BUREAU OF THE NATIONAL COMMITTEE FOR ASEAN
OFFICE OF THE GOVERNMENT OF VIETNAM

Vietnam and AFTA: By Choice or Obligation?

by

Frank Flatters

Hanoi, September 26, 1997

UNITED NATIONS DEVELOPMENT PROGRAM (UNDP)
“Promoting Vietnam’s Integration with ASEAN”
(Project VIE/95/015)

Vietnam and AFTA: By Choice or Obligation?

PREFACE

This report for the Office of the Government was funded under UNDP Project VIE/015/95 “Promoting Vietnam’s Integration with ASEAN”. The author expresses his appreciation for the support of the project management team: Dr. Nguyen Van Luat, National Project Director, Hoang Thi Minh Hong, Project Manager, and Neal Forster, Project Economist. Officials of the ASEAN Department of the Vietnam Chamber of Commerce and Industry provided invaluable assistance in arranging and conducting enterprise interviews in Vietnam for the case studies. Officers of a firms visited were uniformly open and cooperative. Ministry of Trade officials assisted with a briefing and discussion of government policies with respect to AFTA and general trade liberalization. Robert Glofcheski and Jean-Luc Bernasconi, Senior Economist and Economist respectively at UNDP Hanoi, provided data, guidance and comments on early drafts. Professor Le Dang Doanh and other participants at a project seminar provided helpful and stimulating comments on the first draft report. Adam McCarty and Vu Quoc Huy of National Economics University discussed work in progress and provided useful data; Dr. Vu also participated in several of the case interviews. Popon Kangpenkae of Queen’s University gave data support. Duangkamol Chotana, Trent Bertrand, David Dapice and Carolina de los Santos-Guina provided advice, data and useful sounding boards.

Frank Flatters
Department of Economics
Queen’s University
Kingston, Canada K7L 3N6
email: <ff@doug.econ.queensu.ca> or <flatters@mozart.inet.com.th>

Vietnam and AFTA: By Choice or Obligation?

1. Introduction

This is a report on the domestic, regional and international contexts within which Vietnam plans its strategy for economic integration with ASEAN. Achieving the maximum economic benefits for Vietnam requires a recognition that joining AFTA is only one part of Vietnam's ongoing process of integration with global markets.

Economic integration with ASEAN is sometimes viewed as an *obligation* that Vietnam must accept in order to improve its stature in the region and to continue to elevate its role in the global community. Meeting AFTA commitments is seen as a price that must be paid for certain diplomatic, political and security benefits.[1]

This report takes a different view, that AFTA provides an *opportunity*; it is one of many tools for continuing the process of *doi moi*, and for accelerating the development of the economy for the benefit of the people of Vietnam.

As a signal and as an important element of its program of economic reform, Vietnam has acceded to AFTA, and has indicated its desire to join both APEC and the WTO. All of these organizations involve commitments of their members to free and open trade and investment. This is based on two fundamental economic considerations.

Public Service Role of Trade Treaties: Continuation of world prosperity depends on maintaining an open, rules-based international trade and investment environment. This environment is a "public good" whose value depends on the number of countries who participate in its provision. Since many of the benefits of any individual country's membership are enjoyed by other countries, self-interest is not generally sufficient to ensure that a country will join and play by the "rules of the game". That is why it is necessary to guarantee participation through international agreements. By joining an international trade agreement, a country contributes to the global community by making a commitment to participate in the provision of this public good. This is the public service motive for entering trade agreements. The "private" returns to a country's participation are sometimes

[1] According to a recent Economist Intelligence Unit report (Baldwin (1997) p.62), Vietnam initially requested that it be permitted to join ASEAN *without* being required to become a party to AFTA.

enhanced by rules which make benefits conditional on membership (e.g. MFN treatment and access to dispute settlements in the case of WTO, and enjoyment of CEPT tariff preferences in the case of AFTA).

Self-Interest in Trade Liberalization: In an open world trading environment, the prosperity of any single country and the opportunities available to its people will be maximized by minimizing protection of its domestic markets. The principal beneficiaries of trade liberalization are the citizens of the liberalizing country.[2] International treaties and agreements help to ensure that special interests do not manipulate policies to deprive a country's citizens of these opportunities. In other words, participation in international trade agreements prevents countries from "shooting themselves in the foot".

It is the self-interest role of trade liberalization that is emphasized in this report. *Self-interest should be the basis of Vietnam's strategy for economic integration with ASEAN and the rest of the world. In fact, most of what Vietnam might wish to obtain through trade liberalization can be accomplished unilaterally.* But AFTA, APEC, WTO and other international agreements can be useful tools as well.

The report consists of:

- case studies of sectors that will be affected by Vietnam's integration with AFTA and global markets, based on interviews in Vietnam and other ASEAN countries, and on secondary data from a variety of sources;
- analysis of aggregate data on imports and exports of Vietnam and her trading partners;
- reviews of lessons from the experiences of other countries facing similar policy issues.

Case studies help to understand what economic policies mean "on the ground". They provide information on how policies are actually implemented, and on their most important direct

[2] It is well known that trade liberalization is a "positive sum gain"; i.e. there are *mutual* benefits from trade liberalization. However, the extent to which an individual country's trade policies affect other countries depends on its size. A large country, which can affect international terms of trade through its trade policy actions, confers benefits on its trading partners through trade liberalization. By importing and exporting more as a result of trade liberalization, it raises world prices of goods it imports, and lowers world prices of its exports. This improves the welfare of countries that import from or export to this country. However, a small country cannot influence international terms of trade and so affects only its own welfare through liberalizing or restricting trade. Since Vietnam is a small country in world markets, the principal effects of its trade policies fall on its own citizens.

impacts on firms and consumers. They also provide much of the raw material that is needed to understand the overall effects (beneficial and harmful) of government policies. This raw material is of two types: i) views of business persons about how policies can be implemented more effectively, and ii) data that can be used to evaluate the general economic impacts of these policies. Time did not permit detailed studies. Nevertheless, the cases provided useful information and suggested many policy insights regarding Vietnam's integration with AFTA and with the global economy. These results are presented in Section 2 of the report.

Section 3 provides an overview of Vietnam's trade patterns with ASEAN and the rest of the world. It includes some comparative analysis of Vietnam's comparative advantage relative to her ASEAN partners. The results put AFTA in the context of Vietnam's global trading environment and illustrate the dangers of relying solely on AFTA as the path to further economic integration with the world economy.

Lessons from international experience are included throughout the report in the context of the case studies, in the international data comparisons, and as "boxes" on particular issues.

Section 4 summarizes and draws conclusions.

2. Vietnam, AFTA and the World: Sectoral Lessons and Perspectives

Vietnam has made great progress over a short time period in restructuring its economy and integrating with world markets. The economic collapse of the Soviet Union and of Vietnam's special relationship with these economies in the late 1980s was a grave threat. Without the adjustments that have been brought about by *doi moi*, Vietnam's future would have been bleak, with dire implications for the economic security of workers in all fields of economic activity. *Doi moi* prevented this scenario from materializing, and since 1991 Vietnam's per capita income has grown at an annual average rate of more than 7 percent. This puts Vietnam in the top ranks, in terms of economic growth, of the high performing East Asian economies.

While this economic performance has been impressive, it has not been uniformly distributed across all sectors. Some industries and activities have made the transition much more successfully than others. This is not surprising in light both of rapid changes that have been occurring throughout this region, and of the many distortions that needed to be eliminated as Vietnam began to reorient its economy towards international markets. In light of this experience, an examination of differential performance across sectors provides some useful information about the ongoing process of reform.

The transition is far from complete. Much more adjustment will be needed to ensure a continuation of recent economic performance. This will require an acceleration of economic reforms. As has been recognized from the beginning, the benefits of *doi moi* accrue primarily to the Vietnamese people, and not to others. Trade liberalization, which is an important element of the reform process, does not need to be accomplished in the context of international treaties and agreements, such as AFTA and the WTO. Nevertheless, ASEAN can provide a useful part of the framework within which to continue the reform process.

What are some of the lessons that can be learned from looking at the experiences of different industries?

Successful outward orientation

In the 1970s and 1980s Vietnam's few manufactured exports were sold in the Soviet Union and other CMEA countries. The products were generally of low quality (and value) and were uncompetitive in non-communist markets. The collapse of the CMEA markets was potentially disastrous for Vietnam's fledgling manufactured exports.

Shoes were a good example. The state enterprise, Leaprodexim Viet Nam, exported uppers for footwear to the Soviet Union and other Eastern Bloc countries. With the collapse of this market in 1991, this enterprise could have followed the examples of many other sectors by retreating behind the barriers of high protection to try to survive on the basis of sales to the domestic market. Instead, they sought out partnerships with international designers and marketers of athletic shoes and have become a major player in one of Vietnam's most successful export sectors.

This sector is now Vietnam's fifth largest exporter, accounting for $549 million of exports in 1995.[3] The industry is geographically diversified, but with a concentration of production in the south around Ho Chi Minh City and in the north around Hanoi/Haiphong. Total employment in this labor intensive sector is about 250,000 workers. Domestic producers include a broad spectrum of enterprises — SOEs, private firms (even 100% private), and joint ventures (with domestic SOEs and private firms).[4]

Vietnam has captured a significant share of world production of athletic footwear. The main

[3] Based on 2 digit SITC data for 1995; see Table 3.1 below.

[4] Based on discussions with Vietnam Leather and Footwear Producers Association.

competitors are China and Indonesia. To ensure security of supply, major world buyers prefer to diversify production across a number of countries. Since Vietnam's share is already quite large, foreign buyers are unlikely to increase the share of goods sourced in Vietnam significantly. To remain competitive and to increase its share of total world production, therefore, the Vietnamese industry will have to move upmarket into the assembly of higher quality (and higher priced) products and also increase the local content provided by domestic supporting industries. This will require open and efficient markets for raw materials, capital equipment and intermediate inputs.

