Vietnamese Development Policy

Upgrading the Domestic Private Sector Through FDI Linkages

Ben Grozier & Jason Keene
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Executive Summary

Since the Doi Moi reforms of 1986, Vietnam has been an economic success story, generating strong and consistent economic growth while significantly reducing poverty rates. The government's policy towards foreign direct investment has been a major support anchor for the country's export-oriented growth model, and the country's specialization in electronics manufacturing has been advantageous for its economic development.

Nevertheless, the sustainability of this economic model relies on continued investment from foreign-owned electronics firms, which cite a lack of capable domestic suppliers and low levels of human capital as business obstacles. Our analysis suggests that these constraints are evidence of weak absorptive capacity of domestic firms, which is preventing economic linkages that will allow technological diffusion to occur. **We recommend two priority policies: i) the establishment of a business advisory council and ii) reforming existing SME support programs.**

Notably, the ongoing COVID-19 pandemic presents meaningful risks to the current structure of the global economy and world trade. While we expect policies designed to strengthen Vietnam's domestic private sector will remain critical, the country will need to maintain flexibility in adapting to a post- COVID-19 world, especially if supply chains are to become increasingly fractionalized and nationalized.

6x

Income per capita growth since 1986

106%

Exports % GDP

39%

Domestic Value-Add in Electronics

<70%

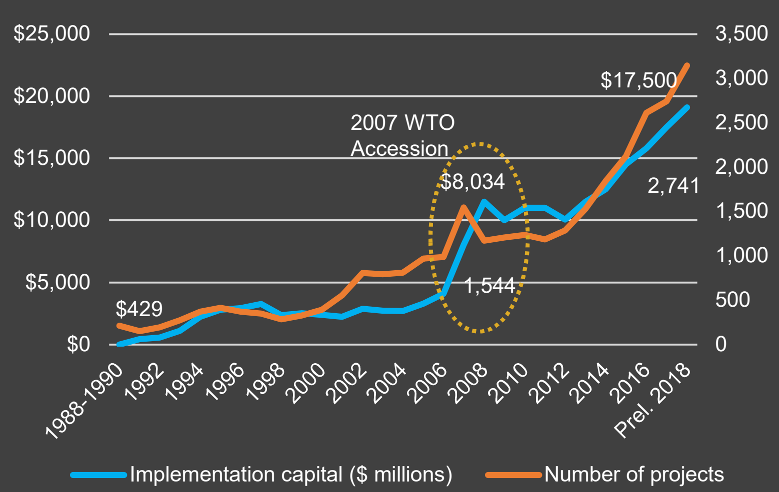
Foreign Firms Using Domestic Inputs

Vietnam's Development Model

Foreign Direct Investment

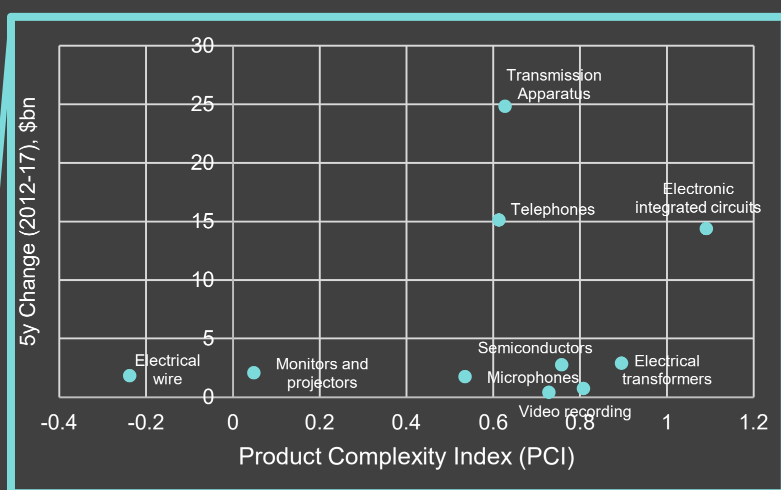
- The Government of Vietnam has successfully attracted FDI through tax incentives, priority access to critical infrastructure, and subsidized electricity prices
- WTO accession and regional FTAs have also contributed to double-digit annualized growth rates in FDI capital
- The country's strategic location and political stability are also critical factors

