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INTERNATIONAL TRADE SPECIALIZATION AND THE FLOW OF FOREIGN DIRECT INVESTMENT IN A SOCIALIST COUNTRY : BENEFITS AND SOURCES OF CONFLICT THE CASE OF VIETNAM

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Recent development in international trade and cross border investment have initiated many new investigations and led to the assumption that the whole world was entering a new stage of economic and financial internationalisation. Simultaneously, a large number of countries were experiencing a dramatic transition from planned to market economies. In these transition processes, trade liberalisation and the openness to foreign investment were considered as key elements of the economic policy required to achieve a successful integration in the world economy.

However, theoretical analysis of the close interdependence of these three majors aspects of economic developments (namely transition to market economy, trade liberalisation and flow of foreign investment) is still scarce, even though each aspect has been the object of much more attention.

This paper is intended to bring some empirical evidence on the questions raised by these recent economic developments, through a detailed look at the situation of the Socialist Republic of Vietnam.

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Vietnam is both an interesting and peculiar case in the sense that the transition towards a market economy is not accompanied by the same kind of political changes which were registered in other « transition countries » with the exception of China. As in this latter case, the Vietnamese authorities have clearly expressed their wish to design a « specific » transition process which would be compatible with the current political structure.

Few areas have been as much affected by this transition as foreign trade and the opening up to foreign investment. The end of the USSR financial support after 1985 as well as the subsequent collapse of CMEA markets were major factors behind the reforms initiated in 1987 under the Doi Moi policy.

A detailed examination of trade performances and the inflows of foreign direct investment (FDI) since the beginning of the decade therefore provides very useful insights into the transition process itself and the main issues confronting Vietnam at this stage of its transformation.

First is examined the pattern of trade opening and liberalisation, and its consequences in terms of international specialisation (section 1) ; the relationship between trade and FDI is analysed in section 2, before looking at the major questions which arise from the flow of FDI and the related issues confronting the country.

I- VIETNAM'S TRADE PATTERN AND INTEGRATION IN WORLD TRADE FLOWS

I-1 Global trends : a significant entry into world trade with high instability of performances

The very rapid opening to international trade is a key feature of Vietnam's economic transition. In 1987, total Vietnamese merchandise exports amounted to a meagre USD 599 mn; in 1996, these exports are estimated to have reached USD 7255 mn. During the same period, total merchandise imports jumped from USD 1142 mn to an estimated USD 11143 mn. With compound annual growth rates of respectively 32% and 29% for exports and imports over the last nine years, Vietnam has clearly made a significant entry in world trade. This is substantiated by the high share of GDP accounted for by external trade, which, at 70% in 1996, is much higher than the overall average for developing countries (just over 50% in 1995) and even a few percentage points over the figure for East Asian and Pacific developing countries (65% in 1995).

The increase in exports and imports accelerated in the last few years (with a 1993-1996 average annual growth rate of 34.5% for exports and 46.5% for imports) and this high global openness to trade makes it difficult to support any assumption that obstacles to trade have a real dampening effect on exports and imports. A detailed survey of barriers to trade and answers from a panel of European companies operating in Vietnam clearly show that tariff barriers are not considered, except for a limited number of goods, as a significant obstacle. The non weighted average of all tariff lines is a very moderate 12% import duty, and an estimate of the effective protection rate was put by the US administration between 15% and 25%, a level which appears consistent with Vietnam's present development stage. However, non tariff barriers to trade (NTBT) appear to be much more effective in constraining exporters to Vietnam (licensing and customs valuation being the most often cited obstacles). These NTBTs will be at the core of the ongoing bilateral negotiations with the US and of the whole WTO accession process.

It is obviously important to remember that Vietnam is both in the middle of its transition process to a market economy and at a fairly initial stage of economic development. Many critical social, economic and financial issues have to be tackled simultaneously, with the various tools of trade policy playing, directly or indirectly, a significant role in most of these issues (budget, corporate restructuring, rural development, financial structures and markets, ... to mention only a few). The conception, design and implementation of a fully coherent trade policy is a formidable challenge for the Vietnamese authorities, inevitably implying hesitation and contradictory moves in the short run.

This peculiar situation may in part explain the relative instability of trade performances, both at a global level and at a more detailed product level. Indeed, the very rapid growth in foreign trade did not unfold through a regular increase: on the contrary, instability is one of the key feature of the past and current trade developments. Year-on-year increases in both exports and imports were very uneven:

Table 1: instability of Vietnam export and import growth

y-o-y %	1989	1990	1991	1992	1993	1994	1995	1996e
exports	80.1	31.1	18.0	21.2	15.2	35.8	28.2	39.6
imports	18.3	6.3	18.7	20.5	38.1	48.5	43.8	47.7

Source : World Bank

The same degree of instability is evident from an analysis of the shares of various trade partners during this period, even when individual countries are aggregated in very large groups. And finally, the structure by products of exports or imports with each individual partner country reveals also a very high degree of instability. A detailed examination of EC trade with Vietnam(2, 4 and 6 digits of nomenclature) shows that both exports and imports register very significant increases as well as declines from one year to another. Even for groups of products accounting for more than 2% of total EC exports to Vietnam or 2% of total EC imports from Vietnam, growth patterns with increases over 50% followed by decline of over 20% are very frequent.

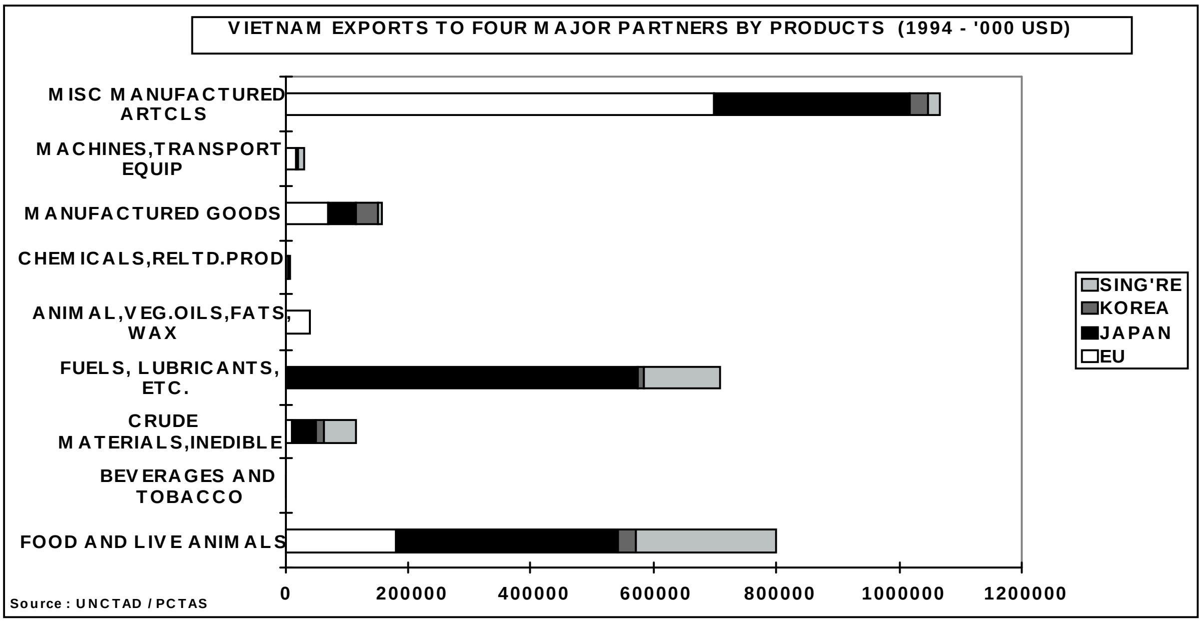
Some of the reasons behind this instability are straightforward, notably the collapse of CMEA markets and the subsequent search for other suppliers and customers. But they also include some crucial aspects of Vietnam foreign trade medium term issues: the ability of Vietnamese exporters to gain ***market access***, either through regulatory measures (textiles and clothing agreement with the EC in 1992) or through marketing and commercial actions which are currently very weak in Vietnam; the ***competitiveness*** of Vietnam's exports, specifically on European markets and the related questions of price/quality mix; the ***stability of the development process*** and its implications on import flows.

I-2 Vietnam as a processing area in a context of growing regional integration

The transition process characterising the Vietnamese economy takes place at a moment when world trade is undergoing very significant transformation: the interrelated influences of the emergence of Asia as a new engine of world trade, the delocalisation strategies of companies world-wide, and the liberalisation of trade regimes in almost every country have deeply affected the ways goods and services move from one country to another. The questions facing national authorities are more and more concentrated on how to insert the productive capacities of the country into these new trade flows and derive the most beneficial domestic consequences of this insertion.

To identify how Vietnam fits into these world trade developments implies to look at its trade flows by broad categories of products and by major partner. This will in particular show the place and role of the EC in this global context. The analysis which follows is based on trade flows reported[2] by four major partners of Vietnam, the EU (12 members), Japan, the Republic of Korea and Singapore. These four trading partners account for respectively 83% and 81%[3] of Vietnam's imports and exports in 1994. Only two large partners are missing, Taiwan and HongKong (about 15% of imports and 7% of exports).

Chart 1 : Vietnam exports by partner and product



55% of Vietnam's exports to these four partners are accounted for by raw materials, mostly fuels (24%) and agricultural commodities (27%, with rice and coffee being the largest items), nearly all of which (85%) goes to Japan and Singapore.