The assembly of shoes and of uppers is the most labor intensive part of shoe production, and has been the source of Vietnam's initial advantage in this industry. As skills improve, Vietnam will continue to move upmarket. And as supporting industries develop, domestic content will also continue to increase. Local content of some athletic shoes is already as high as 50 to 60%.[5] The two biggest potential barriers to a continuation of this development would be a) lack of skill development among Vietnamese workers, and b) policy-imposed restrictions on imports of raw materials and/or machinery used in making shoes and their components. The latter issue is addressed further below.

A less-noticed, but similarly successful export industry is *travel bags and luggage*. Like footwear, this is also labor intensive. Many of the successful bag exporters are closely linked with footwear producers. Like footwear, a large portion of travel bag export production is done under contract with western buyers. Travel bags are Vietnam's eighth largest export,[6] and accounted for $145 million of exports in 1995.

The principal lesson from the footwear and travel bag industries is that Vietnamese manufacturers who choose to be outward-oriented *can* succeed in world markets. Vietnam does have a comparative advantage in labor intensive industries. Firms and industries, state-owned and private, that are able to form links with foreign buyers and technical experts, and who have easy access to necessary imports, *are able to compete*. Starting from an uncompetitive and fractured industry in 1991, the footwear sector has become world-class, and continues to develop its inter-

---

[5] Increased local content has occurred as a "natural" part of the development of the industry. There have been no explicit government programs to encourage this evolution. The only role of the government has been to maintain tax- and other import-restriction-free access to components and, most importantly, industrial raw materials. This stands in stark contrast to the motorcycle industry, for instance, in which the government has implemented a complex set of sanctions and incentives to force development of local supporting industries. The problems with forcing local content are discussed further below.

[6] Based on 2 digit SITC data, 1995; see Table 3.1 below.

industry linkages with the domestic economy.

It is important to emphasize that Vietnam's footwear and travel bags sectors are *world*-class. Only a very small proportion of the sectors' exports and imports go to or come from ASEAN. Vietnam's pattern of comparative advantage for exports is very similar to those of other ASEAN countries. While Indonesia's and Thailand's protection of their local markets will disappear with full implementation of AFTA, this will have an insignificant impact on their imports of these products from Vietnam.

It is not protection, but rather the similarity in patterns of comparative advantage that is the "barrier" to Vietnamese exports to these markets. On the import side, there is some possibility of developing ASEAN-wide supporting industries for certain key components. But the economic basis for such cooperation is not large. Therefore, AFTA is unlikely to result in significant increases in intra-ASEAN trade in footwear or travel bag components. Vietnam's free access to *world* supplies of components and raw materials has been and will continue to be a key factor in export performance for outward-oriented producers.

In light of the international competitiveness of Vietnam's footwear and travel bags, it is surprising that these sectors are still protected in the domestic market by quite sizeable tariffs. Footwear imports face tariffs of 40-50%, while travel bag import duties are 30%. These tariffs, together with the very low import duties on raw materials provide effective protection for domestic market production in the order of 60-200%.[7] *This is an unnecessary subsidy to domestic producers, and is provided at the expense of consumers of a basic commodity*. If the government wishes to tax higher priced shoes in the domestic market, the appropriate instrument would be a sales tax on footwear above some threshold value. This would be much more effective and would have the additional advantage of avoiding domestic production distortions that arise from the use of import tariffs.

Access to industrial raw materials

Manufacturing development depends on, among other things, ready and reasonably priced access to industrial raw materials, especially steel and other metals, and plastics. In the early stages of Vietnam's development, as has been the case in other Southeast Asian economies, this access

[7] Based on author's calculations, under various assumptions about local content. The lower bound is for bags with 50% domestic content and the upper bound is for shoes with only 25% domestic content.

has been largely indirect, since a great deal of manufacturing production has been based on assembly of imported components. In the longer run, however, as the complexity of the industrial structure increases, and as domestic supporting industries are established, direct use of industrial raw materials will rise. Access to these materials can be through imports or through domestic production.

Vietnam does not yet have significant upstream steel or plastics industries. As a result, imports of most basic industrial raw materials are *relatively* free of import restrictions. This confers a great advantage on domestic users of these products.

Existing *steel* mills are inefficient, high cost producers of low grade products whose main use is in construction. Most domestically produced construction steel is protected by import duties of 30%. Galvanized steel, which is produced with imported sheet, faces a 15% import duty. Domestically produced downstream products, such as tubing, barbed wire, steel screens and mesh, steel nails, screws and nuts face import duties of 15 to 30%.[8]

In addition to these import duties, the industry is protected by a complex set of import quotas. Circular 02/TM-XNK (February 21, 1997) on the implementation of Decision 28 of the Prime Minister (January 13, 1997) spells out the system for management of steel imports. The circular classifies steel imports into three categories:

- kinds of steel sufficiently manufactured in the country and not to be imported,
- kinds of steel not yet manufactured or insufficiently manufactured in the country to be imported, and
- kinds of special purpose steel for which the import procedures are to be administered solely through Customs.

Imports of steel in the first two categories are regulated by the Ministry of Trade. Most of them are construction steel, and are the same ones that are protected by relatively high import duties, as described above. Imports in the first category are banned, and quotas are set for those in the second. Forty percent of the import quota is assigned to Vietnam Steel Corporation and the remainder is allocated to enterprises which are granted import-export business permits for these goods. In the case of cast steel, however, the entire quota is assigned to steel rolling mills or firms

[8] Motorcycle and bicycle chains, and parts thereof face very high import duties of 50 and 60% respectively.

approved by these mills.

Imports in the third category are regulated only by Customs and can be made, in principle, by any Customs-approved firm for its own use. Based on our limited discussions, industrial steel users appear to be able to obtain import licenses, at least for products in the third category, and some also get exemptions from import taxes. *Most of the products in the third category are not produced locally, have low rates of import duty, and are essential inputs into many manufactured products in Vietnam. No possible purpose is served by regulating these imports.*

Even with substantial protection, high production costs make it difficult for domestic steel producers to compete against imports. According to newspaper reports, many manufacturers built up substantial stockpiles of unsold steel last year.

Most steel and metal products used in manufacturing industries are not yet produced domestically and can be imported at low rates of duty — generally 0 to 5%. Imported steel is used in a very wide range of industries, producing for both domestic and international markets. Although this has not been a major focus of our research, we have not learned of any significant difficulties faced by importers of steel or other metal materials.

A number of investments are being planned for the domestic production of industrial steel. Products will include pig iron, rolled steel, and alloy steel. A critical issue to be faced in the very near future will be whether to provide import protection to such investments. These decisions will play an important role in Vietnam's industrial policy as well as in its commitments to trade liberalization within AFTA.

Vietnam's practice to date, as illustrated by construction steel and small number of industrial steel products, has been to provide high protection to any manufacturing activity that begins domestic production. When protected products are final consumption goods, the cost is borne by final consumers. The costs of protection of basic steel products, however, will be borne primarily by downstream industries which use these materials. Regulation- and tax-free access to such products in world markets has been an important advantage for Vietnamese manufacturers, and will be essential for the further development of downstream industries.

Despite this advantage, inward-oriented downstream users still find it difficult to become internationally competitive. (See further discussion of the costs of inward orientation below.) The bicycle industry is one such manufacturing sector which is highly dependent on steel imports. An increase in steel prices could be the final blow to this struggling industry.[9]

A broad range of downstream manufacturing industries would be adversely affected by increases in protection for steel materials. Agro-based industries that rely on tin plate for cans would also be hard hit by increases in import duties on this steel product.[10] To ensure the continued development of an internationally competitive manufacturing sector, Vietnam should think very carefully before providing any additional protection to upstream steel manufacturers. *To meet its international commitments (and serve its own self-interest) Vietnam should dismantle existing NTBs on steel products and refrain from imposing any new quotas or other import licensing arrangements.*

Plastics are another basic input into a wide range of final consumer goods, and are an essential component in almost all industrial products manufactured in Vietnam. They are also used in packaging of goods for export and the domestic market. Since 1990, the plastics products sector has been growing at an average rate of almost 30%, about double that of the entire industrial sector and more than triple the rate of growth of the economy. In 1995-96, it grew by more than 45%. Production of plastic products directly employs more than 40,000 workers.

More than half (about 55%) of current production of plastics is household consumption goods, with another 25% packaging, 12% construction materials (especially polyvinyl chloride (PVC) pipe), and the remainder inputs into industrial products. Continuation of the industrialization process will change this structure considerably, with the shares of final consumer goods and of packing materials falling to about 30% each, and that of industrial components rising to 30%, by the end of the decade. About two thirds of the latter is predicted to be in motor vehicles and electronics products.[11]

An important sign of the dynamism of the plastics industry has been the role of the private sector. From 1991 to 1996 the private sector grew at more than 70% per year, increasing its share from about 25% to 55% of sectoral output. State owned enterprises, while continuing to grow, are losing market share, and are finding it increasingly difficult to compete.

---

[9] The case of the bicycle industry is discussed further below.

[10] For several years in the mid-1980s, import restrictions on tin plate were a major barrier to the development of Indonesia’s canned pineapple industry. Removing these restrictions permitted this to become one of Indonesia’s most successful agro-based export industries.

[11] Information on market shares comes from Viet Nam Plastics Manufacturers Association & Saigon Plastics Association, *Viet Nam Plastics*, No. 15, April/May 1997. Projections of shares in particular industrial sectors should be treated as indicative only.