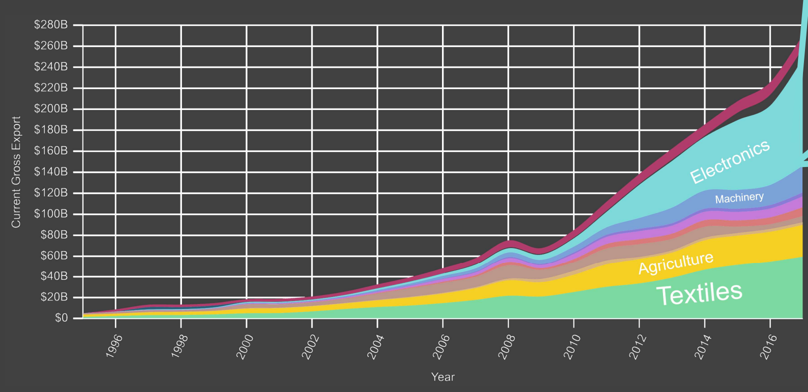
Increasing Foreign Direct Investment



High Complexity Electronics Manufacturing

- Electronics have grown from 14% to 37% of total exports basket in just seven years
- Export growth ex-electronics remains strong
- Vietnam's new, and growing, electronics exports are in complex product markets raising the country's complexity index score



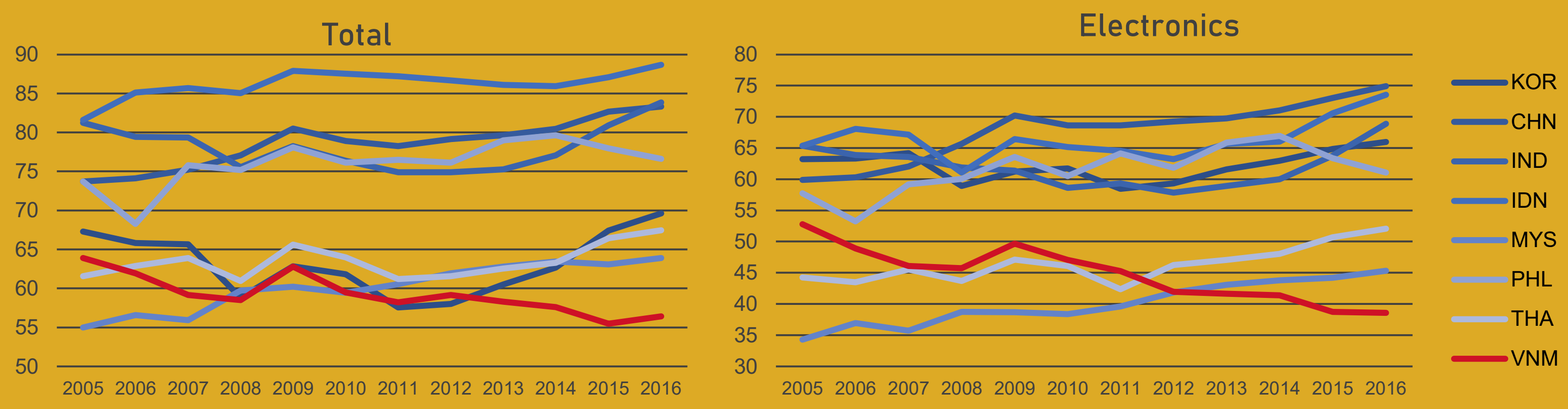


Challenges Facing Foreign Investors

- Firms primarily cite the following two investment constraints:
    - Lack of domestic suppliers
    - Level of human capital

- **PROBLEM STATEMENT:** The lack of technological diffusion within Vietnam's electronics industry is limiting the country's ability to upskill before its demographic window begins to close.

Domestic Value-Added Share of Gross Exports



Creating Linkages in Vietnam

- Leveraging Farole and Winkler's (2014) conceptual framework on creating linkages, we identify the **absorptive capacity of domestic firms** as the binding constraint for foreign investor-domestic supplier linkages in Vietnam.

Spillover Potential of FDI	Absorptive Capacity of Domestic Firms	Business Policy and Institutional Environment
High	Low	Medium
Technologically-productive foreign firms, many of whom express desire to work more closely with local suppliers	Large gaps in technological and managerial knowhow between foreign and domestic firms	Despite a supportive business environment, a lack of balanced policy support appears to crowd out the domestic private sector

Policy Recommendations

Policy Goals

1. Focus on improving the absorptive capacity of the domestic private sector
2. Target policies on technologically productive and link-ready domestic firms
3. Propose policies that are politically supportable and administratively feasible

Targeted Policy Options

Policy Proposal #1: Fund the Establishment of a Business Advisory Council

A Business Advisory Council, consisting of experts who built careers in the global electronics supply chain, would serve in a high-touch capacity with domestic SMEs so that they can meet the global business standards demanded of them.

Plans to scale up a Business Advisory Council over time would be contingent upon early success, eventually including a data analytics team and middle- and back-office support that would require additional resource allocation.

Policy Proposal #2: Reform Existing SME Support Programs to Focus on Skills Development

Between just three ministries (MPI, MoIT, and MoST) there exist 28 major SME support programs already in operation to attempt to resolve the disconnect between foreign investors and the domestic firms. Despite the breadth, there is only one training-specific SME support program aimed at developing business management skills.

SME reform must be targeted to provide support to the technologically-productive firms that are most capable of supplying foreign firms.