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2 the data is supplied by the International Trade Center, UNCTAD/GATT, « International trade statistics » PC/TAS 1995

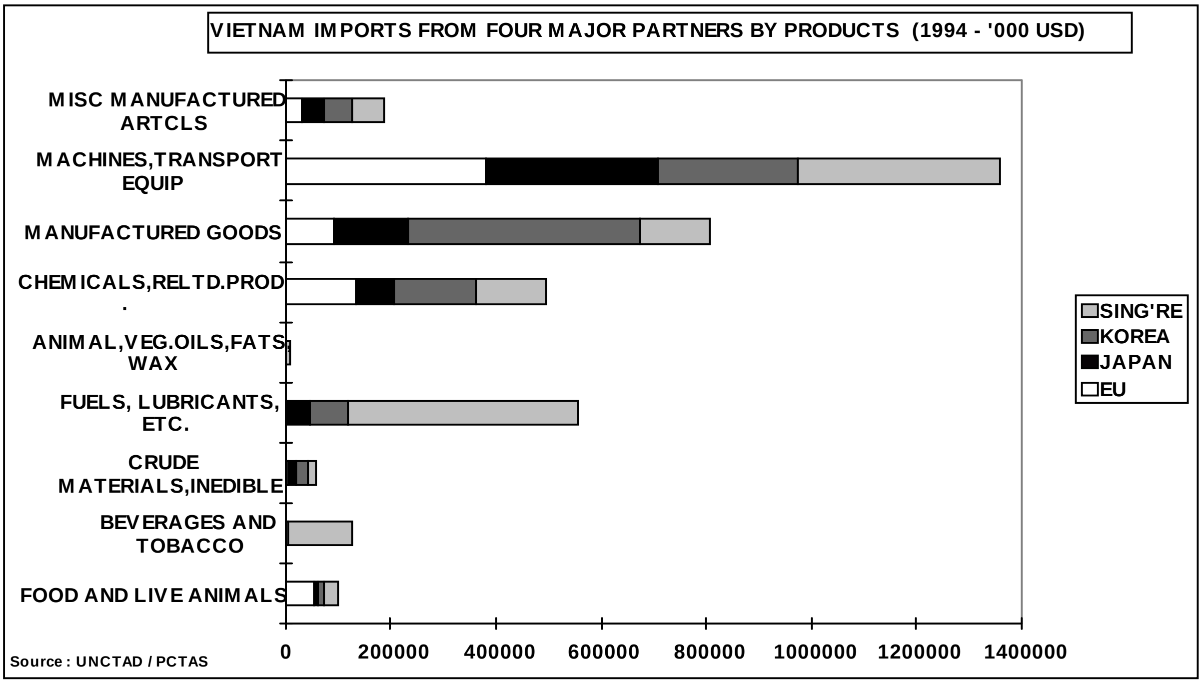
3 in 1994, the shares of total Vietnam's imports are estimated to be: EU:16%, Japan: 14%, Korea: 23%, Singapore: 30%. The shares of Vietnam's exports are estimated to be : EU: 28%, Japan: 37%, Korea: 3%, Singapore: 13%.

Singapore and Korea are the main suppliers of intermediate goods, including refined petroleum products, chemicals and most of the category « manufactured goods ». On the 42% of total Vietnamese imports accounted for by these products, 32% come from the two countries.

The other major category of imports is equipment goods, including transport equipment (36% of total imports). The market is more evenly distributed among the four large partners, with the EC and Singapore supplying 27% each of equipment goods imports, Japan 24% and Korea 20%.

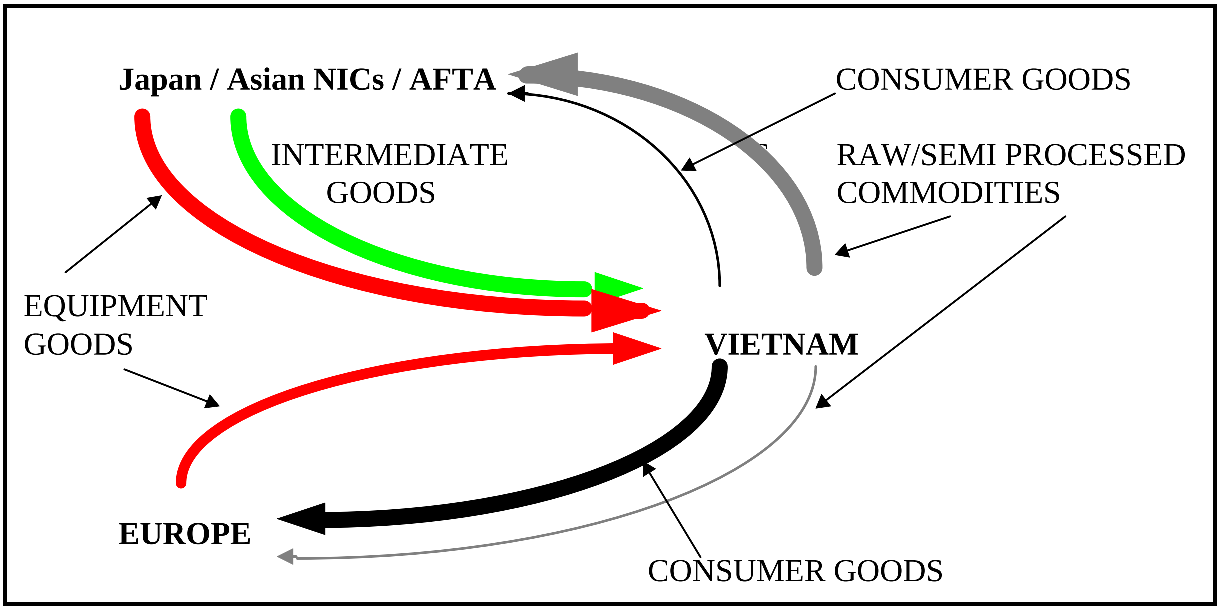
Part of this machinery and intermediate inputs are then « used » through the production process of finished manufactured goods exported to foreign markets: 42% of total Vietnamese exports, of which almost 2/3 go to the EC. In this respect, it can be said that the EU markets play a crucial role in the Vietnamese development process by absorbing most of Vietnam's export of manufactured goods.

Chart 2 : Vietnam imports by partner and product



The overall pattern is therefore for Vietnam to export its raw commodities mostly to Asian countries, then import intermediate goods from the same area and manufacture light industrial goods mostly destined to the European markets.

Simplified structure of Vietnam's trade



I-3 Potential development and risk of trade friction

Prospective developments for Vietnam's exports and imports will be shaped by three inter-related forces: government policies and priorities within its socio-economic development program, the expected growth in economic activity and its effects on industrial and consumer requirements, and the institutional frameworks in which Vietnam is party (WTO, MFA, AFTA). We briefly discuss these factors and draw some conclusions in terms of potential for Vietnamese exports and imports.

Government objectives in term of exports and imports remain global, which is coherent with the general transition process of the economy. The 1996-2000 plan only states:

« Total export revenue during the five years 1996-2000 is projected to be about three times that of the previous five years. Per capita exports are expected to reach USD 170 by the year 2000. The structure of export goods will be renovated, increasing the share of processed products for export, creating additional export categories that generate export earnings in excess of USD 100 million per year, and looking for new commodities and services with export potential.

Total import value during the five years 1996-2000 is projected to increase 2.8 times compared with previous five years. Import policy will concentrate on the improvement in technology and the modernisation of production facilities in the national economy, as well as providing the materials and goods needed to meet the needs of production, construction and consumers. At the same time, some imported products will gradually be substituted by products that can be produced efficiently in Vietnam. »[4]

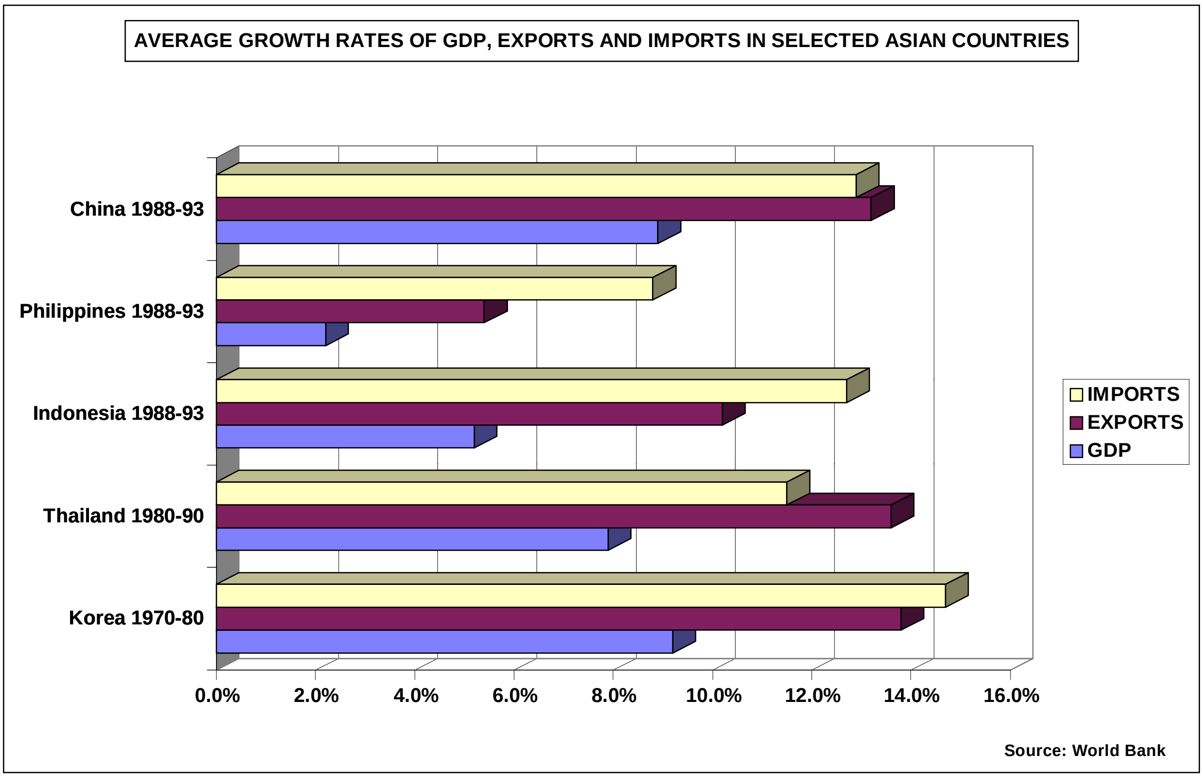
Value added processing and diversification are the major objectives for exports, equipment goods and intermediate inputs will remain the major imports, and import substitution will be

[4] from « Socio- Economic development and investment requirements for the five years 1996-2000 », Government Report to the Consultative Group Meeting, October 1995

encouraged. This pattern typically qualifies the development stage of Vietnam during the next five years.

A look at import and export elasticity to GDP during comparable periods of take off[5] in other Asian countries shows that the government objective is very ambitious. The expected average annual increases in exports (around 24% per year) and imports (22%) have never been achieved on a five year period by other Asian countries at a comparable stage of development; moreover, only very few countries managed to register an average export growth higher than import growth during this stage of development, and this was usually obtained through disrupting cyclical shocks. The ability to reach or even come close to these objectives depend on the transmission of productivity gains in the internationally traded good sectors and on a very rapidly significant access to the US market.

Chart 3: Apparent elasticity of imports and exports to GDP during the early stage of take off



A yearly increase of around 15% for both exports and imports on average during the next five years would already represent a significant achievement, even though it would still translate into a very large trade deficit if these growth rates are applied to 1995 trade figures. Very simple simulations based on the experience of other rapidly growing Asian countries help give a « plausible » range of export and import figures in the year 2000 (in constant dollar terms).

