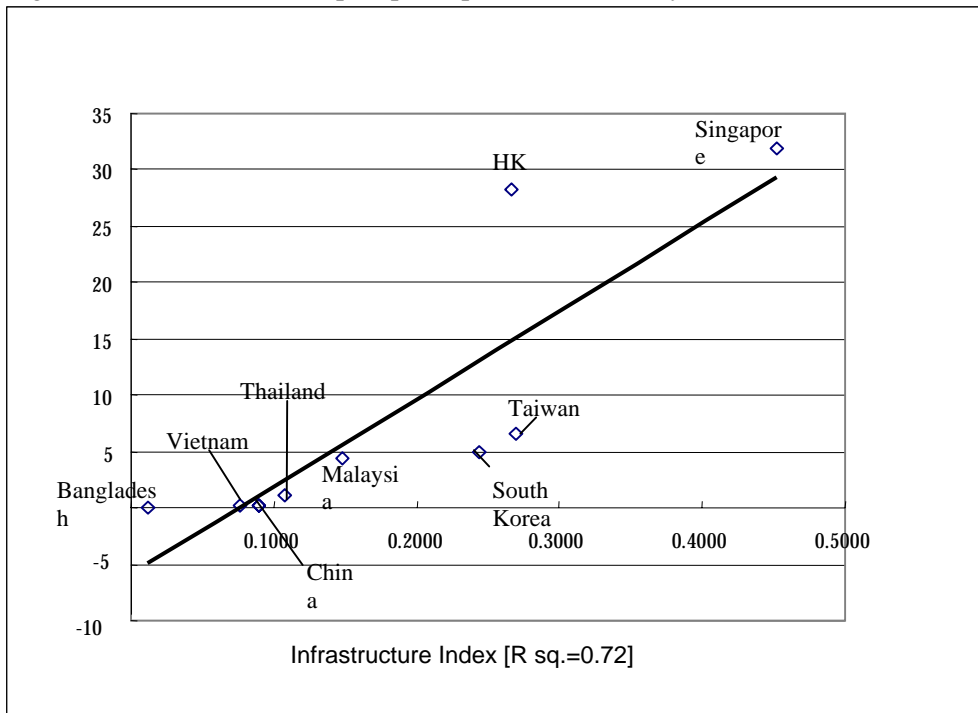
From time to time the government has used control over foreign exchange as a way of restricting imports. For instance in late 1998, when the current account deficit widened after the onset of the East Asian crisis, the MPI in consultation with the Ministry of Trade and other ministries, resorted to such controls on imports of certain consumer goods. Limits on foreign exchange release for imports by foreign invested enterprises were imposed to the actual amount of foreign exchange they had brought into the country in the year (to “balance” their foreign exchange) and an advanced payment was required for importing consumer goods. In September 1998, the State Bank imposed a foreign exchange surrender requirement for exporters, under which all exporting firms had to sell 80 percent of their foreign exchange earnings to banks within 15 working days of transfer of these funds into their accounts. In August 1999, the surrender requirement limit was reduced to 50 percent. The foreign exchange balancing requirement for FIEs was relaxed in May 2000. Since then, FIEs have been able to purchase foreign currency from domestic banks to repay loans obtained from offshore banks.

5. Cost of Infrastructure and Logistics For Exporters

The provision of infrastructure and logistics services in Vietnam is characterized by (i) state ownership and operation of key sectors; (ii) restrictions on investment by non-nationals and non-state enterprises (iii) a weak local private sector unable to participate easily and (iii) administratively determined infrastructure tariffs below full cost recovery¹⁶, for example in power and roads, and (d) very high administrative tariff levels, as for telecommunications and ports.

Better infrastructure appears to hand-in-hand with higher export per capita. This is in part because the quality and cost of infrastructure services are important determinants of the competitiveness of exports. Also, for some labor-intensive exports that compete on small margins, these costs can make them less competitive or uncompetitive. In case of participation in the production of components that are assembled somewhere else, the quality and timeliness of infrastructure services becomes even more critical; many low income countries fail to partake of those opportunities because of poor infrastructure services.

