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The Next Wave of FDI to Vietnam is Coming – Part 3

The Next FDI Wave Will Transform Vietnam's Economy [1]

The last part of this report outlines what to expect after the COVID medical issues subside:

1) Multinational companies will help build the capability of Vietnamese companies

2) Spillover benefits from FDI companies to local industry will accelerate [2]

Further to #1, the previous sections of this report argued that multinational companies now have an incentive to replicate portions of their China-based supply-chains in Vietnam, in order to diversify some production away from China.

Further to #2 above, Vietnam's FDI inflows are already enormous. However, much of that investment has had minimal "spill-over benefits" and has not meaningfully accelerated the growth of home-grown companies. For example, the foreign investment poured into manufacturing low value-added products creates jobs, and the foreign money invested into real estate development boosts Vietnam's wealth, but neither is likely to encourage and/or equip local entrepreneurs to start businesses.

Additionally, investments from massive global companies like Samsung and LG are obviously very beneficial, but those large companies essentially transplanted their own eco-system of suppliers to Vietnam. As a result, there are limited spill-over benefits from FDI companies to the rest of Vietnam's economy. [3]

Consequently, Vietnam has not yet accumulated a "**critical mass**" of the *right type* of FDI that would enable local firms to increasingly drive the country's economic growth. That said, we expect the coming surge of high-quality FDI into Vietnam's manufacturing sector to set a chain reaction in motion that ultimately spawns a plethora of well-managed and well-financed local companies.

[1] Special thanks to Ted Stank, Wendy Tate, and Shay Scott of the UTK Haslam College of Business Global Supply Chain Institute (GSCI) for their invaluable and practical insights that informed this section of the report

[2] "Disentangling Spillover Effects", *Institute for International Economics (Javoricik and Spatareanu, 2005)*

[3] For every 1ha of industrial park (I/P) land that LG rents, for example, the suppliers it transplants from Korea to Vietnam rent about another 4ha of I/P space, which illustrates why the resulting closed "ecosystem" does not foster spill-over benefits that help local industry.

How Multinationals Build Local Firms' Capabilities

When a multinational firm (MNF) embarks on building a local supply-chain in a developing country, it first identifies local entrepreneurs who it can back and/or well-established local firms with which it can work. They then build connections with key local suppliers through a number of ways, including:

- Taking an equity stake
- Lending money
- Entering into a long-term contract that commits the MNF to source from the local firm
- Forming a joint venture (JV)

Further to that last point, note that joint ventures are typically done as a last resort, particularly when that "option" is more-or-less compelled by the developing country's government (e.g., in China). MNFs generally tend to avoid JVs because of anecdotal evidence that JVs often do not function well.

The initial wave of investment by MNFs in Mexico was focused on helping local suppliers produce packaging, fasteners, wire harnesses, and other medium-complexity parts such as screws, and ball bearings, etc. Apparently, the overlap of those local suppliers and multinationals became so enmeshed that it is not always easy to immediately distinguish between the operations of the MNF and the local firm.

Capacity Building in Practice

The measures that MNFs took to build the capability of their local suppliers in Mexico, India, China, Vietnam, and other developing countries include:

- **Training the staff** of the local firm, by conducting courses in-country or by sending the local firm's managers to factories in other countries. [4]

  Common training topics include: Total Quality Management (TQM), Statistical Process Control (SPC), Financial Planning, the Theory of Constraints (introduced by Eli Goldratt in his well-known book, "The Goal"), and other topics related to setting up and optimizing production lines.

- **Engaging consulting firms** to:

  - Cut waste in the local firm's production process
  - Reconfigure production lines to optimize performance
  - Improve intermediate-term production planning

  Further to that last point, one consultant we know was hired by a multinational firm to help its local Mexican suppliers prepare for upcoming product launches. The local suppliers previously waited until production of a new product line was imminent before ordering the specialized equipment (such as a heavy crane) required to manufacture

[4] An example is Intel, which sent hundreds of Vietnamese engineers and technicians to its plants in Malaysia for hands-on training.

intermediate components. Consequently, the multinational firm often suffered production launch delays.

- **<u>Seconding executives to the local firm</u>** to help improve its operations and build capabilities.

  Note that the executives seconded to a local firm could be employees of the multinational or outside managers contracted by the multinational to build the local supplier's capabilities. There is a legion of mid-to-upper level globe-trotting executives who have worked in developing countries around the world, in these types of engagements, with the goal of training local managers to run their firm.

- Helping to set up **<u>supply chain finance/factoring</u>** firms that enable local suppliers to fund their working capital needs more economically. The support that an MNF imparts to a factoring company enables that financing firm to raise money at lower interest rates. [5]

- Fostering the launch of **<u>local trade associations</u>** that facilitate knowledge sharing, as well as healthy competition among local suppliers.

- Cooperating with the Vietnamese Government to set up a "**<u>Local Industry Upgrading Programme (LIUP)</u>**", similar to the one Singapore established in the 1980s. Singapore's LIUP strengthens procurement linkages between multinational and local companies, and before it was established, 80-90% of the city-state's local suppliers could not meet the quality standards required by MNFs or deliver on time. [6] [7]

- Support **<u>local universities and technical schools</u>** through initiatives similar to Intel's Higher Engineering Education Alliance Program (HEAAP) that "trains the trainers" in Vietnam.