[5] based on comparable measure of GDP per capita

Table 5: Simple projections of trade and GDP figures to 2000

constant USD mn, or %	export	import	GDP	trade bal in % of GDP	total trade in % of GDP	imports in % of GDP
base case	15244	20270	30197	-17	118	67
high case	11896	15085	28194	-11	96	54
average case	9371	13818	27296	-16	85	51

base case: government assumptions (exp:+24% p.a., imp: +22%, gdp: +10%)
high case: exp:+18% p.a., imp: +15%, gdp: +8.5%
average case: exp:+12.5% p.a., imp: +13%, gdp: +7.8%)

At unchanged market shares, the average case scenario (lowest figure) would imply EC exports to Vietnam of USD 2.2 bn, and EC imports from Vietnam of USD 2.6 bn in the year 2000.

The development process observed in other Asian countries as well as the priorities stated by the Vietnamese authorities point to a very rapid growth for intermediate inputs, designed to sustain the requirements associated with the industrialisation of the country. In the coming years, domestic demand for organic and non organic chemicals, construction material, metal products, paper and cardboard will inevitably grow faster than the production capacity. All industries related to large infrastructure projects (energy, transportation, water treatment) will find the potentially large Vietnamese market constrained mainly by financing considerations. Finally, equipment goods demand will be largely related to the foreign direct investment flows and to the setting up of export capacities, with a strong potential in agricultural processing machinery (coffee and tea processing, sea food processing) and light manufacturing industries.

On top of these trends will come the impact of the changing regulatory environment in relation with Vietnam's international commitments and agreements, most notably the accession to the WTO, the AFTA agreement, and the trade agreements with the EC (notably the textile and clothing agreement).

On the Vietnamese export side, the most significant actual or potential factors are : the granting by the US of the MFN status, a prospect which still appears rather remote and most likely related to the WTO candidacy process; the gradual phasing out of the MFA regulating textile and clothing exports, which also implies that the WTO process is completed[6]; and the textile and clothing agreement signed with the EC in 1992 and amended in 1995. The latter agreement makes a direct link between the reduction of Vietnamese import tariffs on specified intermediate goods in the textile industry and a progressive increase of quotas for clothing and textiles products attributed to Vietnam. Notwithstanding a general analysis of the agreement and its recent amendment, it is worth noting that the Vietnamese authorities are very sensitive to this aspect of market access, and also that some EU companies producing intermediate inputs for the textile and clothing industries complained about the perverse impact of such restriction. When the EC decided in January 1995 not to put in force the increase in quotas -as a result of difficulties on the Vietnamese side to implement the agreed tariff cuts-, the comments were that imports of intermediate products for the textile industry (yarn and fabrics) were not really competing with the local production because of price/quality differentials and

[6] the 10 years phasing out of the MFA as agreed during the Uruguay Round negotiations will apply only to WTO members, and not to MFA-non-WTO signatories.

that any constraint on Vietnamese apparel exports to the EC has an adverse impact on their ability to sell their own intermediate goods.

On the Vietnamese import side, the major impact of these international agreements will be the reduction in Non Tariff Barriers and a progressive homogenisation of tariff lines. From a global perspective, and considering the present status of barriers to imports, this should progressively make imports of finished products and consumer goods more significant (at least in terms of non parallel imports[7]). However, it is very unlikely that consumer goods imports will take a significant share in the total Vietnamese imports in the foreseeable future. The recent decision to reduce import duties on so-called « luxury goods » and at the same time to increase excise duties on the same categories of goods is a clear indication of a pertinent use of taxes, giving a « level playing field » for domestic and foreign goods, trying to discourage the consumption of such goods and enhancing fiscal revenues.

From the EU point of view, such developments coupled with the geographical patterns identified above point to potentially damaging trade friction between the two partners. Indeed, the twin nature of high concentration on limited number of items and the recent swing in the global trade balance is inevitably leading to concern in European business quarters that some restraint should be exercised. This concern obviously does not take into account the fact that a very high share of manufactured exports are managed and sub contracted by western and often European companies ; similarly, the global trade balance underestimates the importance of Vietnamese imports originating from European companies, especially in the intermediate goods sectors where large European multinational companies operate from other Asian countries, notably Singapore. However, it illustrates that market access to other large developed markets (US, and to a lesser extent Japan) for Vietnamese manufactured exports has to be urgently expanded if friction is to be avoided.

II. TRADE AND FDI RELATIONSHIP

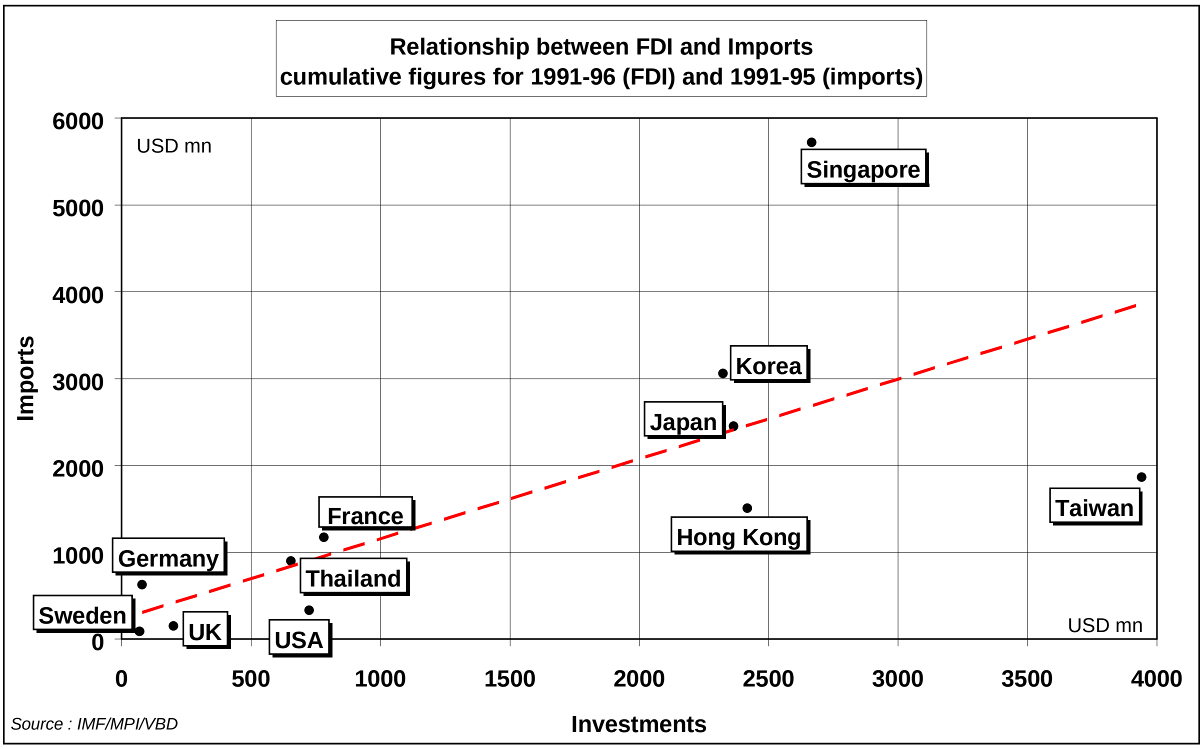
The relationship between trade and foreign investment has been highlighted in recent reports, from the World Bank, the WTO and the UNCTAD[8]. It can be summarised, in the case of Vietnam, through the following points :

- In the context of the so called « globalisation » of world production, there are strong motives for large companies to establish production units on a world-wide basis, each unit having a specialised role in the global firm's strategy, and importing inputs from other units of the same or related firms. Taking into account the fact that of intra-firm trade is roughly estimated to amount to 50% of total world trade, it should be expected that countries which invest the most in a given host country are also very large suppliers of inputs and therefore imports. This is very clearly the case for Vietnam, probably even stronger than in general terms due to the place taken by the large Japanese trading houses and diversified Korean groups. The following chart illustrates the point, with a clear and

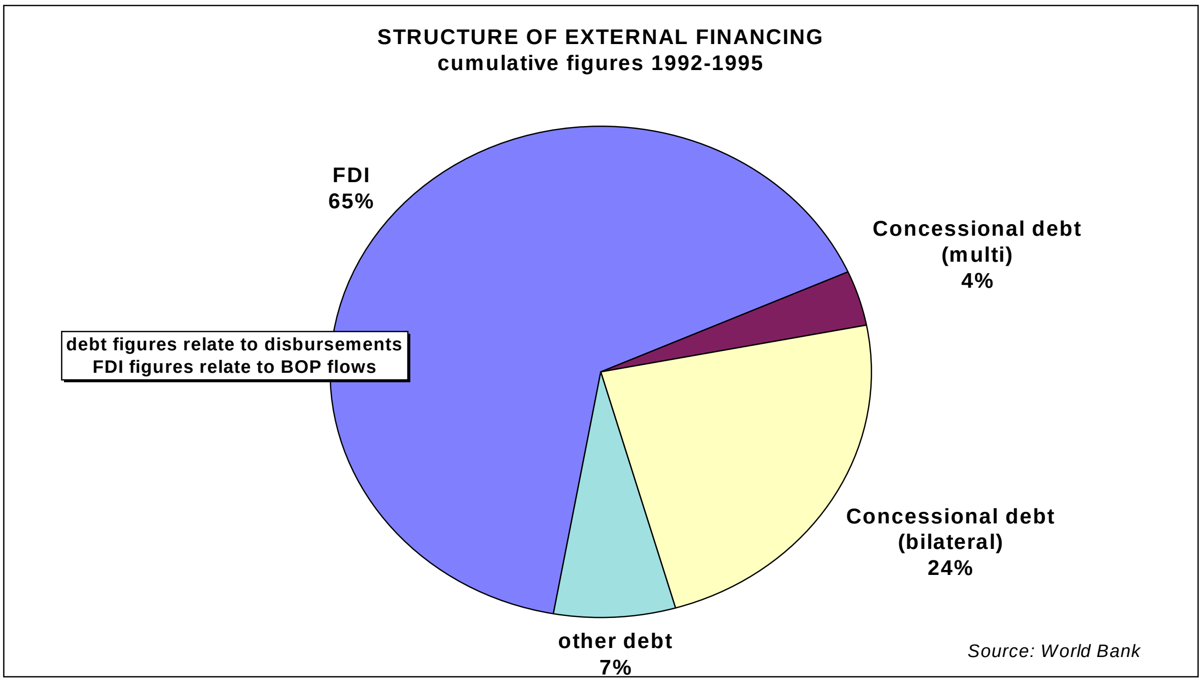
[7] estimates of parallel imports are very difficult to check, with figures ranging from 30% to 60% of total imports, the higher figure probably relating to consumer goods.