A crucial factor in the success of the plastics products industry has been free availability of competitively priced raw materials. Imports of plastic raw materials (PVC resin, polyethylene (PE), polypropylene (PP), polystyrene (PS)) are free of all import duties and are not restricted by quotas or other non-tariff barriers (NTBs). Access to raw materials, therefore, is not contingent on access to special licenses, quotas or other regulations. Restrictions on access to raw materials have not been a barrier to entry of new enterprises. Competitive prices of these inputs have enabled domestic producers of plastic consumer products to compete against imports.

Producers of final consumption goods made from plastic benefit not only from low cost and reliable supplies of raw materials, but also from import duties on final products of 20 to 40%.[12] For a typical plastic goods producer, whose raw materials account for about 75% of the total costs of production, the import tariffs on final products, together with duty free access to raw materials, provides *effective protection* of production for the local market of 80 to 160%. This protection is unnecessary. Competition among domestic producers of most basic consumer products already results in market prices which are far below world price plus tariff. The "natural protection" provided by transport costs alone is sufficient to shelter domestic producers from foreign competition. Therefore substantial tariff reductions could be undertaken, for the benefit of domestic users of these basic products, at little or no cost to domestic producers.

Plastics production so far has been largely for the domestic market. Only about 10% of output is exported. This is because Vietnamese producers still specialize in relatively low value household goods whose high bulk-to-value ratio makes them difficult to export competitively. However, a continuation of current trends and policies will bring about new patterns.

- As domestic incomes rise and as expertise increases, domestic producers will produce higher valued products for local consumption and for export. For this to happen, access to internationally priced plastic raw materials must remain unimpeded.

- Producers, and especially exporters, in other sectors such as electronics, electrical appliances and vehicle parts, will begin to demand inputs from local supporting industries (e.g. cases for VCRs and TVs, motor cycle components, liners and shelves for refrigerators and other appliances). This will increase *indirect exports* of plastic products. Export competitiveness and the development of supporting industries are symbiotic — each one

[12] In addition, the high bulk-to-value ratio of many plastic consumer products provides considerable "natural protection" against imports.

needs the other. Exporters (and internationally competitive producers for the domestic market) do not need to be forced to increase local content. Japanese and Korean electronics producers in Southeast Asia make great efforts to persuade both domestic entrepreneurs and suppliers from their home countries to establish themselves in proximity to their Southeast Asian factories. To make such investments attractive requires access to basic industrial raw materials at internationally competitive prices.

C Growth of the domestic plastics industry will create a sufficiently large market to support domestic production of plastic raw materials. In the longer run, Vietnam's petroleum resources could also make this a competitive location for feedstocks used to produce plastic raw materials. However, local production of plastic raw materials and feedstocks is not necessary for a competitive plastics industry. These commodities are freely available in the international market. Their production is highly capital intensive, and because of the competitive nature of the world market, margins are small. Unlike downstream manufacturing, these industries do not generate much domestic employment. *The greatest danger in developing an upstream petrochemical industry is that the government will be persuaded to protect it.* This would impede the growth of downstream manufacturers.

Vietnam has licensed several investments in plastic raw materials production. Among the first are joint ventures which are already producing PVC compound. This is a low tech, low value added activity.

More significant is the joint venture project which is under way between Japan's Mitsui Corporation and the state-owned Viet Nam National Plastics Corporation (Vinaplast) to manufacture PVC resin from PVC monomer. This is due to come on stream in April, 1998, at a planned capacity of 80,000 tons per year. This will be roughly equal to Vietnam's entire domestic market demand next year. Vinaplast and Mitsui are considering a further investment which would double this capacity and enable them to meet local market demand for many years to come. Another PVC project has been approved, but is now being reconsidered by the investors in light of the Vinaplast/Mitsui projects.

These upstream investments will be beneficial if they can become competitive exporters and/or make plastic raw materials more easily available to Vietnamese producers. Unfortunately, these investments may not improve the raw material supply situation facing downstream producers. The government has been petitioned to impose a 25% import duty on all PVC resin imports. If this proposal is accepted, it will:

- create excess profits (rents) that will accrue largely to foreign investors, and
- raise the cost of this basic industrial raw material to all downstream industrial users.

Upstream investors often seek special treatment; and it is common for governments to be swayed by their pleas for "infant industry" protection. In the mid 1980s, Indonesia imposed a series of import controls, and high tariffs on imports of plastic resins. Thailand has also succumbed to pressure to increase tariffs on plastic raw materials. These actions have hurt downstream producers in both countries, and have deterred investments in potentially competitive export industries.[13]

Upstream producers in these countries, meanwhile, benefit from unusually high protection-induced rates of return. In Indonesia, a 20% tariff on polystyrene provided a subsidy of *more than one and a half times the total capital invested in the project*.[14] On a per worker basis, the annual subsidy from protection is equivalent to about 15 times the average worker's wage.

Upstream producers have been able to use their influence to maintain high levels of protection. Indonesia's current tariffs on plastic raw materials range from 15 to 40%. This has caused so much harm to downstream industries that the government has had to provide blanket tariff exemptions to several key downstream sectors. This, of course, just concentrates the damage on other less fortunate producers, and on sectors that will never have a chance to develop until the protection is removed.

Plastic raw materials are *not* an infant industry. In fact, the basic products being produced in Indonesia and Thailand and which soon will be manufactured in Vietnam are relatively simple commodities, produced with well known and tested technologies. *If investors are correct in their claim that Vietnamese production cannot compete with imported products, they should not invest here. If they are able to compete, they need no subsidies. Protection will harm downstream industries, whose future is critical to Vietnamese workers and to the country's industrial development. Vietnam should not provide protection to upstream plastic raw materials industries*

. Plastic resins are Vietnam's eighth largest import from ASEAN (based on 1995 data).[15]

---

[13] See box on Thailand's recent problems, below.

[14] Based on author's calculations from Indonesian data.

[15] See Table 3.3 below.

Almost 40% of Vietnam's plastics imports come from ASEAN. Therefore, the treatment of these products under the CEPT is of considerable importance. *Most of these products (chapter 39 in the HS tariff code) have not yet been included under any CEPT category*. Polypropylene (HS 3902) has been placed on Vietnam's inclusion list, but the treatment of all other important categories in this chapter is still unspecified. This is odd for such a major ASEAN import.

Thailand: Structural Issues and Export Performance

Why has Thailand's manufactured export growth collapsed?

Thailand's initial phase of export oriented manufacturing was primarily in the form of assembly of labor intensive products in which Southeast Asia's comparative advantage had been shaped by the post-Plaza Accord currency realignments. The Plaza Accord was in part a signal of the successful industrialization of Japan and other East Asian economies, and of the graduation of these original "tigers" from simple labor intensive manufacturing.

A major factor in the initial success of Thailand's manufactured exports was its ability to insulate exporters from the costs of domestic protection and of other cost-raising effects of the economic and bureaucratic regimes. Continuation of export growth, and graduation to more integrated, internationally competitive manufacturing sectors, however, will require some fundamental changes and improvements; in particular

- development of "supporting industries," which, in turn, requires internationally competitive supplies of basic industrial raw materials, whether from domestic production or from imports, and
- increased attention to "fundamentals" such as education, infrastructure, flexibility and competition in markets for basic services (telecommunications, ports, transport, etc.), and a sound and stable legal environment.

These tasks are made more urgent by the rapid development of China, especially as an exporter of labor intensive products, as well as potential competition from other countries in the region such as India and Vietnam, and from Latin America and Eastern Europe.

Thailand has relied too long on "insulation of exporters" as a major tool of export promotion; it can no longer remain complacent with respect to its deregulation of the economy to lower the costs of domestic production. Examples of excessive regulation include a high and variable tariff rate regime, and especially measures to protect "infant" upstream industries such as steel and plastics. They also include a wide variety of other special interest protectionist policies which help particular bureaucratic interests, firms or industries, but which also raise the general costs of doing business.

Government-sanctioned monopolies in basic service industries such as transportation and telecommunications impose high costs, as does corruption in policy design and implementation, from ports and customs to infrastructure development. An efficient and competitive private sector requires parallel performance of the public sector in the provision of "good governance."

The current crisis is bringing a realization that a policy mentality based on a "culture of protection" is not sustainable. In a modern economy, high costs of poor government policies cannot simply be passed on to final consumers or absorbed by the rents from abundant natural resources and/or rapid economic growth. Costs incurred to protect one part of the economy inevitably harm other sectors. This especially true of export activities, whose supporting industries cannot be shielded from high cost upstream producers.

From a trade policy and economic development perspective, the import duty on these basic raw materials should remain at zero. For revenue purposes, and as a means of providing a modest level of protection to upstream industries, the government might wish to impose a 5% tariff on imports.[16] If imposed, however, this tariff should be applied to plastic materials imports from *all* sources. To impose it only on non-ASEAN imports would deprive Vietnam of access to competitive imports from the rest of the world, leave Vietnamese plastic users at the mercy of a potentially oligopolistic ASEAN producers, and invite diversion of imports from low cost world suppliers to higher cost ASEAN sellers.

Competitively priced, high quality plastic industrial components will be an important factor in the development of an internationally competitive industrial sector. Successful and competitive plastics industries will help ensure the development of vibrant manufacturing industries, and *vice versa*. Access to low cost plastic raw materials will be necessary for these synergies to work. The lessons from plastic raw materials apply equally to industrial steel and other metals, as discussed earlier.

