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The Next Wave of FDI to Vietnam is Coming – Part 2

In part one of this report, we outlined the motivations that will drive multinational and Chinese firms to move their production facilities from China to Vietnam, and/or set up new factories in Vietnam instead of in China or other locations going forward. Since Vietnam is a natural recipient of FDI inflows, the amount and quality of FDI that the country actually receives in this upcoming wave will be primarily determined by Vietnamese policymakers. [1]

The steps Vietnam needs to take to attract a significant amount of high quality FDI are already well understood and have been discussed repeatedly by economists, analysts, and corporate executives. In short, multinational firms require:

1) An abundant supply of skilled labor
2) The ability to easily ship their manufactured products
3) Minimal bureaucratic obstacles to set up and operate their factories

The specific measures that FDI firms most frequently say that they want the Government to take (in rough order of importance) are discussed below.

What FDI Companies Want

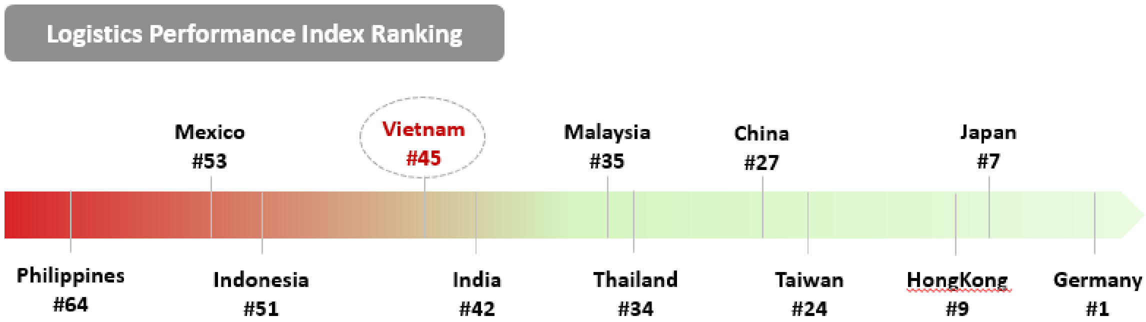
Most importantly, Vietnam's physical infrastructure needs significant upgrading to facilitate the shipment of finished goods, as well as the import of production inputs, between the country's industrial centers and its sea and airport. The Cai Mep and Cat Lai seaports, as well as Long Thanh International Airport outside of HCMC all need to be completed, as do other vital infrastructure such as "ring roads" around HCMC and Hanoi, public transportation for workers, to name a few.[2]

We believe that the master planning of Vietnam's infrastructure upgrades should be done at the central government level to optimize the country's supply-chain and logistics capabilities, as well as to fully utilize each province's strengths (i.e., human resources, local resources, etc.). We also believe that the Government's focus should include improving Vietnam's ranking in the World Bank's

[1] Vietnam is in an extremely advantageous position to attract FDI inflows. In contrast, if certain countries in Central Asia or Sub Sahara Africa decided to take dramatic actions to encourage FDI, these efforts would probably end up being in vain. Vietnam only needs to take a few modest steps in order to unleash an enormous wave of FDI into the country.

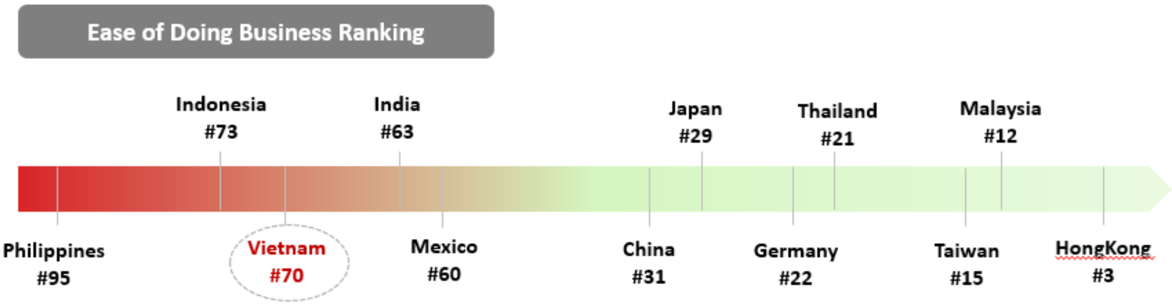
[2] The Long Thanh International Airport was originally scheduled to begin operations this year, but construction has yet to start.

Logistics Performance Index (LPI), although we note that LPI rankings include factors not directly linked to infrastructure, such as the ease of customs clearance.



The Government also needs to raise the country's Ease of Doing Business Rankings as produced by the World Bank and others by streamlining the bureaucratic processes around launching and operating a business in Vietnam. In the most recent World Bank survey, Vietnam ranks 70th out of 190 countries, far below Malaysia and Thailand, but comparable to India and Indonesia.

The Government's recently announced "fast track" initiative to expedite the licensing of FDI projects is a good example of the steps it can take to reduce the "red tape" and bureaucratic obstacles companies face when setting up and operating their businesses in Vietnam.



Next, Vietnam's vocational training needs to be significantly improved, to ensure that the work force can perform tasks that require higher skill levels. [3] Finally, the Government should continue to maintain a stable macroeconomic environment and especially a stable USD-VND exchange rate in order to protect the value of foreign investors' investments.