[8] « Global Development Finance », The World Bank, 1997, « Annual Report », WTO, 1996, « World Investment Report », UNCTAD, 1996

positive correlation between cumulative FDI and cumulative imports by major partners since the beginning of the decade.



- The second major relationship is related to external financing : FDI is a major source of external finance, the need of which is dictated by the magnitude of the trade deficit ; the trade deficit itself is related to FDI through the massive import content of foreign investment, and the subsequent (but always with a time lag) development of exports or reduction in imports because of the induced improvement in products quality and management skills. Again, this relationship is very clear in the case of Vietnam, where FDI is (and is officially expected to remain) the major source of external finance with ODA. Taking the official figures reported in the « Global Development Finance » (World Bank, 1997) for debt disbursements and FDI estimates published in the World Bank Country Report, the breakdown between these two major sources is the following :



It is noteworthy that cumulative disbursements by multilateral institutions of concessional funds has represented less than 5% of the total external funding, even if it should be stressed that multilateral institutions have committed much larger amounts that was actually disbursed up to 1995 ; it remains however that on a cumulative basis, FDI has been the single largest source of external finance for Vietnam.

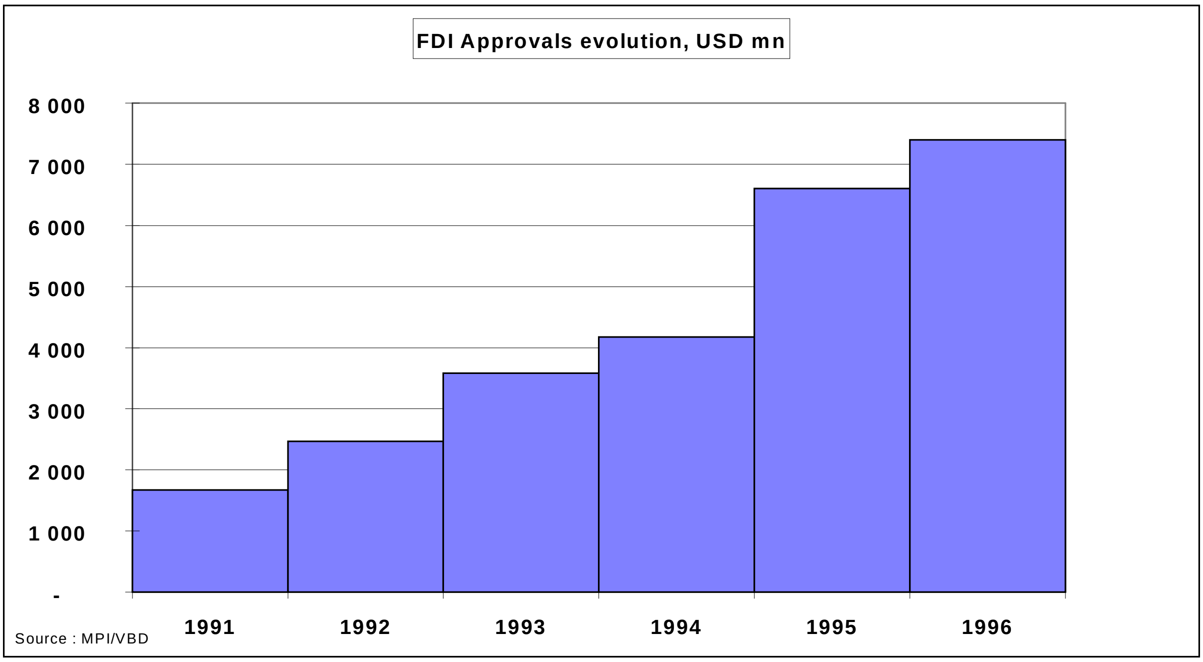
At the same time, imports generated by the foreign investment is estimated to about USD 2.0 bn in 1996 (18% of all imports) and exports of goods made by foreign invested companies to USD 800 mn (11% of all exports) to which a significant part of the tourist revenues should be added.

III. ISSUES RELATED TO FDI FLOWS AND POTENTIAL SOURCES OF CONFLICTING ECONOMIC OBJECTIVES

III-1 Global trends : is the investor's fatigue real ?

After a record increase in 1995, FDI approvals slowed down during most of 1996. A USD 2.1 bn real estate development project involving Indonesian et Singapore interests was officially approved in the final weeks of 1996, enabling the total amount for the year (USD 7.1 bn) to top the previous record of USD 6.2 bn. On a cumulative basis, FDI approvals[9] reached USD 25.1 bn at 1996 yearend.

[9] after deduction of cancelled/revoked licences, and including joint ventures (JV), 100% foreign owned (FO) and business co-operation contracts (BCC). Unless otherwise mentioned, FDI figures will exclude the USD 2.1 bn last minute approval (for lack of precise information)as well as all BCC licences, which represent only 1.8% of total approvals and are highly concentrated in the oil sector and to a lesser extent in telecommunication operations.



In terms of effective disbursements, questions arouse around three inter related themes :

- The possible inclusion of a debt component in FDI balance of payment figures : the I.M.F. and the World Bank have suggested that reported figures for FDI flows in the balance of capital could include such debt funding[10] up to 30-40% of the actual FDI flows. The strikingly high differences between various sources for actual FDI flows gives some weight to the assumption :

FDI ESTIMATES (USD mn)						
	1990	1991	1992	1993	1994	1995
World Bank: World Development Indicators (1997) (net inflows)	16	32	24	300	650	1400
World Bank: Vietnam Report (Oct 96)	120	220	260	832	1048	1781
United Nations: World Investment Report (1996)	16	32	24	25	100	150

If this were to be confirmed, it would have significant implications both on the implementation success for approved FDI and on the country's external debt picture by adding approximately USD 2 bn to Vietnam's total foreign indebtedness.

The detailed analysis of all FDI approvals during 1991-1996 does not allow for any definite answers, but might provide some clues : an estimate of the debt component of every project was made by calculating the difference between the licensed *investment capital* (the total investment cost of the project) and *registered capital*, considered as the equity component.

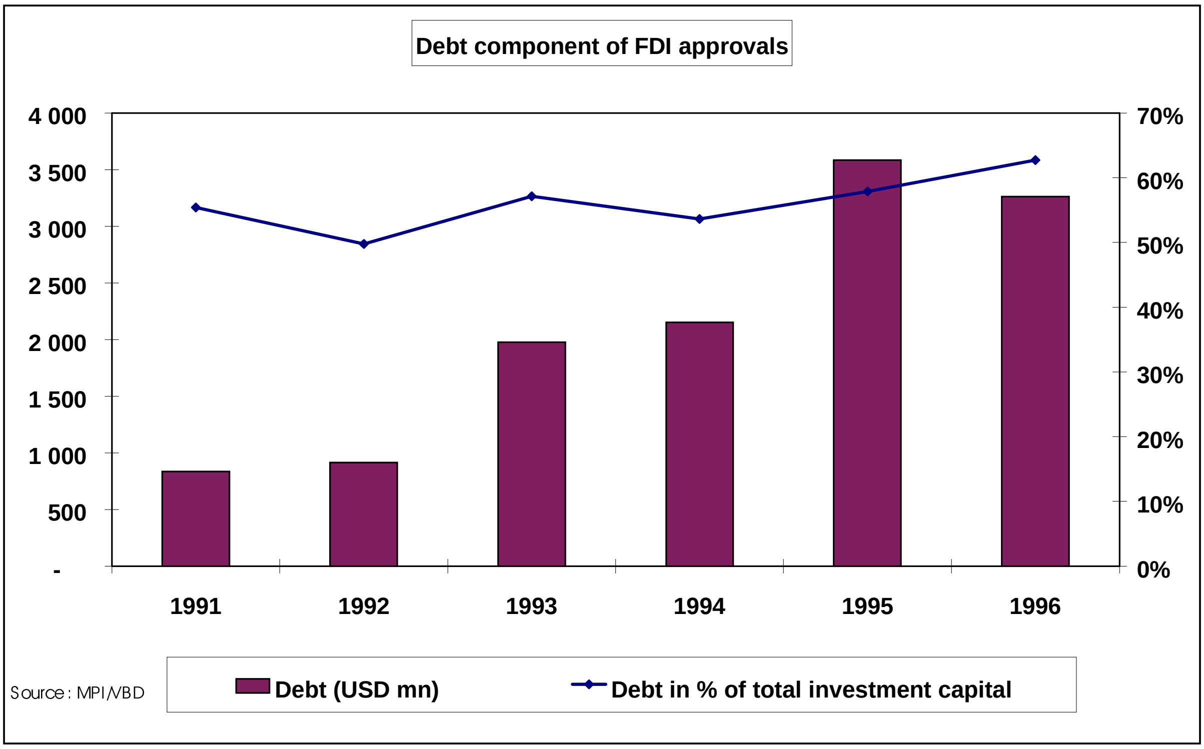
[10] This is a general problem raised for all countries reporting their balance of payment transactions to the I.M.F., and does not apply specifically to Vietnam.

The foreign share of this registered capital should translate into « pure » (i.e. ex-debt) FDI, but with a time lag.