Vietnam currently has a strong advantage over many other industrializing economies — it provides little protection to upstream producers of basic industrial raw materials. This advantage should not be given away in order to provide special privileges (and excess

[16] While the absence of import duties on plastic raw materials has been a key factor in the dynamism of the plastic products industry, it has also represented a lost revenue opportunity. Plastic raw material imports totaled $275 million in 1995. A modest 5% import duty would have yielded almost $14 million of revenue. With projected raw material demand growth of 25% per year, imports would rise (at constant prices) to about $840 million in 2000. This would yield revenues of $42 million with a 5% import tariff. To the extent that domestic PVC production displaces imports, of course, tariff revenues would be correspondingly reduced. At this point, therefore, the long run revenue contribution of an import duty on plastic resins is likely to be very small. Donovan and McCarty (1997) conduct a general analysis of revenue implications of tariff reforms in the context of AFTA.

profits) to large, and mostly foreign, investors.[17]

Forced increases in local content

It is sometimes argued that the only way to increase local content is to restrict imports of components that could be produced locally. This is the approach being followed in the motorcycle industry, for instance.

This type of policy has been pursued in several sectors in a number of ASEAN countries. The most common target of such policies, however, has been automotive and other motorized vehicle industries. In some cases, governments simply dictate a timetable for "deletion" of imported components from CKD kits. These highly detailed "deletion programs" are required to be followed by local producers.

Any required deletion that would not be voluntarily undertaken, of course, raises the cost of local production of the final product, while at the same time giving (implicitly) very high protection to local production of the "deleted" components. The cost-raising effect of deletion means that a standard byproduct of these programs is the granting of very high levels of protection to the final product. This is true of automobiles in almost all ASEAN countries, for instance.

In addition to this general cost of such programs, *specific* deletion programs such as those just described are inefficient for another reason. Given that the government wishes, for whatever reason, to increase local content, it would be more cost-effective to allow producers of the final good to choose, on the basis of relative costs of the alternatives, which particular components to delete in order to meet the government's local content targets. Better still, of course, would be to set explicit ceilings on the costs that the government would be willing to incur in order to achieve local content goals. This could be achieved, in principle, by providing a series of explicit subsidies or incentives that embody these "acceptable costs" of deletion.

The Vietnamese incentive system for increasing local content of motorcycle production actually bears a superficial resemblance to such an "ideal" deletion program — i.e one which avoids some of the high costs of achieving local content goals. The motorcycle and parts sector faces a tariff schedule on imported parts which provides higher levels of effective protection for achieving higher levels of local content. This is done by defining different types of "kits" (SKD, CKD1,

[17] In response to the current economic crisis, Indonesia has just announced reductions in import duties on a wide range of industrial raw materials and intermediate inputs. This is directly aimed at increasing the competitiveness of her downstream manufacturing industries.

IKD1, IKD2, and IKD3, which are distinguished by what is excluded from the set of imported parts), and imposing lower tariff rates on those which exclude more parts.[18] The excluded parts are those which will be sourced locally. The import tax savings from using kits with lower import content is the protection or subsidy provided achieving higher domestic content. Subject to these incentives, producers are free, in principle, to choose the cost-minimizing level of local content.

The first effect of this program, through the high tariff (60%) and occasional bans on imported CBUs, is to raise the domestic price of motorbikes. The complex structure of "deletion rates" for import tariffs is the source of several additional problems and costs. First, the definitions of the various types of kits specify the particular components that must be excluded, rather than setting general local content levels, say, as a proportion of the total production cost. Thus, producers are not permitted to find the least cost manner to meet any proportionate local content rate. Second, *the implicit subsidies to incremental local content under the existing scheme are extremely high, thus encouraging considerable economic waste in order to increase local content*.[19]

Restricting imports to increase local content is generally unnecessary and is always counter-productive. It is unnecessary because producers themselves wish to raise local content wherever it is cost-effective, in order to take advantage of close access to and communication with component suppliers. And it is counter-productive because it raises the cost of producing the final goods, and so impedes the development of the downstream industry upon which all other supporting industries depend.

We have not heard any reports, for instance, of difficulties faced by shoe producers in importing components and raw materials. This is one reason for this sector's success in generating exports and employment for Vietnamese workers. Forcing the industry to meet local content requirements that are not cost-effective would jeopardize the success of this industry. Imposing local content rules on electronics and electrical appliance makers would further delay investment and the emergence of internationally competitive exporters of these products in Vietnam.

---

[18] The tariff rates range from 55% for an SKD kit to 10% for an IKD3.

[19] To give an idea of the basic cost of protection of motorcycle production, a Honda Dream 2, which currently costs about $2500 in the local market, can be obtained on the Lao side of the border at Lao Bao for about $1600. The CIE (1997) report (p.92) provides some illustrative calculations of the very high levels of protection to (and economic waste caused by) incentives for incremental local content.

The only deletion programs that have been “sustainable” in other ASEAN countries have been in sectors which, for general reasons, or because of the deletion programs themselves, are unable to be internationally competitive, and survive only on the basis of high costs imposed on domestic consumers.

Inward orientation: unintended effects of protection

High tariffs, import bans and non-tariff barriers against imports are intended to protect domestic producers of similar products. Import tariffs are also an important source of government revenue. Protection is a form of subsidy whose costs are borne by domestic consumers. When protection is given to industrial goods, as seen above, the price is paid by other producers, which makes protection self-defeating. There are limits to the amount of protection that can be provided, even to consumer goods. Excessive protection often fails to achieve its protection goals and always hurts government revenues.

Until last year, Vietnam’s *bicycle* producers were protected by a 60% import tariff. Following complaints that this protection was insufficient, largely due to smuggling of bicycles from China, the tariff was increased recently to 70%. This provided no increase in protection or in government revenues. Even at 60%, the tariff provided such a large subsidy to bicycle smugglers that very few Chinese bicycles entered Vietnam through official channels.

The China-Vietnam border is long and porous; *it is almost impossible to prevent smuggling when import duties make the returns so high*. The principal market effect of the high import tariff is to make non-Chinese, non-Vietnamese bicycles unavailable, or at least much more difficult and expensive to obtain for Vietnamese consumers. In the central and southern parts of Laos, by contrast, Chinese bicycles are rarely seen in the market. Retailers say that bicycles from other ASEAN countries, while slightly more expensive than those from China, are much preferred because of their higher quality. *High but unenforceable tariffs on bicycles reduce government revenues, do not succeed in protecting the local industry, and deprive low income consumers of valuable market choices*.

On May 9th this year, to save foreign exchange by reducing imports, and at the same time to protect local producers of *electric fans*, imports were banned.[20] The ban added to the protection that was already provided by 40-50% import tariffs. Fans were only one of a number of

[20] Circular 5071/TM-XNK (May 9, 1997), on implementation of Decree 49/CP (May 6, 1997).

products subjected to new bans.[21] Two and a half months later, on July 23rd, these bans were quietly removed. Aside from the fact that they violated Vietnam's commitments under AFTA, there were two other reasons the bans were rescinded. First, since fans could not be legally imported at any tariff rate, the ban resulted in reduced import tax revenues. Second, smuggling of fans increased in order to circumvent the new policies. In the northern part of Vietnam smuggled fans come from China. In the central and southern parts they come from many sources, including Thailand and even Laos.[22]

Ad hoc protection and policy instability

Any major economic and systemic restructuring process inevitably creates uncertainties. These uncertainties relate to the speed of reform, its sequencing, and sometimes even the direction of change.

Measures intended to reduce the effects of this uncertainty for certain investors often have the unintended effect of increasing systemic uncertainty. "Made-to-measure" protection of the type that has been seen in the steel industry and which is being considered for PVC resin in the plastics industry (see above), might create some temporary certainty of protection against imports for the upstream industries. At the same time, however, these types of policies increase systemic uncertainty for existing and potential investors in all downstream industries. This is a major deterrent to downstream investments, which are the ultimate source of demand for products of the upstream industries. *Arbitrary, made-to-measure protection of upstream industries is a vicious circle*.[23]

The use of import quotas and other NTBs is another source of policy uncertainty. Quotas create uncertainty because of the impossibility of designing clear and transparent rules about the quantities of imports that will be available to consumers at any point of time. Allocating import licenses to domestic producers of similar goods, as is done for steel in Vietnam, increases the arbitrariness of import licensing regimes. The recent imposition and subsequent removal (only two

---

[21] The five categories of goods whose imports were banned at this time were writing and printing paper, construction steel, white construction glass, cement, and consumer goods such as bicycles and fans.

[22] On the Lao-Vietnam border, warehouses are stacked with fans which enter Vietnam through a well-established "back door" that circumvents official Customs procedures. This back door is used for a wide variety of electronic and electrical products, as well as motorcycles, and motorcycle parts.

[23] See earlier box on Thailand's recent performance for an overview of long term costs of a "culture of protection".

and a half months later) of import bans on several groups of products illustrates how much uncertainty can be created by quota systems.

Policy uncertainty imposes many direct costs on the economy. *In addition, uncertainty about government policies induces investors to allocate entrepreneurial resources to manipulating policy processes. This is seen as a necessary cost of doing business. Ad hockery soon breeds further ad hockery. This causes high costs, and, by the creation of special privileges, it also promotes a sense of unfairness about government policies. These perceptions undermine the legitimacy of the policy regime and of the economic reform program.*

Consumer electronics and electrical products are sectors in which Vietnam should be able to be internationally competitive. Many parts of this industry are labor intensive. It is a sector that is well developed in ASEAN, with portions of it allocated to different countries according to historical choices and patterns of relative costs. Because of changing labor costs, the ASEAN industry continues to evolve rapidly, with many products that used to be produced in Malaysia and Singapore, for instance, now moving to Thailand and Indonesia. Malaysia and Singapore now specialize in more capital and/or skill intensive components and products. As a deliberate strategy of Japanese and Korean investors, this specialization is accompanied by considerable intra-ASEAN trade in components and sub-components. Vietnam should be well placed to participate in this regional division of production.