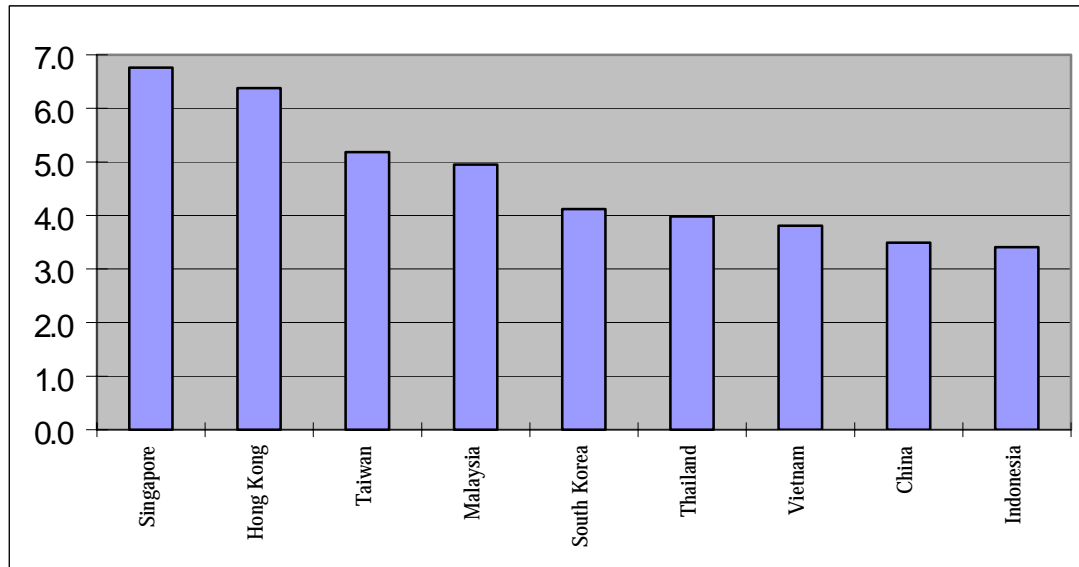
Figure 11. Infrastructure-Export per capita (USD '000) (year 2000)



Vietnam also suffers from slow customs processing and poor access and efficiency of port facilities. Rigidities and delays in customs' procedures have given rise to widespread use of unofficial payments, which raise transactions time and costs of doing business, especially exporting. Managers of footwear exporting companies who were interviewed said that the following "standard" unofficial payments were required to process incoming shipments: \$20 for clearing a 20 foot container, \$40 for a 40 foot container, \$100 "late inspection fee"¹⁷. There is need to improve the functioning of ports, given the dependence of all exports on both customs and port efficiency

¹⁷ According to a 2001 survey by IMPR of 150 firms in the textiles and garment industry, 20 percent of the firms spent five to 25 days and about 10 percent spent 15 to 32 days in clearing customs.

Figure 12. Ports (access and efficiency)



Source: Global Competitiveness Report (2000)

In the short term, the aim should be to improve clearance time for imports of raw materials and spare parts and to conduct trials of electronic clearance schemes. In the long term, greater competition among operators is essential and Vietnam should look at setting up a private pre-shipment inspection, something that other countries have done to improve port facilities. Improving the port infrastructure, along with incentives and institutional reforms, would help Vietnam's foreign trade expand rapidly.

Telecommunications costs are very high in Vietnam. This is in part because the sector is still not open to entry; while foreign investment is permitted through BCCs, no foreign management of telecommunications facilities are permitted. Only mobile operators have come in.

Various short-term and long-term measures have to be taken to reduce costs and improve quality of services. The Government could do the following: provide additional accelerated price reductions for IDD and leased lines; streamlined procedures for leased line applications; reduced "firewalls" to speed up Internet access and open all "ports" to allow "real time" communications; allowing equity participation by changing BCCs into joint ventures, concessions or licensed operations.

In the long-term, private entry should be permitted into the monopolized sectors of local, long distance and IDD, and the Government is already committed to doing this under the USBTA. The Government should also consider an inter-ministerial body to promote the Internet, rather than vest power solely with the Directorate General of Power and Telecommunications. It would be also be helpful to separate post from telecommunications, given their different orientations. It would also be feasible to sell equity in Vietnam Post and Telecommunications (VNPT) activities.