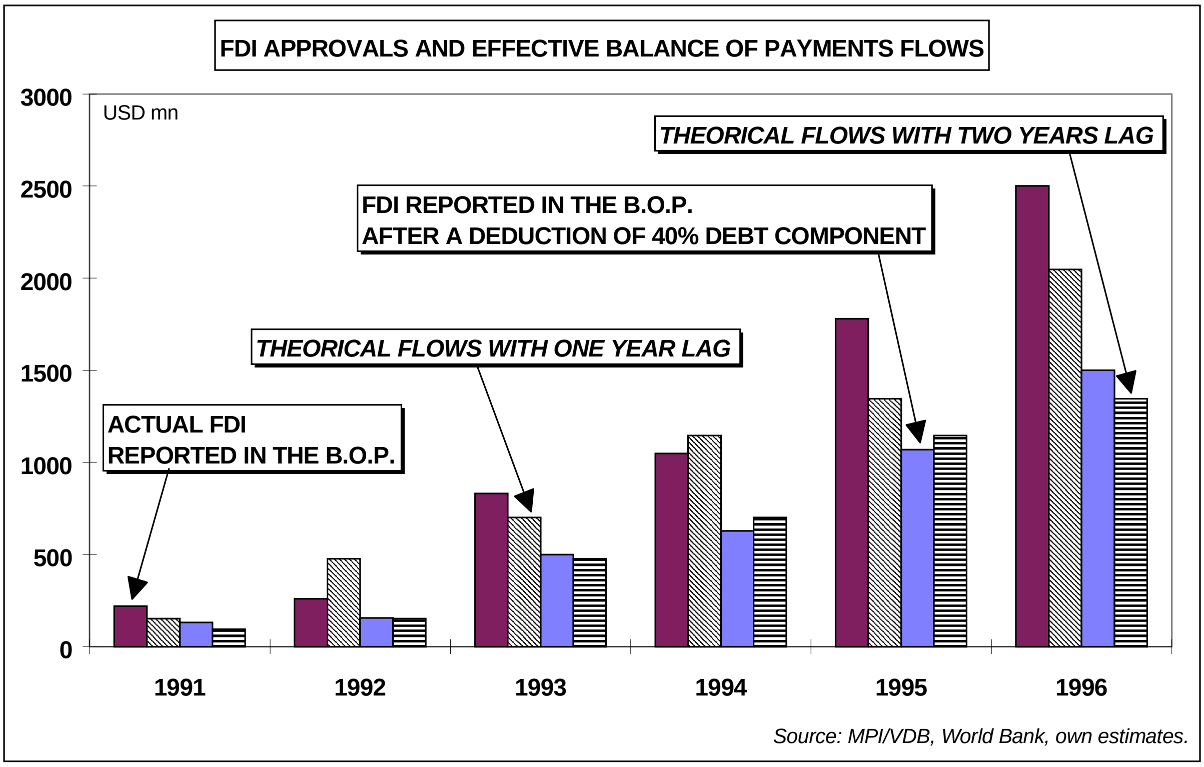
(USD million)	cumulative 1991-96	as a % of approvals
FDI approvals	22 204	100.0
of which registered capital	9 482	42.7
of which foreign share	7 206	32.5
balance of payments FDI	6 641	29.9

source : own calculation from MPI/VBD, World Bank

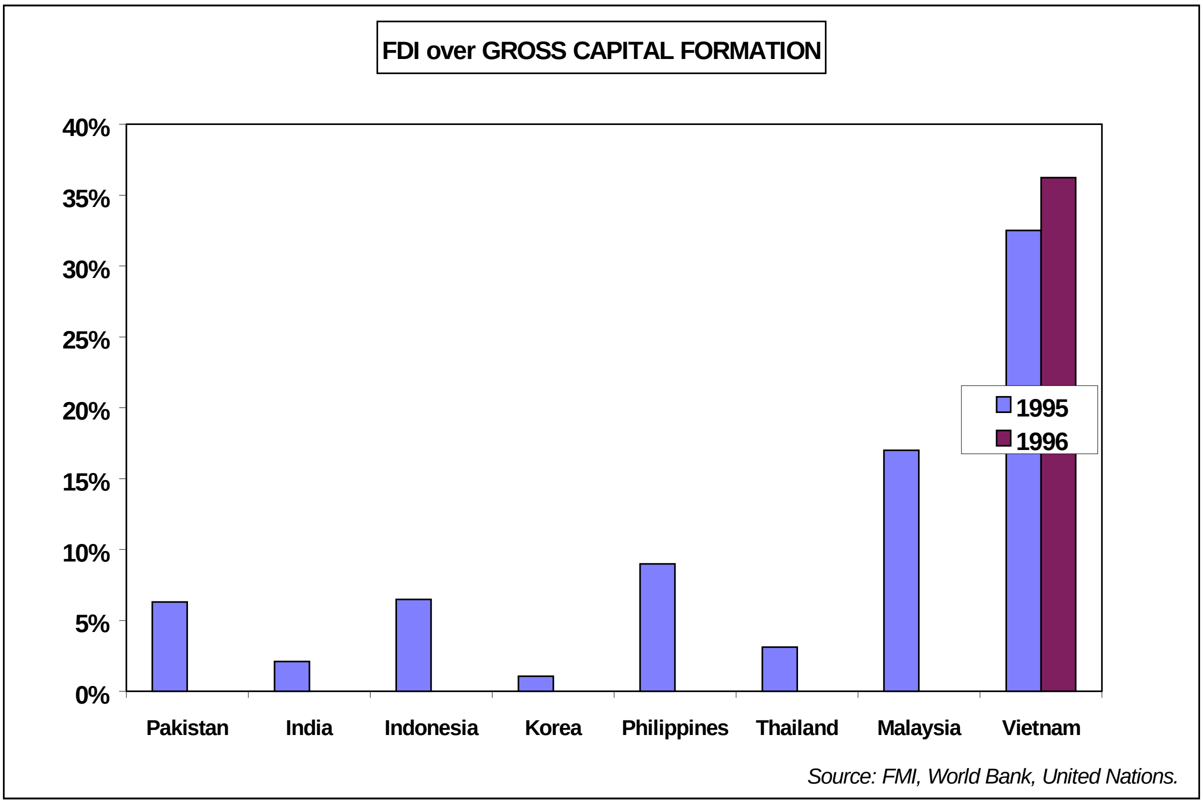
The same calculation shows however that the debt content of approved projects is on an increasing trend, with a sharp jump in 1995 and 1996. Total debt incurred (including possible debt in local currency) if all projects were to be implemented would be a cumulative USD 12.7 bn since 1991.



- <u>The disbursement rate and the efficiency in implementation</u> : the two questions are clearly inter-related : assuming a given time lag between approvals and the transfer of funds, and applying the same calculation as above (taking into account only the foreign equity share of the investment), it is possible to have a *theoretical pure FDI flow (TPFDI)*, to be confronted with actual balance of payment figures. What can be shown is that a one year lag leads to a TPFDI larger than the actual flows, by a 12% margin which could be assimilated to a foreign debt component, leaving actual flows as « pure » FDI. Conversely, a severe assumption of a 40% debt component in balance of payment flows associated with a two-year lag implies a TPFDI very close to « corrected » balance of payment flows. The most probable is a combination of debt and efficiency in-between these two broad assumptions, with a time lag around 18 months (fairly satisfactory in the Vietnamese context) and a debt component around 20-25% (translating into « pure » FDI of USD 5.1 bn and a debt component of USD 1.5 bn, on a cumulative 1991-96 basis).



- <u>The need for a further increase in FDI</u> : the argument is forcefully supported by the rapid deterioration in the current account balance, notwithstanding the structural benefits of FDI on competitiveness and technology transfers. However, this support has to be qualified because of the small size of the Vietnamese economy and the expected role of the public sector as desired by the Vietnamese authorities. Even with the previously used severe assumption on the debt component of the FDI flows, a comparison between « pure » FDI and total domestic capital formation shows a 22% share for foreign investors, climbing to approximately 50% if productive capital is concerned (excluding infrastructure and other investment outside the corporate sector). Based on actual balance of payment flows, an international comparison gives weight to the argument for more nuance in the appreciation of required or desired FDI.



This latter feature highlights a crucial dilemma for the Vietnamese authorities, with the macro-economic aspects of FDI showing two contradictory features:

- As a consequence of the war periods and the present level of development, both infrastructure and industrial investment requirements are huge. The level of domestic savings is still low (estimated at 17% of GDP, compared with more than 30% in most East Asian countries) and therefore economic development requires significant foreign savings.

- however, the process of transition towards a market oriented economy, the institutional and financial difficulties for the domestic corporate sector (public and private) to undertake large investment and the constraints on external borrowing may imply a considerable weakening in the domestic sector if its share in total investment becomes too low.

It is in this context that the perception by potential and actual investors has shifted since 1995 from an over enthusiastic stance to one characterised more by a prudent attitude and some vocal concern, reinforced by a number of highly publicised pull-outs and setbacks, notably in the real estate, tourism, oil, and mineral production sectors. The decline in the total number of approved projects (from 321 in 1994 to 346 in 1995 and 308 in 1996), the growing importance of very large operations (with a higher risk of significant swings in actual flows), and the increase in both the debt component and the share of 100% foreign owned projects, are relevant indicators of this change in perception.

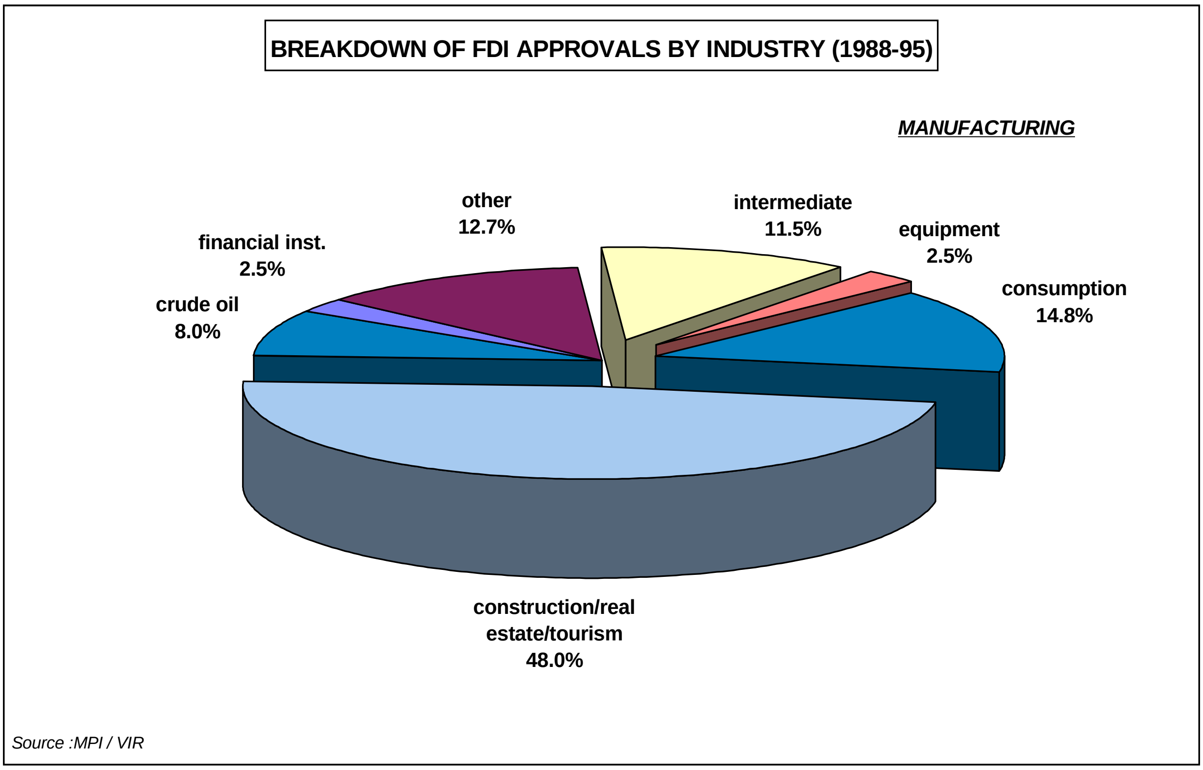
One of the reasons behind the perceived investors' fatigue is the decline in large real estate or tourism projects, except for the last minute USD 2.1 bn approval. Such a decline seems appropriate in the context of a rapidly growing supply of office and hotel capacity in large cities. It is also correlated with the significant decline in total approvals in HoChiMinh City (down approximately by 45% over 1995) and Hanoi (down 30%, except again for the very large late project), and the symmetric increase in various provinces, some of them close to the large urban centres (+80% in Vung Tau, +250% in Song Be, +56% in Hai Hung).