In making their location decisions, international investors in this region consider not only Vietnam and other ASEAN countries. China is, of course, one of the major alternatives. How does Vietnam compare?

Within ASEAN, Vietnam has a number of advantages, mostly related to the quality and cost of its labor. However, in order to compete with other ASEAN locations, Vietnam must be able to maintain good access to intra-regional trade in components and raw materials. Major electronics investors are not yet convinced by any actions that have been revealed so far that Vietnam is fully committed to free trade within ASEAN. In particular, the recent arbitrary import bans has been widely noted and has created doubt among electronics investors. In addition, other "hidden costs" of doing business in Vietnam have been a major source of concern. The customs system is often cited by investors in this regard.[24]

China has some of the same advantages and disadvantages of Vietnam. This has caused major investors to be cautious about commitments to China as well. However, China has one large advantage over Vietnam — the size of its market. The Chinese market is large enough on its own to support not only assembly of a wide range of final products, but also local manufacture of many subcomponents. This scale factor alone is sufficient for many investors to overcome many of the other drawbacks of investing in China. Vietnam does not have this luxury.

One major Asian electronics investor has provided data indicating it has invested $550 million in new factories in Asia-Pacific countries (ASEAN plus China and India) since 1994. Of this amount, only 1.2% has come to Vietnam. And the Vietnam investment is only for assembly of final goods for the local market.[25]

Indonesia: Customs Reform as Trade Liberalization

In the early 1980s the corruption and inefficiency of the Indonesian customs administration were well known. Cartoons in local newspapers depicted administrative procedures which were designed to maximize the number of approvals (and hence bribes) required to clear goods through customs. Despite their low official salaries, customs officials were known to have large incomes. At the same time, import procedures were notoriously slow, with two to three month clearance times at the port being quite normal. Rather than trying to simplify import procedures, senior customs officials worked with counterparts from other ministries to develop increasingly complex tariff and exemption structures and broaden the scope of non-tariff import restrictions, thus increasing the discretionary authority of Customs and hence their scope for corruption.

In 1984, the government announced a complete transformation of import procedures. Under the new system, imports were not inspected by Customs. Instead, they were inspected in the country of export by a Swiss surveying firm, Societe General de Surveillance (SGS).

Under the pre-shipment inspection (PSI) system, SGS inspectors determined the description, customs classification and value of the shipments, and then sealed them to prevent any tampering. The

[24] Vietnam's customs problems are similar in many ways to those of Indonesia in the early 1980s. See box on Indonesian Customs for a description of the costs of inefficient customs clearance, and of how Indonesia dealt with these problems.

[25] By contrast, 85% of this company's post-1994 Asia-Pacific investment has gone to China, and almost all of this is for production of components, including some which are quite technically advanced.

PSI report was forwarded to the Indonesian importer and to the relevant government departments and banks. The importer used this report to clear all import tax obligations, often before the arrival of the goods. The only role of Customs was to verify that SGS seals had not been tampered with and that there was documentation of payment of taxes. In the absence of clear evidence of tampering, Customs was not permitted to interfere in any way with shipments supported by SGS documents. Only goods in consignments of less than $5,000 could be imported without SGS inspection. In such cases, importers had the choice of following SGS procedures or clearing their goods through Customs in the 'normal' manner.

The workload of Customs was enormously reduced. However, no officials were fired. They were required to report for work as usual, and were paid their normal government salaries. But, with the opportunities for corruption reduced, their actual incomes fell drastically.

The immediate results of this reform were spectacular. Within months, members of the Indonesian Importers' Association reported that importing costs had fallen by 20 percent. Clearance times for imports at the ports fell from weeks and months to a few hours. And import tax revenues rose While this was only the first in a series of trade policy reforms involving special measures for exporters, decreased reliance on non-tariff import barriers, and lowering of import tariffs, it was arguably Indonesia's most important trade liberalization measure of the 1980s.

The initial SGS contract was for three years. It was the government's intention from the beginning to use the PSI system as a temporary measure until it could prepare a new Customs law and regulations, and reform its customs service. This process of administrative, legal and regulatory reform took much longer than expected, and was finally completed on April 1, 1997.

This is a sector in which Vietnam can be internationally competitive. Uncertainties about the direction, speed and methods of policy reform, however, are creating barriers to the realization of this potential.

There are many ways to reduce policy uncertainty and its associated costs and inequities, including the following.

- Cease using import quotas and all other forms of NTBs, other than those required for public health or security reasons. This is a requirement of AFTA and of WTO membership.
- Simplify the tariff schedule. Reduce the number of rate categories, and eliminate all high rates. This is required with respect to CEPT rates in AFTA; but the principle should be applied as quickly as possible on an MFN basis. Vietnam has been slow so far to take advantage of AFTA to introduce substantive reductions in its import tariffs. The only products committed to low tariffs under AFTA are those that already have low tariffs.

Vietnam has also included in its general exception list many products whose protection is unrelated to national security, health or cultural protection, which are the only reasons for which general exceptions are permitted under AFTA.

- C Announce a timetable for tariff reform, which includes the dates and rules whereby rates will be reduced to achieve the final targets referred to in the previous point. Indonesia and the Philippines provide clear examples of this procedure in the individual action plans presented at the Manila APEC meeting last year. (See box on this subject.) Vietnam has been very slow to set out a public schedule for tariff reductions even under the CEPT. It has made even less progress recently in implementing or even announcing more general tariff reform.

- C Abolish the system of “made-to-measure” protection immediately. Rejecting therequest for protection of PVC production would be a significant first step in this regard. All new investors should be protected according to the tariff schedule described in the previous two points. This will eliminate all the costs and the perceptions of inequities and special privileges created by the current system of import protection.

In addition to undertaking these measures, there should be a comprehensive review of all other aspects of the policy environment that contribute to the “hidden costs” of doing business in Vietnam. *It is a widely held view among investors and other observers that these costs are very high, and that they are substantially undermining many of Vietnam’s competitive advantages. An objective review will reveal which of these views are undeserved myths, and will assist the government to dispel them. And it will identify the areas in which policy actions are required.*

Indonesia and Philippines:

Using International Agreements to Secure Domestic Reforms

Indonesia and the Philippines have been engaged in a complex domestic process of economic liberalization for more than a decade. As in many other countries, the internal struggles have pitted various special interests against each other and especially against the policy makers who wish to implement welfare-enhancing liberalization measures for the benefit of their citizens. Progress in achieving reform has been uneven. However, both of these countries have used international commitments to secure and extend domestic economic reforms. Recent events in APEC illustrate the point.

Indonesia was the host of the second APEC Economic Leaders’ Meeting in Bogor in November

1994. At this time, Indonesia's domestic economic reforms were facing increased resistance from powerful interest groups wishing to maintain protection for their industries. President Suharto used the occasion of this meeting of global leaders to insist on a strongly worded Bogor Declaration in support of "free and open trade and investment in the region" by 2010. His leadership on this issue sent a strong signal to his own country about his personal commitment to continuing the path of domestic economic deregulation.

At the fourth APEC Economic Leaders' Meeting in Manila, in 1997, both President Ramos and President Suharto surprised many observers with their detailed blueprints for unilateral, MFN-based tariff reform. Manila's action plan for tariffs was a schedule for achieving a uniform tariff of 5% by 2003; Indonesia's was a detailed plan for reducing all high tariffs and achieving a simplified system of three rates, with a maximum of 10%, by the same date. These plans were in no way reciprocal or conditional on "concessions" from any other country. They were based on each country's own self-interest in bold trade policy reform. The Manila meeting was an opportunity for these leaders to achieve domestic goals by making international commitments.

Special burdens on state enterprises

SOEs have been pointed out by many to be a major stumbling block in the path of continued economic reforms. These enterprises operate under an ambiguous system of incentives. The most important incentive, however, is the perception that SOEs will not be allowed to fail. To ensure this, SOEs are protected by a variety of methods, including tariffs and NTBs, which shield them from import protection. The strong government commitment to the survival of SOEs, together with the SOEs' alliances with powerful ministries, form a potent coalition to obstruct further reforms.

A principal reason for the desire to protect SOEs is a wish to safeguard the economic security of the workers in these enterprises. The close links between enterprise security and worker security is due to the traditional life-time employment system in SOEs.

There can be no argument with the government's desire to protect workers' economic security. However, maintaining SOEs at any cost is a counterproductive form of social safety net for the young and for the elderly. The most effective safety net for the young is rapid employment growth; and the most effective form of security for their parents is economic success for their children. Tying workers' security to their firms is inefficient and ineffective, especially in a time of rapid economic change and restructuring. Vietnamese workers and entrepreneurs can be very creative and adaptive. Allowing these abilities to express themselves will be the basis for Vietnam's long term success.

In our case studies, it was apparent that SOE managers are aware of the need for change. In some cases, for example footwear, they have been very successful already. In other cases, however, special social burdens and obligations were hindering their ability to adapt. The lifetime employment system was an unspoken but clearly important constraint. A number of firms have already found creative ways to overcome this obstacle by creating new types of employment contracts and relationships. This has enabled some enterprises to engage in investments and new productive activities that would have been impossible under the traditional system.

In the process of economic restructuring it is inevitable that some state-owned and private enterprises will fail. To tie the fate of the workers to the fate of the firms themselves is cruel and unnecessary. And it hinders the ability of the economy to adapt and to grow. What is important is to find other means to provide long term security to workers. As mentioned above, rapid growth and expanding overall employment opportunities is one means to this end.