Box 5. High Telecommunication Costs in Tourism Trade

Telecommunication costs, especially those related to Internet use, fax and to a lesser extent telephone, typically represent 20 to 30 percent of a tour company's operating costs. The Internet is an important promotion and communication tool and the slowness in Internet access and high cost compared with other South East Asian countries were reported to impact negatively on the competitiveness of tourism-related businesses in Vietnam.

In respect of power and transport, various other actions can be taken to improve the service and reduce the cost:

- **Power Sector.** Short-term measures should include the identification of the extent of deadweight losses from power cuts and interruptions and investing in targeted transmission-distribution upgrades. Average prices have to be raised to eliminate cross-subsidized pricing, to change the demand pattern and to boost the Electricity Vietnam (EVN) balance sheet. In addition, the authorities should consider lengthening the existing power purchase agreements from one year to commercially feasible periods. This would encourage independent power providers (IPPs) in EPZ/Izs to reach agreement on pricing and on other issues to expand supply and create a positive demonstration effect for other suppliers. Finally, an important short term measure would be to pass an electricity law to establish an independent regulator. In the long-term, the sector needs to be restructured to separate generation and transmission from distribution. Equity stakes could be sold in generation and distribution companies. In the long term it is vital to create a transparent and responsive power sector by promoting competition and wider private sector participation in line with the regional trend.
- **Transport (Internal)** In the case of internal transport, short-term measures could include allowing foreign forwarders to set up industry associations and join VIFFAS and also allow FFF 100 percent FI license to promote “advance infrastructure” logistics in Vietnam. It would be advisable to abolish price fixing to encourage more investment and upgrades of rolling stock and facilities.

In the long-term it is necessary to promote greater contribution from rail and coastal shipping by making them more commercial in outlook and operations and allowing more competition.

- **Transport (external).** The short-run essentials are to abolish price fixing in port tariffs, to promote competition and reward efficiency. It would be necessary to monitor closely the productivity of ports and examine the effect on transport costs for Vietnam exporters. The government could also consider immediate measures to provide better incentives for this activity and undertake trial privatization of State-owned and operated ports to increase their efficiency at least to regional standards. In the long-term, although international shipping and air transport are competitive, there is need to allow more foreign shipping lines to own or operate concessions particularly for ports and also provide warehousing facilities “off-docks” through inland ports and depots.

6. Development of Business Services Sector

Business and Producer Services

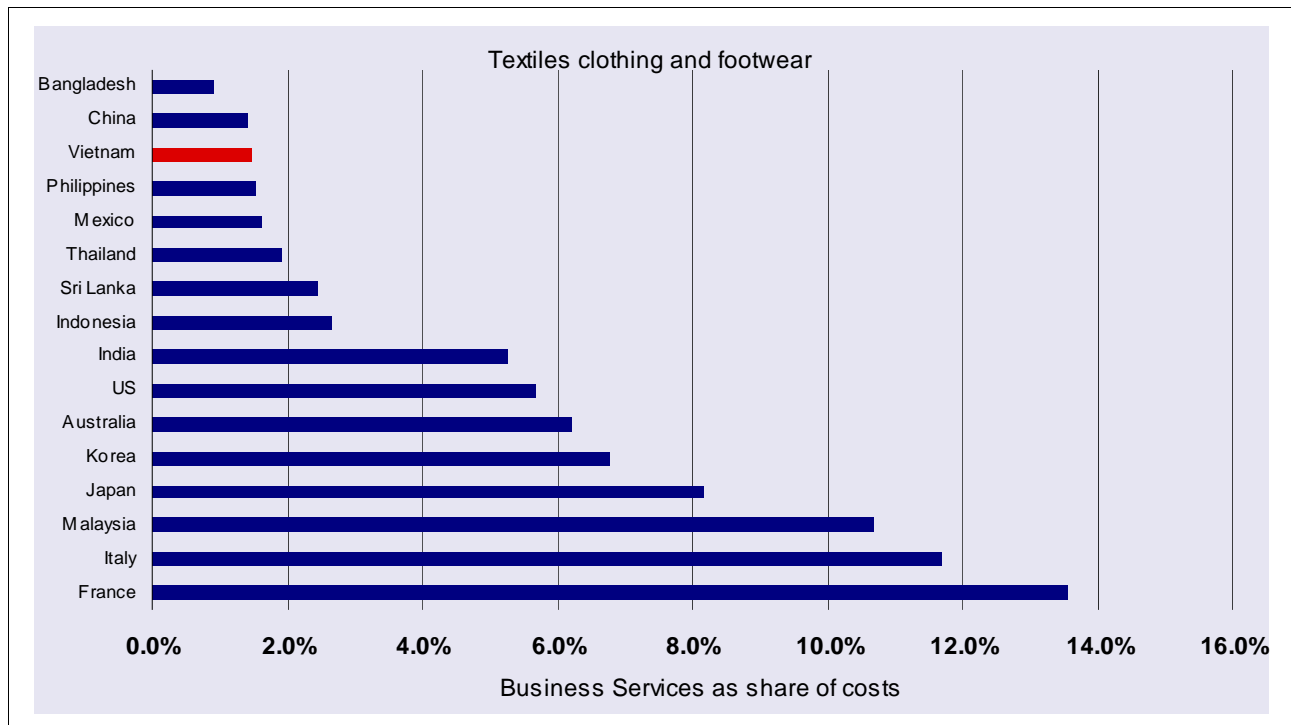
Manufacturing and other types of businesses, including exports of manufactures, draw on a range of goods and services in their production processes. For example services such as financial intermediation, insurance, legal and accounting, real estate, logistics and ICT are increasingly not only key inputs into manufactured inputs but also exports themselves. Going forward, improvements in the quality of an economy’s service sector will therefore have important impact on export growth in Vietnam.