III-2 Increased differentiation between investing partners

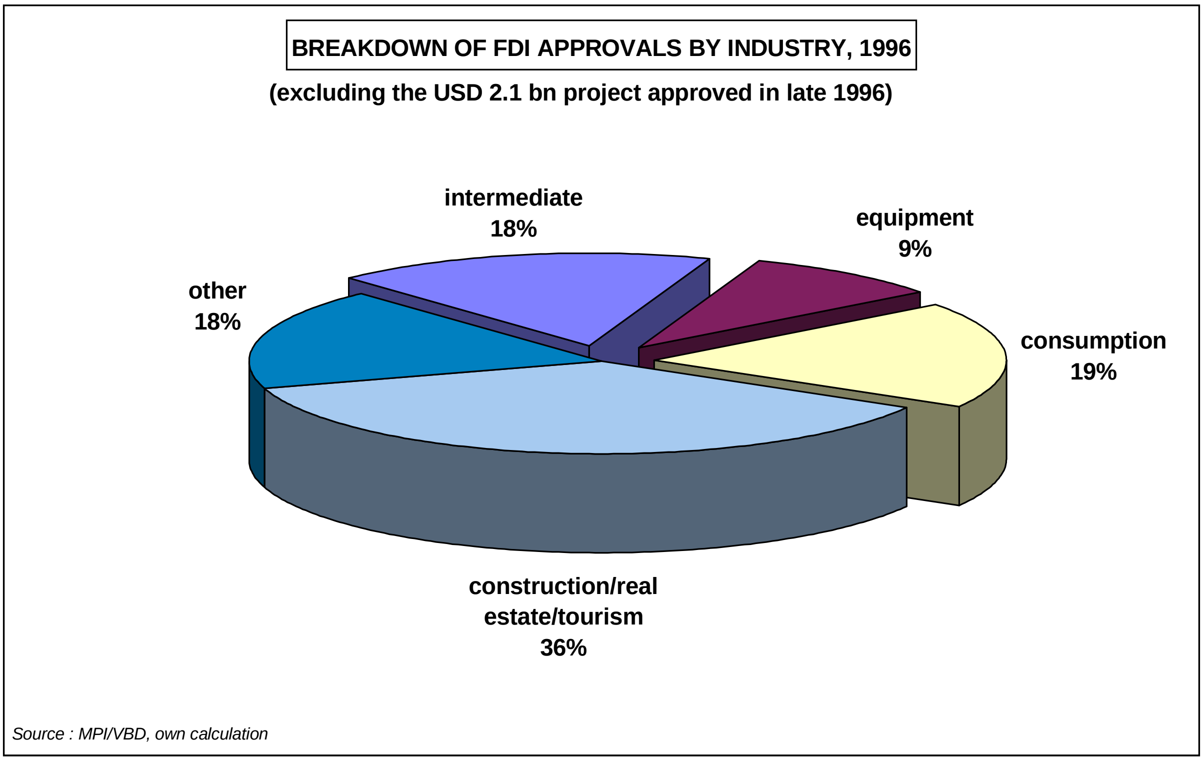
The very recent period has witnessed a rapidly increasing foreign investors' interest in manufacturing activities, with significant development in both intermediate (notably construction materials, textile yarn, leather, chemicals and metallurgy), consumption (notably garments, footwear and toys), and equipment (notably telecommunication, shipbuilding and light equipment tools) goods industries.

The following charts provide details on the FDI approvals by sectors and by investing countries, with differences between past and more recent figures :

total 1988-1995



1996, *excluding* the last minute USD 2.1 bn project

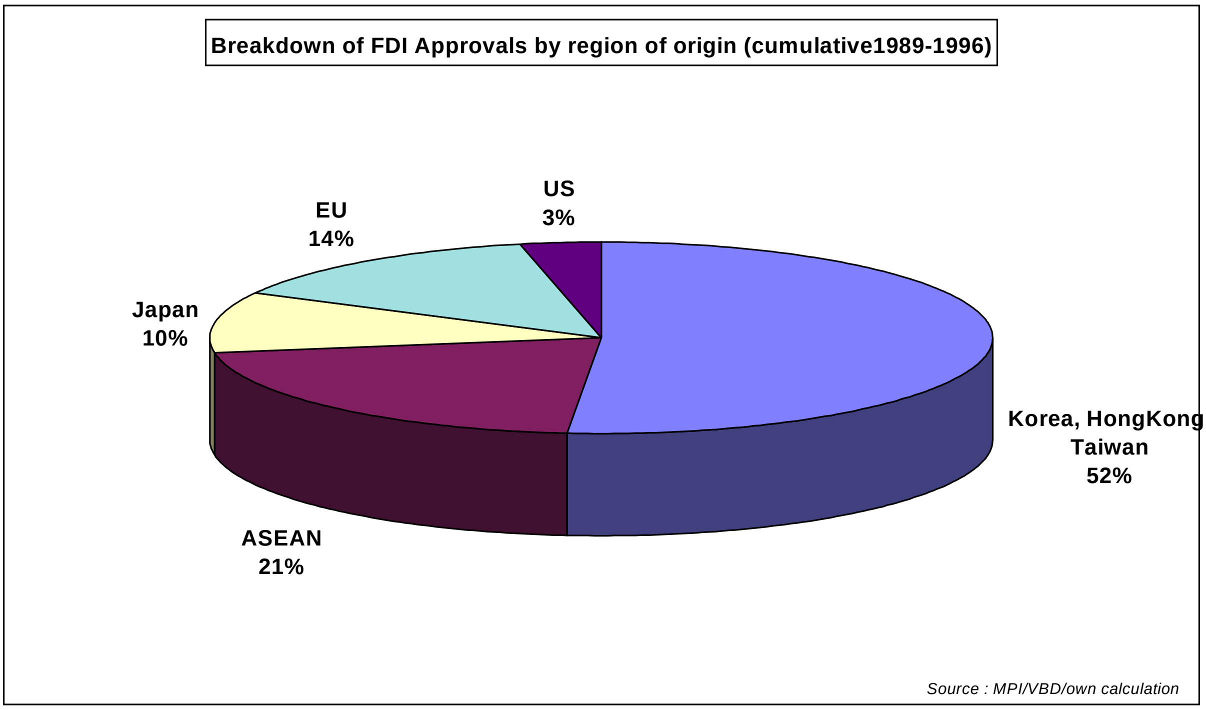


The breakdown by major investor countries[11] confirms the well documented overwhelming presence of Asian partners, with Singapore[12], Hong Kong, South Korea, Taiwan and Japan toping the list.

[11] Caution should be exercised when analysing investment data by partner country : the official country of origin is where the company making the investment is registered, even in the case of a subsidiary from a larger company incorporated in another country. A Dutch company investing from its Singapore subsidiary would be registered as a Singapore investment, as a European subsidiary of a US company making an investment in Vietnam would be registered under the European country label. This bias was estimated last year to be an under estimation of 10-15% of recorded investment for European countries.

[12] Including the USD 2.1 bn of late 1996

Cumulative 1989-1996 (excluding Singapore's USD 2.1 bn investment of late 1996)



The Asian dominance in FDI spread over all sectors. The following table is intended to show the persistent weakness of European investment in all sectors, in absolute dollar terms, on a cumulative basis for 1994-1996 approvals ; the amounts over USD 150 mn are in bold:

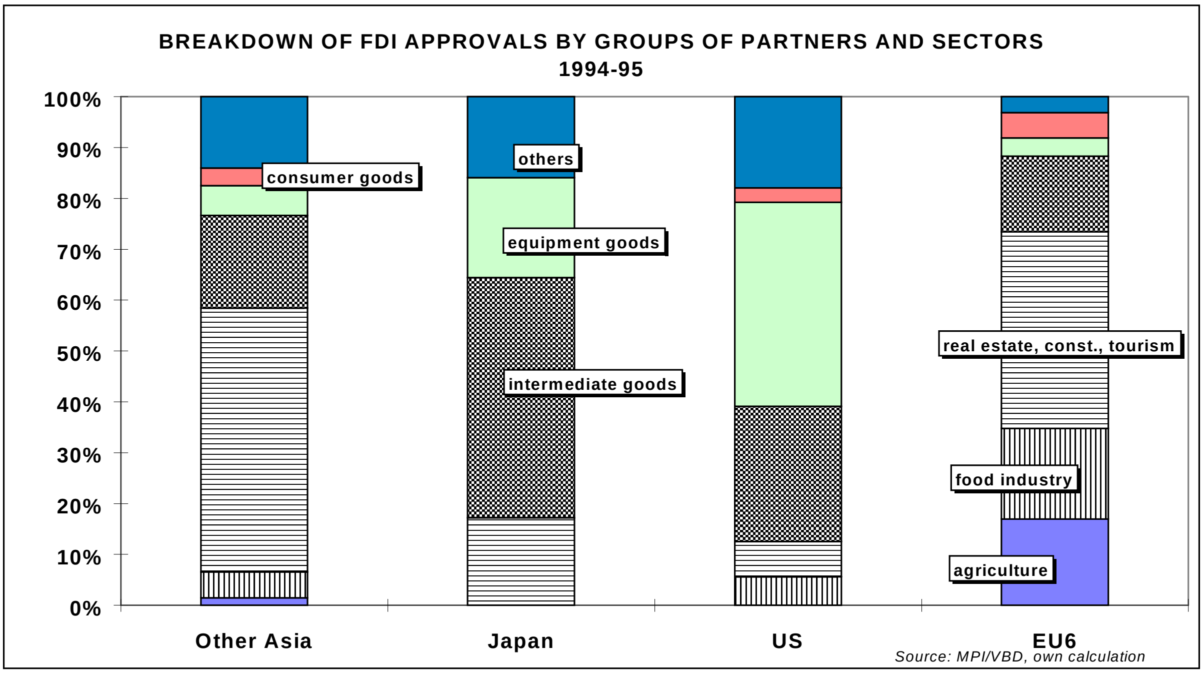
FDI APPROVALS 1994-96 BY GROUPS OF COUNTRIES AND SECTORS

USD mn	Korea, Taiwan Hong Kong	Singapore Thailand	Japan	US	EU6 (*)
Agriculture	94.66	41.07	-	7.79	120.77
Food, beverage, tobacco	**178.14**	**490.16**	22.89	41.06	**153.18**
Real estate, construction, tourism	**2 168.82**	**1 977.16**	**328.65**	86.87	**438.11**
Intermediate goods	**1 303.21**	**441.90**	**974.39**	**261.97**	134.56
Equipment goods (including cars)	**252.54**	**340.44**	**561.34**	**294.19**	30.10
Consumer goods	**455.31**	-	-	20.97	37.59
Others	624.62	428.82	434.41	140.79	142.78
Total	*5 077.30*	*3 719.55*	*2 321.69*	*853.65*	*1 057.09*

Source : MPI/VBD, own calculation (*) calculation based on 6 countries only : France, Germany, the UK, the Netherlands, Belgium and Italy.