The exchange rate

The exchange rate is a key macroeconomic variable which, among other things, determines the relative prices of tradable and non-tradable goods. An important determinant of the success of the "second tier Asian tigers"[26] since the early to mid 1980s has been macroeconomic policy regimes which ensured low rates of inflation and kept their currencies closely tied to the US dollar. The rise of the Japanese yen (and other East Asian currencies) relative to the dollar as a result of the Plaza Accord in 1985 kept the values of their currencies low relative to the yen, and ensured the competitiveness of the manufacturing sectors of these countries as East Asian production moved offshore in the face of rising domestic costs. In addition, Indonesia and Thailand both engaged in intentional devaluations to further strengthen the competitiveness of their tradable goods sectors at critical times over the period.[27]

Under these policy regimes, these countries enjoyed high rates of economic growth, rapid

[26] This term is used to describe Indonesia, Malaysia and Thailand over the entire past decade, and now includes the Philippines, whose economic reform efforts in recent years have begun to pay off in terms of substantially improved economic performance.

[27] Prior to this year, Indonesia devalued twice over the period, in 1983 and 1986. It then switched to a "managed float" in which the Rupiah slowly depreciated within a band set and managed by Bank Indonesia. Over the same period, Thailand devalued the baht once, in 1987, and then kept it pegged to a basket of currencies, in which the major weight was assigned to the US dollar.

industrialization and employment growth, and the development of increasingly competitive manufactured export sectors. In early 1996, however, at the same time as the US dollar began to strengthen against the Japanese yen, some warning signals began to appear, most particularly in a slowdown of export growth and widening of the current account deficits of all of these countries. The problem was most serious in Thailand, but affected all four countries to some extent.

Underlying the decline in export growth and the other economic difficulties that have ensued have been a number of important structural and policy issues. (See box on Thailand, below.) Part of the problem, however, was that exchange rates had gotten out of line. Once again, the issue was most serious in Thailand, and it was aggravated by policy makers who treated the exchange rate as a matter of national pride and delayed action far too long. Ultimately, as is now very well known, Thai authorities recognized the need to abandon their overvalued exchange rate, and the other three countries followed soon thereafter.

Table 2.1 shows the values (in $US) of the Thai baht, Philippine Peso, Malaysian Ringgit, Indonesian Rupiah, and the Vietnam dong (VND) since the end of 1995. Exchange rates are shown at three points prior to the recent devaluations of the ASEAN currencies, and in early September this year, after the devaluations. As the final column shows, with the exception of the VND, all of these currencies have depreciated substantially versus the dollar since the end of June. The Singapore dollar depreciated the least, only 6.4%, while the depreciations of the other currencies ranged from 17 to 29.9 percent. By comparison, the VND has held its value almost intact, depreciating by only 0.3 percent over the same period.

As reported in local newspapers recently,[28] Vietnam's monetary authorities take justifiable pride in their decision last year to let the VND depreciate gradually against the US dollar. As Table 2.1 shows, the VND has depreciated by 6.2% against the dollar since the end of 1995. However, this depreciation has been quite small relative to the other ASEAN currencies. The only other currency whose depreciation has been (almost) as low has been the extremely strong Singapore dollar. The other ASEAN currencies have depreciated from 16 to 32% since the end of 1995, much more than the VND.

Looked at another way (see Table 2.2), the VND has appreciated by 11.7 to 33.4% against the other ASEAN currencies since the end of 1995, and by 20.1 to 42.3% since the end of June this year. The appreciation since the end of 1995 has been the greatest against the baht

---

[28] See *Vietnam Daily News*, September 10, 1997.

(30.2%) and the rupiah (24.5%). Thailand and Indonesia are the two ASEAN countries against which Vietnamese exporters are in closest competition. Do economic fundamentals in Vietnam justify such an appreciation of the VND?

In the same newspaper report that discussed the good performance of the VND over the past year or so, it was also mentioned that there was an increasing need to protect Vietnamese producers against imports from ASEAN and elsewhere. Declining competitiveness of producers of tradable goods is a sure sign of currency overvaluation. If Vietnamese producers truly are becoming less competitive, a close look at the exchange rate might be in order. The recent Thai experience illustrates the very high costs that arise from delaying necessary exchange rate adjustments.

Vietnam is, of course, different than Thailand and other ASEAN countries. In particular, Vietnam's foreign exchange laws allow for much more direct intervention in foreign exchange markets than in other ASEAN countries. The legal requirement that foreign investors balance their demands and supplies of foreign currencies, for instance, is a strong weapon if the government wishes to restrict the supply of foreign exchange. Direct controls on foreign exchange transactions can be used to mask underlying foreign exchange imbalances. In countries with freer foreign exchange markets, such imbalances would soon lead to pressures on foreign exchange reserves and thus on the exchange rate.

While direct controls provide extra degrees of freedom to policy makers, they at the same time mask important economic signals, and can impose high costs on the economy. The use of direct controls is almost always arbitrary and non-transparent. Variations in the implicit subsidies and taxes that result from the use of exchange controls seldom bear any relation to underlying economic factors. They seriously distort the price signals given by the market. And the uncertainty they create is a serious barrier to new investment and subsequent growth.

An overvalued exchange rate is a tax on producers of tradable goods — import-competing and exports. The tax is borne across all sectors, including both agriculture and industry. *Failure to ensure a realistic exchange rate is the single most effective way to undermine any program of trade liberalization.* (See box for a demonstration of how the exchange rate affects exporters.)

The use of exchange controls to preserve or to delay necessary adjustments to an overvalued exchange rate aggravates the underlying problems and introduces additional economic distortions. *Two important lessons from the economic success of ASEAN's "charter" members over the past decade and a half are a) the need to maintain competitive and* *realistic exchange rates, and b) the benefits of relatively unrestricted foreign exchange regimes.*[29] *A lesson from the most recent events in these countries is that the costs of delaying necessary exchange rate adjustments are high.*

The Exchange Rate and Exporters

Exchange rate devaluations assist exporters by raising the local currency price of their sales. At the same time, of course, a devaluation raises the local currency price of any imported inputs. The argument is sometimes made that, since many of Vietnam's manufactured exports have very high import content, a devaluation will not help them very much, and might even harm them. This is not correct. The proportional assistance provided to exporters by a devaluation is independent of the amount of import content in their production.

Consider an exporter that sells a product in world markets for $100. At an initial exchange rate of 1000 VND, say, this brings local currency revenues of 100,000 VND. Following a 20% devaluation, the local currency value of these exports rises to 120,000 VND.

Suppose that this exporter's production has high local content, say 60%. Such an exporter needs to import $40 of imports for each $100 of exports. His net local production (or value added), therefore, is $60, or 60,000 VND at the initial exchange rate. After the devaluation, the same exports (and associated imports) bring net revenues of 72,000 VND to cover local costs. This is 12,000 VND more than the 60,000 VND pre-devaluation value-added. The effect of the 20% devaluation, therefore, is to provide a 20% subsidy to the exporters's local value added.

Suppose instead that local content was only 10%. The pre- devaluation domestic value-added per $100 of exports would be $10 ($100 - $90), or 1,000 VND. After the devaluation the domestic currency value of this local value-added would increase to 1,200 VND. The net subsidy to this exporter's local production resulting from the 20% devaluation is 200 VND, or 20% of pre-devaluation value-added.

A devaluation gives the same assistance to exporters with high import content as it does to those with low import content. And overvaluation, of course, *taxes* all exporters at the same rate!

[29] Indonesia abolished all capital controls in its foreign exchange markets in 1970. This has served as a strong incentive for foreign and domestic investors and as a discipline on monetary authorities to ensure that the macro policy environment remains stable and attractive.

Table 2.1: Comparative ASEAN Exchange Rates

	Exchange Rate (Currency/$US)				% Depreciation since:		
	Dec. 1995	Dec. 1996	Jun. 1997	Sep. 1997	Dec. 1995	Dec. 1996	Jun. 1997
Indonesia	2294	2362	2432	3040	24.5	22.3	20.0
Malaysia	2.55	2.53	2.52	3.04	16.0	16.7	17.0
Philippines	26.2	26.3	26.4	32.8	18.8	18.5	18.2
Singapore	1.42	1.40	1.43	1.53	7.0	8.3	6.4
Thailand	25.2	25.7	25.3	36.1	30.2	28.8	29.9
Vietnam	10980	11055	11668	11700	6.2	5.5	0.3

Notes: Dec. = Dec. 31; Jun. = June 25; Sep. = September 4.

Depreciation is measured as the percentage fall in the $US values of the currencies.

Basic rate data collected by UNDP from IFS, The Economist, Asian Wall Street Journal and VN News.

Table 2.2: Appreciation of VND Against ASEAN Currencies

	Value of Dong (Foreign Currency/VND)				VND % Appreciation since:		
	Dec. 1995	Dec. 1996	Jun. 1997	Sep. 1997	Dec. 1995	Dec. 1996	Jun. 1997
Indonesia	0.20893	0.21366	0.20843	0.25983	24.4	21.6	24.7
Malaysia	0.00023	0.00023	0.00022	0.00026	11.7	13.4	20.1
Philippines	0.00239	0.00238	0.00226	0.00276	15.6	16.0	21.9
Singapore	0.00013	0.00013	0.00012	0.00013	0.9	3.1	6.5
Thailand	0.00230	0.00232	0.00217	0.00309	34.4	32.7	42.3

Notes: Dec. = Dec. 31; Jun. = June 25; Sep. = September 4.

Appreciation is measured as the percentage increase in the VND against the other currencies.

Calculated from data in Table 2.1.

3. Vietnam's Trade Patterns: Putting ASEAN in Context

In order that both fears and expectations are in line with likely outcomes, it is important to be realistic in assessing the direct economic effects of ASEAN integration. An important step in this regard is to examine existing trade patterns. This will help clarify some of the implications of different regional and global trade policy options facing Vietnam.