- Support **<u>vocational education</u>** in developing countries to build the capability of the workforce. In India, Mondelez set up a technical high school to train workers for its nearby factory.

Apple Embarks on a "Multiyear Process" in Vietnam

Earlier in this series, we mentioned above that Apple will produce its new Airpods Studio headphones product in Vietnam as part of a move to reduce its reliance on China. In the past, Apple's sub-contractors manufactured products in Vietnam <u>after</u> the production of those products in China was <u>already</u> up-and-running. This marks the first time an Apple product will be made in Vietnam without having been made in China first.

However, "training workers and creating a new cluster of component providers (in Vietnam)" will be a "multiyear process" because Vietnamese manufacturers are "still learning basic processes such as work orders", according to reporting in the *Wall Street Journal*. [8]

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[5] "Vertical Integration and Supplier Finance", *Canadian Journal of Economics (Gorg and Kersting, 2017)*
[6] "Competitiveness Strategy in Developing Countries: A Manual for Policy Analysis" *(Wignaraja, 2003)*
[7] "Global Manufacturing and Local Linkage in Singapore" *(Perry and Hui 1997)*
[8] https://www.wsj.com/articles/tim-cook-and-apple-bet-everything-on-china-then-coronavirus-hit-11583172087

One reason we expect Vietnam's growth trajectory to dramatically improve in the coming years is because local manufacturers are starting from a low base. Local companies will absorb best practices ***quickly*** when firms like Apple start making a concerted effort to improve the capability of their Vietnamese suppliers, and when demanding multinational customers motivate local suppliers to improve their capability, in order to land lucrative contracts with those MNFs.[9]

"Spillover Benefits" From FDI Firms to Local Firms

When FDI flows into a developing county, "advanced production technology, managerial knowledge, and working practices are transferred from foreign investors to local firms, boosting the productivity of local producers", according to the Brookings Institution and others. [10] These "spillover benefits" increase as the number of multinational firms in the developing country increases, but the benefits are exponentially magnified when the size and scope of the FDI firms' operations in the country increase.

There is an extensive body of academic literature analyzing the positive impacts of "backward linkages" between MFNs and local suppliers, "forward linkages" between local firms and FDI suppliers, and "horizontal spillovers" between FDI and local firms.[11] However, the primary mechanisms by which spill over benefits help accelerate the development of local industry are:

1) Employees of multinational firms leave their jobs to start businesses that supply the multinational and/or its competitors

2) Employees of multinational firms are hired by local firms that were started by former multinational employees

3) Increased competition among local firms to land lucrative contracts with multinational firms prompts local suppliers to upgrade their operations

The first two dynamics listed above follow a predictable pattern, making Vietnam's improved growth trajectory over the next 5-7 years inevitable.

Lessons from China

We researched the surge of FDI into China during the early 2000s [12], and we expect some of the same dynamics seen there will apply to Vietnam's next wave of FDI inflows, including:

- When a local employee is hired as a manager/professional at a multinational company, it takes about five years for that person to gain sufficient knowledge before they are able to transfer their knowledge to the local industry.

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[9] Demanding customers (aka "Demand Conditions") are a key factor to improving the productivity of a country's domestic companies, according to Michael Porter's Diamond Theory of National Advantage.
[10] https://www.brookings.edu/blog/africa-in-focus/2015/11/19/understanding-fdi-spillover-mechanisms/

[11] "Disentangling Spillover Effects", *Institute for International Economics (Javoricik and Spatareanu, 2005)*
[12] China's annual FDI inflows nearly reached 5% of GDP in the early 2000's but have since dropped to around 1% in recent years

- After five years, many of those local managers aspire to start their own firms, or they are ready to leave the multinational to work for local suppliers that were founded by an ex-multinational employee. [13] In China, many employees began feeling overly stifled by the bureaucratic working conditions of their large multinational organizations after five years.

- Start-ups founded by former employees of multinationals tend to be much more successful than other local suppliers in emerging markets. [14]

- After a sufficient number of locals had worked at multinational firms in China for over five years, many new, truly competitive local firms began to sprout up. This explains why Vietnam's industrial upgrading will accelerate after the country attracts a critical mass of high quality FDI inflows ("high quality" FDI entails MNFs hiring local employees as factory line-managers, production engineers, mid-level accounting managers, etc. rather than only as assembly line workers).

- Local suppliers that were started by former managers at FDI firms often pay higher compensation than FDI firms, as a way to entice middle managers to leave their secure multinational jobs.

Further to that last point, when China's FDI inflows first surged, local managers and professionals were very happy to get jobs at FDI companies because those jobs paid high salaries and were considered prestigious. However, many outstanding local firms formed for the reasons outlined above; those firms were often able to pay higher salaries than multinational firms, which had higher overhead expenses, including the salaries paid to expats.[15]

[13] "Spillovers From Foreign Firms Through Worker Mobility", *Scandinavian Journal of Economics (Gorg & Strobl, 2005)*

[14] Ted Stank and Wendy Tate at the Global Supply Chain Institute noted this point.
[15] There are a couple of examples of a similar phenomenon in Vietnam, although those firms produce products that are sold into the domestic market, which is not the focus of this report.