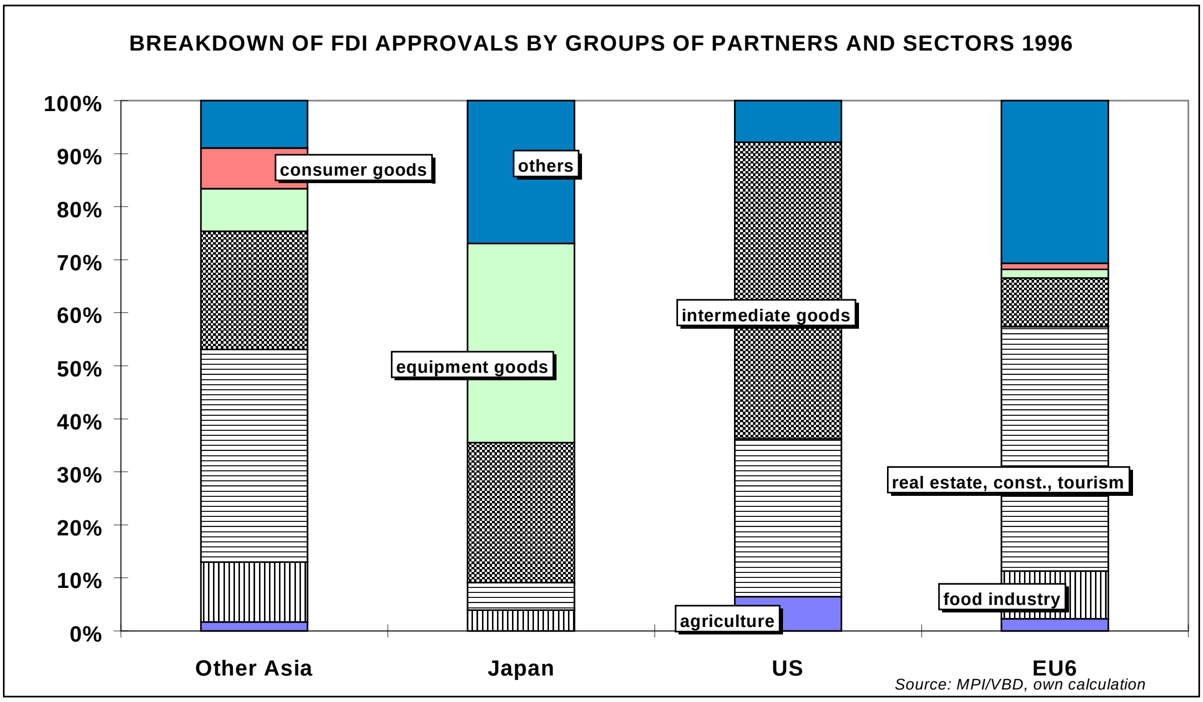
Only in the food-industry and in the real estate/construction/tourism do the European investments appear to be really significant, as well as in the agriculture sector where it is the largest foreign investor. The focus on intermediate goods and equipment goods by Japanese investors is revealing a very different long term strategy ; conversely, the very high amounts approved for real estate investment from the other Asian countries could spell some difficulties ahead, considering the questions arising for the real estate markets in large Vietnamese cities. These countries' investments in industrial sectors (intermediate goods, and to a lesser extent consumer goods and equipment goods) are still very high in absolute terms, and certainly will have significant consequences on the future trade pattern of Vietnam.

This specific investment pattern was already visible in 1994-1995, where industrial sectors, except food and beverages, represented a far more important share in Asian FDI.



In 1996 FDI approvals show that this past trend has been reinforced, with further significant divergence in the choices of activities by foreign investors. Indeed, EU companies still invested massively in real estate/construction related sectors (about 45% of total approvals for EU projects) and to a much lesser extent in agriculture and food industry (about 11.5%).

Conversely, Japan, Taiwan and to a lesser extent Korea continue to operate a switch towards the intermediate goods industries (chemicals, construction materials, glass, metallurgy) and some targeted equipment goods (shipbuilding, electric equipment, light tools).

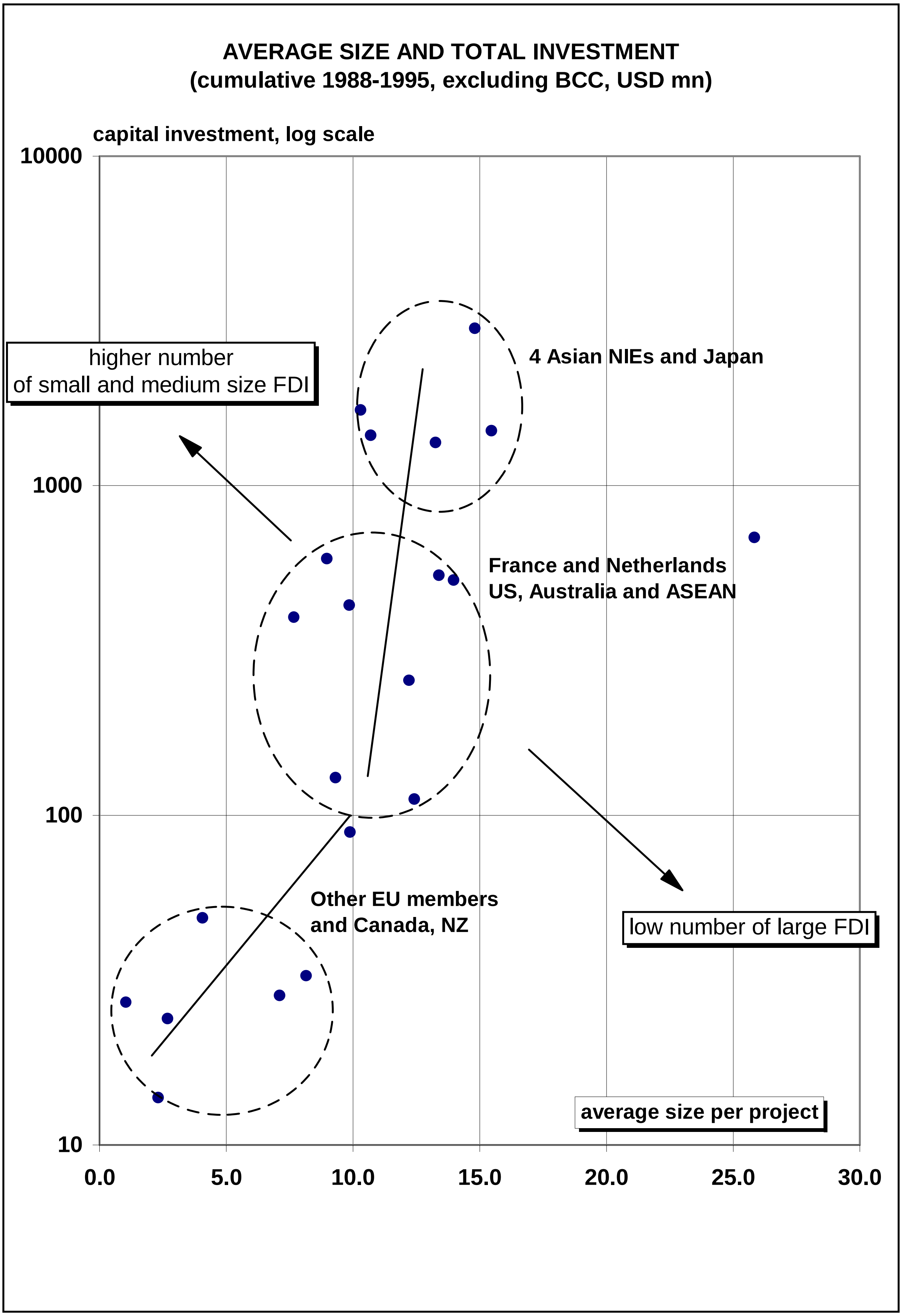


III-3 Ways for an increased European presence : a cross-factor analysis by country of origin and the dynamics of investment patterns

The analysis of the dynamics of FDI patterns and a clarification of the relative status of European investment in Vietnam are aimed at identifying the key strategic and policy factors which can be conducive to increased European FDI.

The major question which we try to deal with relates to the type of FDI to encourage (both from EC sources and from Vietnamese policy measures) in order to accelerate the global flow of FDI from the EC.

The following chart allows to sort major investing countries according to the average size of capital investment per project (used as an indicator of the need for larger investment) and the total capital investment approved.