Exports

Table 3.1 provides a summary of Vietnam's principal exports and markets in 1995. The first part of the table shows the eight top exports for that year, at the two digit SITC level. These eight products alone accounted for almost 80% of Vietnam's total exports in that year. The three most important exports, in order of importance, were crude petroleum, clothing and apparel, and coffee and spices. Next in importance, almost equal in value, were fish and footwear, followed by cereals, and finally at a much lower value, travel goods, and yarn and fabrics.

There are only three of the top eight products for which the ASEAN share of exports exceeded 10%. ASEAN accounted for 15% of coffee and spice exports, 19% of crude petroleum, and 53% of cereals. Except for cereals, therefore, ASEAN accounts for only a very small share of Vietnam's principal exports. In total, ASEAN markets accounted for only 14.5% of Vietnam's exports in 1995.

The second part of the table lists Vietnam's top 12 exports to ASEAN. While the rankings are a little bit different, the listings are similar to those in the first half of the table. The two most important additions to the list are oilseeds and crude rubber. In 1995 Vietnam exported almost $77.9 million of oilseeds, almost all of which went to ASEAN. Crude rubber exports totaled $82.4 million, of which 37% went to ASEAN. The other "important" exports to ASEAN were non-ferrous metals, specialized industrial and agricultural machinery, clothing and apparel, wood, fruit and vegetables, and miscellaneous products. In all of these cases total exports were in the range of only $11-13 million, and, only for machinery and miscellaneous products did the ASEAN market share exceed 50%.

ASEAN is clearly not yet an important market for Vietnam's exports. Is the natural evolution of Vietnam's trading patterns and/or membership in AFTA likely to change this in the future? We consider Vietnam's major export groups in turn.

Crude Petroleum

There are two issues here.

First, is the ASEAN market likely to become more important to Vietnam in the future? ASEAN's share of world petroleum demand will grow along with its above average rate of economic growth. However, ASEAN is a net exporter rather than importer of petroleum products. The world market will remain very large, and there is no particular need nor is there any great likelihood of Vietnam's significantly increasing its exports to the ASEAN market.

Second, the most important determinant of Vietnam's future exports of crude petroleum will be domestic decisions to invest in refining capacity. Since Vietnam is currently a large exporter of crude and importer of refined petroleum (with a slight but growing net trade surplus at the moment), significant domestic investments in refining capacity would eliminate the bulk of Vietnam's exports and imports of petroleum.

Under any likely scenario, therefore, membership in AFTA is unlikely, in itself, to have a significant impact on petroleum exports.

Cereals (esp. Rice)

With appropriate domestic economic management in Vietnam, and in the absence of excessive domestic protection in ASEAN, this country could be an even stronger competitor in ASEAN markets, even in Thailand, especially at the low end of the market.

Fish

ASEAN accounts for only a very small share of Vietnam's fish exports. Given the comparative advantage of other ASEAN countries in the same products, this is likely to remain the case. Furthermore, depletion of domestic fish stocks means that Vietnam's long term prospects for export growth in this sector will be severely limited in the absence of major improvements in resource management.

Coffee and Spices; Fruit and Vegetables

These are also agricultural or resource based products in which Vietnam shares a comparative advantage with other ASEAN countries. Freer trade in ASEAN would undoubtedly open up markets in these countries in which Vietnam could be competitive. However, the major potential for Vietnam's exports of these products will continue to be outside of ASEAN. Vietnam's ability to exploit this potential will depend, once again, on domestic economic management rather than any events occurring in the context of ASEAN. Once again, therefore, while these products still have considerable unexploited export potential for Vietnam, AFTA is not likely to play a major role.

Manufactures

ASEAN accounts for only a trivial share of Vietnam's major manufactured exports. There are several reasons for this.

- Vietnam is beginning to export, at the lower end of the market initially, the same products as those exported by other ASEAN countries (clothing and apparel, footwear, travel bags, and yarn and fabrics),
- ASEAN countries still protect these products in their own markets, and
- Vietnam faces serious competition, in ASEAN and other markets, from other emerging manufactured goods exporters, especially China.

Vietnam's export challenge, and therefore one of its major development needs, is to enable its existing and potential new labor intensive manufactures to compete in global markets. While ASEAN might continue to protect some of these industries at present, these barriers will be reduced as AFTA comes into full force. As that happens, Vietnam, with its relative low labor costs compared with other ASEAN countries, has the potential to increase its exports of labor intensive products to this market. Preferential access under the CEPT will provide a small but conceivably important advantage to Vietnam over China.

An important measure of Vietnam's success over the next decade or two, however, will be the growth of its manufactured exports to *all* world markets (including ASEAN, of course). The major barriers facing Vietnam are *not* import restrictions in ASEAN or in other markets. The obstacles are domestic policies which are within the control of Vietnamese policy makers. Vietnam has considerable power to control its own destiny on the world stage.

While Vietnam's manufactured export performance has been quite good so far, it could be much better. Experience of Vietnam's neighbors demonstrates that a continuation of domestic reforms will be necessary just to maintain current performance, let alone improve it.

Three areas of domestic policy are likely to be critical in determining Vietnam's manufactured export performance: a) trade liberalization, b) state enterprise reform, and c) macroeconomic and especially exchange rate management.

Trade policy reform is important for a number of reasons.

- Protection of firms in the domestic market breeds inefficiency and makes it more profitable (privately, but not economically) to sell locally than to try compete in world markets.

- Import restrictions, whether they are in the form of tariffs, quotas, import licenses, high costs of port and customs clearances, or any other barriers, raise domestic costs of production and hence directly impede local producers from competing internationally. Imported goods are a direct and indirect element of the costs of exporting, and anything which raises their domestic prices hurts exporters and the workers who are employed in these activities.[30]

- Export processing zones and/or duty drawback or exemption programs for exporters, if they work well, can alleviate some of these direct costs of protection in the short run. (See box on duty drawback programs.) However, as export production moves beyond simple assembly of imported components, which it must do to remain sustainable in the long run, it becomes increasingly difficult and ultimately impossible to shield exporters from the costs of protection. This becomes especially critical if and when inefficient and highly protected upstream heavy industries become entrenched. The only solution in the longer run is to reduce all forms of protection. The more rapidly and comprehensively is this done, the faster will be the development of a successful, sophisticated and internationally competitive export sector. As observed in the previous section, Vietnam has a significant advantage over many other countries by not being burdened with protected upstream producers of basic industrial raw materials.

- An import substitution based protection regime also hurts exporters indirectly by causing an artificially high value of the exchange rate. An overvalued exchange rate is an especially potent killer of export industries.

State enterprise reform is also important for a number of reasons. State-owned enterprises (SOEs) are often burdened with social obligations that makes it difficult for them ever to become competitive. Because of this “social role” and because of their bureaucratic and political strength, they also tend to impede exports indirectly by their support for high cost import protection

[30] See boxes on Thailand’s recent export collapse and on Indonesian Customs for examples of policy-induced trade distortions in ASEAN countries.

regimes.[31] It is especially dangerous for exporters when SOEs become involved in upstream heavy industry.

Macroeconomic management has many direct and indirect effects on manufactured export performance. But the single most important manifestation of inappropriate macro policies from this perspective is an overvalued exchange rate. As already mentioned above, an inappropriate exchange rate is a natural result of high levels of import protection. This can be aggravated by policies which allow large current account imbalances to persist without corrective action to restrain domestic aggregate demand, improve the competitiveness of exporters, and/or adjust the exchange rate itself. Excess demand often arises from uncontrolled public sector deficits and/or lack of control over losses accruing to state enterprises. Capital controls add to the problems of an overvalued exchange rate.

Duty Drawbacks and Exemptions for Exporters

Import taxes and NTBs raise the cost of imported inputs used by domestic producers. Producers who sell only in the local market can be "compensated" for this cost disadvantage by the use of import taxes on their final products, which enables them to sell at a higher price than foreign competitors. If import taxes on final products are equal to or exceed the average rate of import tax upon imported inputs, import competing domestic producers will actually gain from protection.

In the absence of export subsidies, however, exporters cannot be compensated for the cost-raising effects of protection in the same way — in order to export, they must sell at internationally competitive prices. Taxes or other restrictions on imported inputs, therefore, put exporters at a competitive disadvantage.

A standard and internationally accepted procedure for dealing with this problem is to find ways to exempt exporters from import taxes and other import restrictions, or to give them rebates of taxes paid on imported inputs used in export production. These rebates are called duty drawbacks. WTO rules permit such drawbacks as long as they do not exceed the actual import duties paid on inputs and raw materials used to produce goods for export. Payments in excess of this are regarded as export subsidies and are hence countervailable.

Duty drawback schemes which meet WTO requirements can be relatively complex to design and to implement. They have proven almost impossible to design for indirect exporters — i.e domestic

[31] High levels of import protection are only one of many types of subsidies given to SOEs . This form of subsidy is especially harmful in the context of Vietnam's global economic integration, however, because of the penalties it imposes on other potentially competitive firms and industries.

producers of inputs for exporters. The only effective long run solution to the cost-raising effects of protection on exporters is to reduce protection.

Vietnam currently provides exemptions to firms producing in export processing zones and to other exporters on the basis of export promotion privileges. This does not cover all actual and potential exporters, especially those who sell both domestically and internationally. Those who do not benefit from exemptions must rely on drawbacks.

According to information obtained from case studies and from secondary sources, duty drawbacks work relatively well for many Vietnamese exporters. The reason for this appears to lie, not in the excellence of design of the drawback system, but rather in Vietnam's peculiar system of import tax collection. Vietnam does not collect import taxes at the time of import. Rather, importers are given a substantial period of time after the date of import to clear import tax obligations. This is a rare kind of system by international standards. By allowing taxes to be paid *after* the release of goods, Customs gives away much of its leverage to collect these taxes.