These services play a key role in the internationalization of production networks driven by the recognition that different parts of the production process have different input requirements and sub-processes could be located to take advantage of differences in input prices across countries (Navaretti, Haaland and Venables, 1998). But for Vietnam to participate in this process - -which it has not done

much up to now – it must ensure that the standards and cost of services like logistics, financial services, and ICT are at least up to the standards of other competitor countries.

Vietnam sectors makes very little use of business services, as is evident in export oriented manufacturing sectors such as textiles footwear and clothing (TCF) and food manufacturing. The figure below shows that Vietnam is well down compared to other developing and developed countries in respect of its use of business services in the TCF sector. Vietnam is similarly placed in regards to the food processing sector.

Business services as a share of textile, clothing and footwear sector costs in selected countries 1997



Data source: GTAP Database.

Services and productivity growth. Even more generally, development and expansion of producer and business services improves productivity and growth for the economy. Recent experience with regulatory reform in OECD countries shows that liberalization in services industries and utilities resulted in significant gains in sectoral productivity, cost reductions and growth of output. For instance, total factor productivity in the telecommunications and electricity industries in Germany, France and Spain rose 40 percent on average as a result of recent regulatory reforms. Given the starting point for Vietnam’s services sector, conceivably reforms should secure even bigger productivity gains than for the OECD economies.

While this service sector development is to some extent a function of natural progression to higher incomes, policies can help to promote it too. The historical experience of developed and developing countries provides a firm basis for stating that, as aggregate incomes rise, they lead to an increase in the share of services in an economy. Consumer services expand as people move from the necessities (food, clothing and shelter) to better-quality necessities. Producer and business services grow as they become more vital to the production of the kinds of new goods and services demanded by society. But policies play a role in enhancing the income-responsiveness of service development.

Private provision of services has expanded in Vietnam, but needs to be nurtured further. Segments of the insurance system, education and health care, tourism and hotels, road transport, and business services like legal, accounting, logistics, and so on, already contain a significant number of private sector actors, albeit in a stunted form. The flexibility, interaction with consumers, and ceaseless pursuit of cost-savings required to succeed in services provision make this an ideal sector for the growth of private firms in the future.

Private participation. However, going forward, there is need for further opening of the services sector to the domestic private firms. In addition, there would be a need to promote additional human resource development, including special training programs with Universities that are aligned with the objective of developing these business services.

Liberalization of service sector. This is likely to be implemented as part of Vietnam's commitments under the United States Bilateral Trade Agreement (US BTA). The BTA provides for greater competition from US firms across the range of key service sectors — banking, non-bank financial sector, insurance, telecommunications and other business sectors (legal, accounting, engineering, computer-related, and construction areas). In terms of the level of access, under the BTA, Vietnam will be providing greater access than low and middle income countries under the Uruguay Round and only slightly less than larger transition economies (World Bank 2001).