AVERAGE SIZE AND TOTAL INVESTMENT
(cumulative 1988-1995, excluding BCC, USD mn)
capital investment, log scale
10000
1000
100
10
higher number
of small and medium size FDI
4 Asian NIEs and Japan
France and Netherlands
US, Australia and ASEAN
Other EU members
and Canada, NZ
low number of large FDI
average size per project
0.0
5.0
10.0
15.0
20.0
25.0
30.0

Using a log-scale for total investment capital, a clear break in the relationship between the two variables and the grouping of countries allows to make the following points:

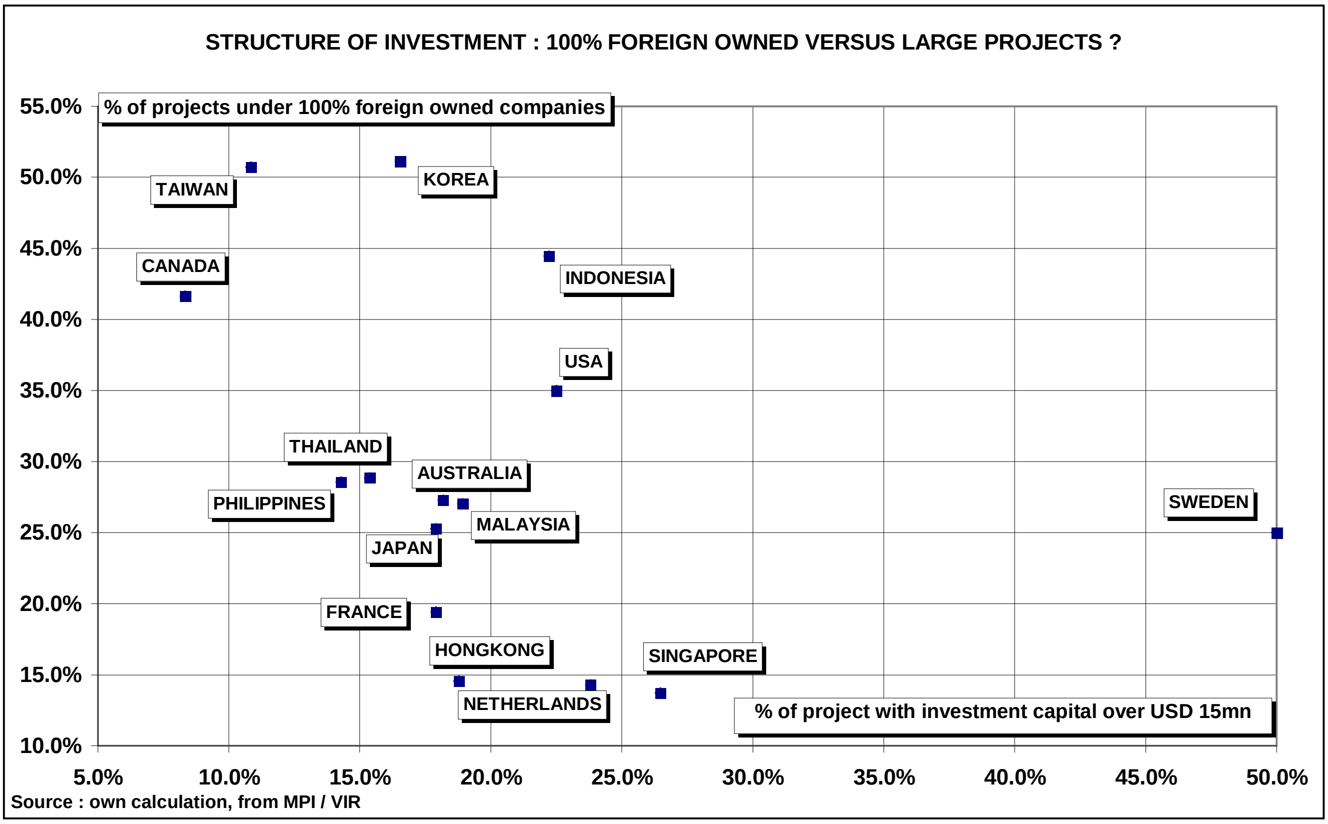
- before the average size of investment has reached a level of USD 10 mn, both an increase in this size and a higher number of projects are required to reach a significant level of participation in the total FDI (USD 100 mn): within EU member states this concerns mostly Germany, Belgium and Italy.

- By contrast, the steeply sloped trend characterising countries with an average size over USD 10 mn clearly points towards the priority to be given to a larger number of medium size projects over a low number of very large operations. This is particularly true for France and the Netherlands, and to a lesser extent for the UK.

- In terms of competition vis-à-vis European companies, the US and Australia are at the same stage of participation in the FDI process; Australia is probably a more immediate competitor, in relation with its rather intensive technical and financial co-operation and the fact that many late coming US projects are not yet close to completion and operation.

A connected strategic interrogation evolve around the possible relationship between the size of the investment and the degree of control exercised by the foreign investor. The following chart, crossing the % of projects with capital over USD 15 mn and the % of projects which are 100% foreign owned (based on the total number of projects), is highlighting very strong differences in the approach of the Vietnamese market.

On the one hand, Taiwanese, Korean and to a lesser extent Indonesian and US investors have a stronger preference for 100% foreign owned operations, but this is associated with a much lower share of large projects. On the contrary, Swedish companies, as well as Singapore, Hong Kong, Dutch and to a lesser extent French ones are tilted towards larger projects which imply more often the need to share the equity with a Vietnamese partner.



IV. CONCLUSION : MACRO-ECONOMIC ISSUES RELATED TO TRADE AND INVESTMENT

Trade and investment issues are both at the heart of short term economic tensions and constraints, and key elements for the next steps of reforms. It is no surprise that all multilateral institutions and the large countries negotiating on a bilateral basis either on trade issues (most notably the US) or on investment protection (including large member states of the EU) do consider that these inter related issues are to be rapidly tackled by the Vietnamese authorities.

In the context of the trade and investment patterns identified above, and considering Vietnam's specific socio-political features, the macro-economic imbalances emerging in 1996 have to be related to trade and financing questions, most importantly the need and way for a correction of the trade deficit on the one hand, the question on external financing to support the investment requirement of the country on the other.

- Concerning the trade deficit, it is clear that the present level is not sustainable in the medium term, notwithstanding the argument that most imports are equipment and intermediate goods. The 1997 first four months figures show that the trade deficit is still very high (exports reaching USD 2.7 bn and import USD 3.6 bn), and recurrent tensions on external finance availability appear, putting the country in a vulnerable situation considering the low level of foreign exchange reserves.

Faced with such an imbalance and the corresponding need for correction, the Vietnamese authorities may be tempted to resort to administrative controls over imports : the « temporary ban » put in place in April 1997 for paper products, cement, electric fans, construction glass and bicycles, and the announcement in May 1997 that foreign invested companies might have to pay for their imports with their own foreign currency resources[13], are clear example of the solutions favoured so far in the face of the deficit.

However, even if such measures might be warranted in the very short run to prevent a currency and liquidity crisis, it should be clear that they will inevitably entice two major drawbacks and further difficulties for Vietnam : first, administered quantitative restrictions are totally contradictory with the basis of the WTO process, and such measures would obviously put the Vietnamese candidacy to this organisation in partial jeopardy, and will probably also make any bilateral trade negotiation more difficult ; second, if domestic demand remains as strong as it is, with no change in the global macro-economic picture, such quantitative restrictions will put a significant upward pressure on domestic prices. It can certainly be said that Vietnam was able to enjoy fast growth with a declining inflation partly because imports filled the gap between demand and local supply ; therefore, an administered reduction in foreign supply brings the risk of reinitiating prices increases, especially in the intermediate goods sectors with an inflation spill over in the entire economy.

Another alternative may considered by the Vietnamese authorities : in the short term, it seems that an appropriate combination of a gradually depreciating exchange rate with an economic policy targeted at a moderate slowdown in domestic demand could very rapidly improve the trade picture : the elasticity of imports to domestic demand is very high (above 3), implying that a demand growth rate reduction of 2% could translate into a 6-8% reduction in the growth rate of imports. This would be amplified by the depreciation of the currency, which would also stimulate exports. A key feature of this kind of macro-economic management is to announce clearly in advance the pace of the Dong depreciation, with such mechanisms as a pre-determined « crawling peg », in order to keep confidence in the currency and in the whole economic policy. The slowdown in domestic demand could be obtained through administrative measures (including control over large investments with a high import content), but also with a monetary tightening which would encourage savings.

- The question of external finance is clearly related to the magnitude of the trade and current account deficits, but has also to be analysed in a medium term perspective, if the size of FDI and the slow process of ODA disbursements are taken into account. The urgency is to encourage domestic savings, with a short term impact on demand growth and the external deficit, and medium term positive effects on overall investment financing. To achieve such an improvement in domestic savings mobilisation requires to devise a financial sector strategy while pursuing rather restrictive monetary policies. In the Vietnamese context, it seems appropriate to develop medium term instruments which both the Central Government and SOEs could use to strengthen their financial resources and help the restructuring process for the latter. The emergence of a stock market partially fits into such

[13] Implying that the Central Bank will not sell foreign currencies for these companies' import requirements.

a strategy, but it should also be envisaged to develop a bond market : this would facilitate the questions of ownership and control (for the SOEs) while at the same time provide medium term and flexible instruments for domestic investors, and at a later stage foreign financial investors.

Apart from domestic resources mobilisation, there has been increasingly divergent views on the external debt situation of the country. According to World Bank figures[14], Vietnam's total external debt stood at USD 26.5 bn at the end of 1995. Considering the 1996 current account deficit and flow of actual FDI, it is likely to be around USD 29 bn at the end of 1996. However, the largest share of this external indebtedness is the bilateral debt due to Russia (ex Soviet Union) converted in dollars at the official exchange rate of the Rouble at the time of the financial contracts (i.e. around 1.7 dollars per Rouble). Such an exchange rate is very unrealistic, and it seems unlikely that Vietnam will have to repay this debt at such an exchange rate. The experience of previous agreements with other Central European countries which also have bilateral financial contracts with Vietnam allows to consider that the debt owed to Russia will translate into much lower repayment obligation for Vietnam. If this bilateral debt is taken out, about USD 11 bn remain as the « true » external debt, representing slightly over 100% of total current account revenues, a very comfortable level by any standard. The largest chunk of this debt is on concessional terms, implying a debt service ratio of 5.8% in 1995 ; there again, the situation looks much more comfortable than in many developing countries, with a threshold of 25% usually taken as implying a higher sovereign risk. In this context, a larger use of medium term borrowing from private sources (international banks or bond markets) may be warranted, notwithstanding the World Bank and I.M.F. opposition. In the absence of such medium term funding, the risk is to have a rapid build up of short term commercial debt, with potentially damaging consequences on the international liquidity of the country. It seems also that such foreign funds will have a multiplier effect by allowing an acceleration of disbursements from multilateral donors. The USD 3 bn committed by the World Bank and the ADB (USD 1.5 bn each) for the three years 1997-2000 could be used more efficiently if the Vietnamese authorities were more able to bring forward their own share of the projects' financing. The successful concluding of the London Club rescheduling with banks (concerning USD 800 mn, mostly due to Japanese institutions) is therefore a very important prerequisite for increased commercial borrowing. In this background, it is worth remembering that the highest the concessions obtained by Vietnam from banks, the more restrictive these banks may be in the future.

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