Further to that last point, maintaining a stable currency exchange rate was a key strategy that China used to attract FDI in the 2000s. During the Asian Financial Crisis (AFC) in 1997, which saw the currencies of Indonesia, Thailand, and Malaysia depreciate by 40-60%, the People's Bank of China made an extraordinary effort to maintain the USD-CNY peg, which helped drive huge FDI inflows to the country. [4]

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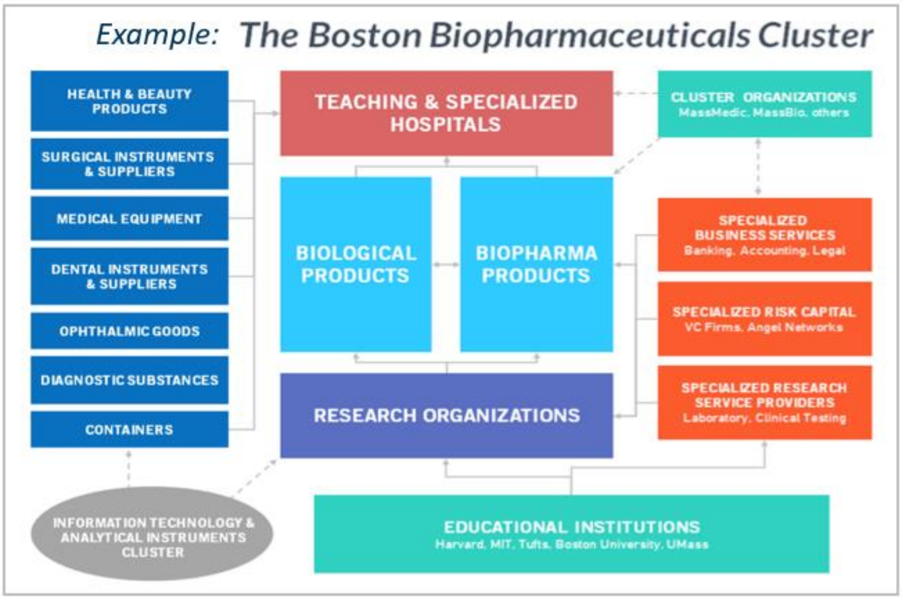
[3] Policy makers are advised to investigate Australia's TAFE program.

[4] Note that the State Bank of Vietnam (SBV) no longer maintains a "hard peg" between the value of the US Dollar and the VN Dong because the peg encouraged too much speculation on the country's currency, which in turn led to occasional, large gaps between the currency's unofficial and the official values. In 2016, the SBV implemented a "crawling peg" regime, which dramatically stabilized the USD-VND exchange rate and essentially eliminated differences between the official and unofficial values of the VN Dong.

Other Measures the Government Can Take To Encourage FDI Inflows

In addition to the measures discussed above that FDI companies consistently push for, here are some additional steps the Government should consider around promoting high-quality FDI inflows:

- Set up an Investment Promotion Agency (IPA) that actively markets Vietnam's advantages as an FDI destination to multinationals around the world. At present, the Government tends to approach FDI reactively, and works with foreign companies that approach it, although the Ministry of Planning & Investment and other relevant Government departments have become more aggressive in chasing up potential leads.



- Encourage the formation of industrial clusters in desirable industries such as electronics.
  - The "cluster" industrial development strategy (also known as an "ecosystem strategy"), was first advocated by Michael Porter, a noted professor at Harvard Business School. It entails fostering a geographic concentration of manufacturers, suppliers, and other institutions such as universities and research institutes.
  - This strategy would have the dual advantage of maximizing Vietnam's benefit from FDI investment and giving firms more confidence to locate their higher value-added activities in the country. Further to that last point, in addition to not having a strategy to market Vietnam's strengths as a destination for FDI, the country has not articulated a coherent strategy for the types of companies and industries it wants to attract.

- Invest in research and development and upgrade the country's technical universities, which has been an extremely successful industrial development strategy in China.

- Target investments from the overseas Vietnamese community in the US and Europe.

- Pursue "micro-level infrastructure development" projects, such as constructing an access road to a highway or building a wastewater treatment plant, that would prompt specific companies to invest in Vietnam.

Further to that last point, business executives, consultants, economists, and others consistently cite *infrastructure development* as Vietnam's most pressing need to attract more high quality FDI over the long-term. However, those experts are usually referring to the development of large-scale projects such as a new HCMC airport, which typically take years to build.

The "micro-level" infrastructure development strategy would entail the Government engaging with a range of specific companies to identify and fulfill the prerequisites that those firms need to set up their business in Vietnam. We understand that this type of special engagement currently only occurs when an enormous MNC is involved.

A Note About Free Trade Agreements and Tax Incentives

We end this section by briefly mentioning the role Free Trade Agreements (FTAs) and tax incentives have in attracting FDI to Vietnam. FTAs certainly help attract FDI to a country, especially when they entail measures that improve a country's ease of doing business. However, it is important to note that Vietnam is *already* a party to more FTAs than any country in the world,[5] and our focus in this report is on *additional* measures that the Government can take to encourage FDI.

Meanwhile, "*tax incentives are not critical*" to attracting FDI and "…*cannot substitute for political stability, good macroeconomic fundamentals, the availability of infrastructure, and a sound legal framework*"[6], according to the IMF. This suggests that Vietnam's Government does not need to offer overly generous tax breaks to attract FDI. Furthermore, as mentioned earlier, the decision-making frameworks that firms typically use do not prioritize tax incentives.

[5] Vietnam is a party to 14 FTAs, including the recently ratified European Vietnam Free Trade Agreement (EVFTA); the Government is currently negotiating to join another three FTAs.

[6] "Foreign Direct Investment in Emerging Market Countries", *(IMF, Working Group of the Capital Markets Group, 2003)*