Opening up the service sector has been an important instrument for developing the services, both due to access to technology that it permits, as well as the competition it generates. Liberalization of telecommunications and financial services have not only promoted growth in those sectors, but also in their income. affected how fast economies grow (Mattoo et al, 2001)¹⁸.

7. Issues of Market Access

7.1 Impact of China's WTO Accession on markets

China's joining the WTO will have a big impact on Vietnam. All countries of the region, including Vietnam, will have better, more transparent and predictable access to this huge market. China has been a powerful driver of growth in East Asia: over the past ten years, its from ASEAN have grown by 390 percent, while ASEAN's share of China's imports has risen from a little below 6 percent in 1990 to 9 percent in 1999.¹⁹ China's WTO accession will further open the country's huge market.

Competition with China in third markets will also intensify, presenting a big challenge for Vietnam, especially to those industries that have similar comparative advantage in labor intensive goods. There is a number of reasons why competition will intensify:

- Accession will lead to the abolition of quotas on Chinese textiles and apparel exports to the US and the EU during a transition period up to 2007.²⁰ This implies that textile and garments producers in south and southeast Asia will be squeezed as prices drop due to the surge of Chinese products in third markets.

¹⁸ On the whole, they found that countries with fully open telecommunications and financial services grew up to 1.5 percentage points faster than other countries. CIE also estimated that for every 1 percent improvement in productivity in the services sector, real GDP would be 0.8 percent higher, much of it driven by a 1.3 percent gain in exports

¹⁹ Source: UN Comtrade System.

²⁰ China will be subject to additional textile safeguard quotas until 2008, but these will be applicable for only one year at a time, unlike the existing quotas which were put in place for an indefinite period of time.

- Reduction in China's own protection implies a lower costs of Chinese goods because import taxes on intermediate goods used in manufacturing will be lower. The real exchange rate effect of the tariff reductions also lowers the cost of non-traded goods and other factors used as inputs in production. This will lead to increased competition in the domestic markets of other economies. These factors imply a decline in prices, output, exports, wages and welfare in competing economies.
- China has a vast labor force, including a large stock of underemployed agricultural workers, spread over vast geographical areas that differ in stages of economic development. China also has much lower labor cost per unit of output, not only relative to developed countries, but also compared to most developing countries. This suggests that its cheap labor supply will last for a long time regardless of China's rate of growth (Wang, 2002).

China's output is expected to increase most significantly in sectors where there is additional demand for exports – mainly textiles, apparel and automobiles. Other goods as different as plant fibers and livestock will also increase, the first as an important input in Chinese textiles, the latter as consumption of higher end agricultural products rises. Output of textile and processing industries in Japan, Taiwan, Korea and Hong Kong will rise as a result of increased demand for these products to be used as intermediate inputs in China. On the other hand, the automobile sectors in Japan and NICs will be squeezed. Production of electronics in Singapore, Hong Kong and Taiwan may rise as China's tariffs on these products fall. Other countries could participate in this emerging vertically integrated production platform for exports through China, but for that specific supportive policies would have to be adopted.

China's WTO accession threatens the greatest damage to the apparel industry in all developing East Asian economies, including Vietnam, as quotas on Chinese sales to North America and Western Europe are removed between 2005-07. The textile industry in developing East Asian countries will be affected, though nearly not as much, as some of these countries start exporting textiles to China and other NICs. With time, the south east Asian economies could overcome the negative impact on their apparel and textile sectors by expanding their processing, electronics and other manufacturing industries, to respond to increased demand in China and in China's closest trading partners.

By global standards Vietnam is a small exporter of garments and light manufactures. In 1997 Vietnam had less than 1 percent share in the global apparel market. However, at the national level, apparel exports are an important export sector accounting for more than 14 percent of Vietnamese exports and providing a livelihood for thousands of unskilled workers. Apparel is also a potential growth sector since the recent USBTA opens up the US market to Vietnamese clothing and apparel. China's WTO accession now calls into question how much market share will Vietnamese exporters be able to capture in the US.

Increased Vietnamese exports to China stimulated by its WTO accession will not be enough to offset the decline in apparel exports to other regions. Despite increases in exports of traditional products like rice, processed food, light manufacturing, metals and less traditional ones like petrochemicals, electronics and other manufactures, it is estimated that overall Vietnam will lose.

Vietnam's response. It is essential that Vietnam responds to China's WTO accession by aggressively improving its business environment, especially the legal and enforcement systems. As China's business environment improves, investors will become less tolerant with the problems in doing business in Vietnam. If there is decline in export growth and investment will lead to a drop in real activity of 0.4

percent. Although modest, it is nevertheless the largest drop in real GDP estimated among all neighboring Asian countries due to China's accession to the WTO.

7.2 Access to the US Market

The US-Vietnam Bilateral Trade Agreement (USBTA) was implemented by the US Senate in October 2001 and ratified by Vietnam's National Assembly the following month. The deal commits Vietnam to broad economic reform, including substantial reductions in tariffs; transparency in government procurement; uniform implementation of standards, taxes, and dispute resolution; removal of quotas; market access rights; elimination of trade-related investment restrictions; and acceptance of World Trade Organization (WTO) rules on customs valuation, intellectual property rights, and trade in services. The United States has committed to granting Vietnam Normal Trade Relations status, which will provide Vietnam's exporters with Most-Favored-Nation (MFN) status in the US market, and stimulate US companies to invest in Vietnam.

The major impact of the BTA is likely to be on Vietnam's exports. Using the Global Trade Analysis (GTAP) model, a recent World Bank sponsored study⁹ that found that increased market access to the United States will bring significant gains to Vietnam. The direct terms of trade improvement resulting from increased market access accounts for 60 percent of the total gain, with the remaining 40 percent derived from gains in efficiency. Vietnam's exports to the US are expected to double in the first year of MFN status, with the largest increases occurring in seafood, textiles, footwear and agricultural products. However, benefits could be greater with larger and faster reductions in Vietnam's import tariffs.

7.3 WTO Accession

Vietnam has applied for membership in the WTO in which it currently has observer status. The Government submitted its application to join the WTO as a developing country at the beginning of 1995. A detailed Memorandum on Vietnamese Foreign Trade and Economic Policy was prepared for the WTO Working Party and a number of meetings have taken place between Vietnam and the Working Party to address questions concerning trade and intellectual property rights. The recent BTA with the United States lays the foundation for many WTO standards on market access, non-discrimination and transparency (for details, see Burke and Bich Lien, 2001).

7.4 AFTA Scheme

Trade between Vietnam and other ASEAN member countries is subject to each country's commitments under the ASEAN Free Trade Area (AFTA). The Common Effective Preferential Tariff (CEPT) is the principal tariff-cutting mechanism for the AFTA and was ratified by ASEAN member countries in 1993 and implemented one year later. Following a transition period, the agreement establishes a free trade area in which all ASEAN member countries will apply a common tariff to each other's goods, but tariffs with non-ASEAN countries will continue to be individually determined.

The scheme originally aimed to reduce tariffs on all manufactured goods from their 1993 levels to less than 5 percent over a 15-year period. The implementation period was accelerated in 1994, when the transition period was reduced to 10 years. In 1998 the transition period was again accelerated, to 2000 for the original ASEAN members and to 2003 and 2005 for the new ASEAN members. The transition

⁹ Fukase and Martin (2000) (add complete reference)

period for Vietnam was extended to 2003. A free trade area will be created in 2018 when new ASEAN members reduce all tariffs to zero.

The product coverage of reduced tariffs and duty-free access to the AFTA market was initially limited to manufactures, including capital goods and processed agricultural products. Unprocessed agricultural products were excluded from the CEPT scheme, but later added. The original exclusion of unprocessed agricultural products was mainly because of restrictive policies to protect domestic producers. Unprocessed agricultural products are treated under separate lists: (a) Immediate Inclusion List; (b) Temporary Exclusion List; (c) Sensitive List; and (d) those included under the General Exclusions List. Tariffs of unprocessed agricultural products in the Immediate Inclusion List have been gradually reduced since 1996 and are to be within the 0-5 percent range by 2003. Member countries are also required to eliminate quantitative restrictions (QRs) and other non-tariff barriers (NTBs) on these products. Unprocessed agricultural products in the Temporary Exclusion List can be kept out of the CEPT Scheme only for a limited time and must be phased in by 2003. Unprocessed agricultural products in the Sensitive List will be included into the CEPT scheme by January 2010.

In addition to tariff cuts, an important part of the CEPT scheme is the elimination of quantitative restrictions such as quotas and licenses, and the reduction and eventual elimination of other NTBs to trade, such as customs surcharges and technical regulations. Unlike the WTO, the CEPT scheme contains no specific agreements that cover 'sanitary and phytosanitary' (animal and plant health) measures, technical barriers to trade, pre-shipment inspection, customs valuation, and import licensing procedures. Under Articles IV and V of the Protocol on the Special Arrangement for Sensitive and Highly Sensitive Products, adopted in September 1999, a time-line is established for the elimination of all quantitative restrictions and NTBs to trade on sensitive and highly sensitive products. The deadline for Vietnam is 2013.

While the categorization of most products drawn up by a majority of countries appears to comply with CEPT rules, some items for temporary exemption or on sensitive lists are questionable. These lists are often viewed as instruments to avoid opening up regional trade, and to prolong the use of protectionist policies for key industries and for trade with non-ASEAN countries. Vietnam's general exception list appears to breach the principle of CEPT since it includes items such as fuels, broadcasting and receiving equipment, switchboards and exchanges, vehicles with fewer than 16 seats, scrap and used consumer goods. These are all items in which Vietnam has strong protection and revenue objectives. In 1996 these goods accounted for approximately 41 percent of its imports from ASEAN members. Vietnam has taken steps to meet its AFTA commitments on tariff reductions, although it has often done so by declaring goods that are already at zero or low rates and it has yet to announce the schedule to reduce tariffs on products included in the general exception list. There have therefore been no significant reductions in protection for Vietnam; in some cases protection has increased in a manner contrary to AFTA commitments and to obligations that must be met under WTO accession.

GSP Arrangements

The actual tariff rates applied by industrialized countries to products originating from Vietnam and other developing countries are usually less than the MFN rate because of tariff preference schemes like the Generalized System of Preferences (GSP) and other preferential trade arrangements (PTAs). Countries offering the GSP apply low or zero-rate tariffs to certain commodities originating from developing countries eligible for participation in the scheme. The GSP scheme is unilateral, meaning that developing countries are not required to extend reciprocal tariff reductions. The program is intended to give preferential tariff treatment to developing countries until their exporters are able to

compete on world markets with normal, non-preferential tariffs. GSP benefits from the United States are likely to be smaller than those from Europe given the type of Vietnam's exports to the United States.

The US, the European Union, Japan and Australia, offer Vietnam beneficial access to their markets under GSP arrangements. Assessment of the effect of the GSP and other PTAs on the average tariff level applied to eligible developing countries is complex because of the variety of schemes and the fact that goods can be included or excluded from time to time over the life of the program. It is clear that recent patterns in world trade are diminishing the intended effects of the GSP. As multilateral trade agreements reduce tariffs worldwide, the margin between the GSP preferential rates and MFN rates becomes smaller. Moreover, the growing number and size of other preferential tariff arrangements are also diminishing the value of tariff relief under GSP.

Vietnam's exports are shifting from natural based products to manufactures. This is good news for Vietnam given that the manufactures are labor-intensive. Increasing specialization in manufactures would provide the opportunity for the country to boost its growth rates for exports and meet its income and poverty reduction goals. However, the crux of its challenge is that the shift to manufactures is occurring less rapidly than needed to meet these goals. To speed up the shift it is necessary to address a few key policy issues sooner than later.

Countries do not have to be bound by static comparative advantage as indicated by revealed comparative advantage measurements. Using the speed and increasing share of exports as a guide, Vietnam could exploit potential market opportunities where its comparative advantage is similar to its Asian neighbors. There is a significant degree of similarity between Vietnam's exports and those of the rest of ASEAN. Rather than be inhibited by this competition, the country could exploit opportunities from the similarity of products to develop cross border production facilities and to realize economies of agglomeration and scale. One way to exploit this opportunity is to be more open to FDI than at present, by providing a level playing field for FDI. (See Chapter V on FDI issues in this report).