An important side effect of this system for exporters, however, is that, as long as they export goods before import tax collections on inputs are enforced, there is never a need to collect a drawback.

As Vietnam modernizes its import tax collections, it is very likely that it will also have to redesign its duty drawback system for exporters.

Imports

Tables 3.2 and 3.3 show Vietnam's principal imports for 1995. Table 3.2 ranks the main imports according to size of imports from the world. Table 3 ranks them according to imports from ASEAN alone.

There are several differences between import and export patterns. Comparing Tables 3.1 and 3.2, it can be seen that imports, as would be expected, are more diversified across commodities than are exports. In the case of exports, only eight two digit SITC groups account for 78 percent of the total, and the most import export product accounts for 18.6 percent of the total. For imports, on the other hand, it takes 18 of the top import groups to account for 78 percent of the total; and the top import accounts for only 9.4 percent of the total.

Interestingly enough, the top export product, petroleum, is also the top import, at the two digit SITC level. In fact, a mentioned earlier, Vietnam's principal export is crude petroleum, while its main import is refined products. In 1995, Vietnam exported $1,050 million of crude petroleum, and imported $769 million of fuels and other refined products. There are several other products which, at the two digit level, are included in the lists of top imports and of exports — yarn and fabrics ($734 million of imports and $141 million of exports), cereals ($140 million of imports and $309 million of exports). The yarn and fabric imports are largely inputs into the manufacture of fabrics and garments for export.

A very large share of Vietnam's imports comprise capital goods, intermediate products and raw materials used in domestic production. Only a relatively small share is accounted for by final consumption goods. The small share of final consumption goods is in large part a result of deliberate policies to restrict such imports. While many of the quotas and NTBs on consumption goods have been eased since 1995, the tariff and tax structure still strongly discourages imports of consumer goods.

The large role of imported capital and intermediate goods is typical of a country at Vietnam's stage of development and can be expected to continue if Vietnam's strategy to develop an internationally competitive industrial remains successful. This is not to suggest, of course, that Vietnam will remain dependent on imports for all intermediate and capital goods. Successful industrial development through the current renovation and globalization program will lead to the development of a strong set of "supporting industries" for the industrial sector. Strong industrial growth and the growth of supporting industries will be mutually reinforcing under a world market oriented development strategy.

Table 3.3 highlights the role of ASEAN in Vietnam's imports. Overall, ASEAN accounts for 36 percent of Vietnam's imports, a substantially higher proportion than for its share of Vietnam's exports. Imports from ASEAN are less diversified by 2 digit SITC commodity than are her overall imports. Petroleum alone accounts for 22 percent of imports from ASEAN; and ASEAN actually supplies 85 percent of Vietnam's petroleum imports. Tobacco, tobacco products and fertilizers account for another 15 percent of Vietnam's imports from ASEAN, and ASEAN supplies over half of Vietnam's imports of these products. There are only four other two digit sectors in which ASEAN supplies 35 percent or more of Vietnam's imports: resins and plastic materials, other metal manufactures, organic chemicals, and other chemicals (pesticides, etc.).

Thirty five percent of Vietnam's imports from ASEAN, therefore, are accounted for by three product groups, petroleum products, tobacco and tobacco products, and fertilizer. Two of these three groups of imports could disappear if Vietnam chooses to invest in major petrochemical and fertilizer production facilities. If fertilizer and petroleum imports were to cease as a result of such investments, ASEAN would account for only 30 percent of Vietnam's imports. Of course, if domestic investments in these sectors require protection to make them viable, this could lead to significant conflicts with Vietnam’s AFTA obligations. The same could be true for Vietnam’s fourth largest ASEAN import, road vehicles (including motorcycles).

A significant potential benefit of ASEAN integration is the fostering of intra-industry specialization, whereby production of industrial inputs is diversified across countries in the region to take advantage of both differences in relative costs and economies of scale. At the two digit level, at least, it appears that Vietnam currently participates in relatively little such intra-industry trade within ASEAN. Only 16.4 percent of Vietnam’s yarn and fabric imports, for instance, come from ASEAN. The proportions for industrial and agricultural machinery, other electrical machinery and appliances, general industrial machinery and equipment, resins and plastic materials, and telecommunications and sound recording equipment are larger, but the amounts of trade are smaller.

The proportions of trade in industrial products currently taking place with ASEAN suggest another danger, in fact — that preferential trade within ASEAN could cause significant trade diversion. That is, lowering of trade barriers to ASEAN, without a simultaneous and similar reduction in trade restrictions with respect to the rest of the world, could cause Vietnamese importers to switch from low cost non-ASEAN supply sources to higher cost imports from ASEAN.

Table 3.1: Vietnam's Major Exports, 1995 (thousands of US$)

SITC	Description	Exports to World	Exports to ASEAN	Top Market	Exp. to Top Mkt.	ASEAN % Share	Top Mkt. % Share
			A. Ranked by Exports to the World				
33	Crude petroleum	1050408	199283	Japan	606820	19.0	57.8
84	Clothing & apparel	852115	12366	Japan	372261	1.5	43.7
7	Coffee, spices	800315	120805	USA	154596	15.1	19.3
3	Fish, fresh & proc.	590362	43472	Japan	364759	7.4	61.8
85	Footwear	549009	4914			0.9	
4	Cereals (rice & grains)	308763	164995	China	102189	53.4	33.1
83	Travel goods, bags, etc.	145221	2064	Japan	42157	1.4	29.0
65	Yarn & fabrics	141202	4798	Japan	62345	3.4	44.2
	Subtotal above	4437395	552697		1705127		
	Total Exports	5657727	818212			14.5	
	Subtotal/total (%)	78.4	67.5				
			B. Ranked by Exports to ASEAN				
33	Crude petroleum	1050408	199283	Japan	606820	19.0	57.8
4	Cereals (rice & grains)	308763	164995	China	102189	53.4	33.1
7	Coffee, spices	800315	120805	USA	154596	15.1	19.3
22	Oilseeds	77863	75683	Indonesia	41475	97.2	53.3
3	Fish, fresh & proc.	590362	43472	Japan	364759	7.4	61.8
23	Crude rubber	82404	30891	Singapore	15741	37.5	19.1
68	Non-ferrous metals	26260	17196	Malaysia	13130	65.5	50.0
72	Indust. & agric. mach.	21762	12964	Singapore	12727	59.6	58.5
84	Clothing & apparel	852115	12366	Japan	372261	1.5	43.7
24	Wood	52867	12232	Japan	26775	23.1	50.6
5	Fruit & veg., fresh, proc.	70208	11979	China	15677	17.1	22.3
93	Goods n.e.c.	23349	11918	Philippines	9365	51.0	40.1
	Subtotal above	3956676	713784				
	Total Exports	5657727	818212			14.5	
	Subtotal/Total (%)	69.9	87.2				

Source: Statistics Canada, *World Trade Data Base*

Table 3.2: Vietnam's Top Imports, 1995 (ranked by imports from world)

SITC	Description	Import Values ($000)			Shares of Regional Totals			Share by Sector	
		From World	From ASEAN	Non-ASEAN	World	ASEAN	Non-ASEAN	ASEAN	Non-ASEAN
33	Petroleum	769,284	652,817	116,467	9.4	22.2	2.2	84.9	15.1
65	Yarn & fabrics	734,859	120,194	614,665	9.0	4.1	11.7	16.4	83.6
78	Road vehicles (incl. motorcy.)	723,986	163,912	560,074	8.8	5.6	10.7	22.6	77.4
72	Indust. & agric. machinery	525,919	116,287	409,632	6.4	4.0	7.8	22.1	87.9
12	Tobacco & products	417,092	224,845	192,247	5.1	7.6	3.7	53.9	46.1
76	Telecomms. & recording app.	378,277	93,757	284,520	4.6	3.2	5.4	24.8	75.2
74	Gen. ind. mach. & eqpt.	361,482	111,368	250,114	4.4	3.8	4.8	30.8	69.2
77	Other electric. mach. & appl.	350,013	112,789	237,224	4.3	3.8	4.5	32.2	67.2
56	Fertilizer	327,827	219,205	108,622	4.0	7.5	2.1	66.9	33.1
58	Resins & plastic materials	275,758	104,916	170,842	3.4	3.6	3.2	38.0	62
67	Iron & steel	266,885	48,563	218,322	3.3	1.7	4.2	18.2	81.8
54	Medicines & pharmaceuticals	243,309	35,752	207,557	3.0	1.2	3.9	14.7	75.3
69	Other metal mfrs.	206,027	77,693	128,334	2.5	2.6	2.4	37.7	62.3
66	Other non-met. min. mfrs.	194,123	53,492	140,631	2.4	1.8	2.7	27.6	72.4
89	Misc. Mfg.	184,477	40,560	143,917	2.3	1.4	2.7	22.0	78
71	Power gen. mach. & eqpt.	164,313	23,622	140,691	2.0	0.8	2.7	14.4	85.6
51	Organic chemicals	143,764	70,946	72,818	1.8	2.4	1.4	49.3	50.7
04	Cereals	140,513	32,797	107,716	1.7	1.1	2.0	23.3	76.7
68	Non-ferrous metals	136,042	37,186	98,856	1.7	1.3	1.9	27.3	72.7
64	Paper & paperboard	115,071	33,801	81,270	1.4	1.1	1.5	29.4	70.6
59	Other chemicals (pest., etc.)	107,913	37,335	70,578	1.3	1.3	1.3	34.6	65.4
87	Prof. & scientific instruments	107,637	21,117	86,520	1.3	0.7	1.6	19.6	80.4
	Subtotal Above	6,874,571	2,432,954	4,441,617	83.9	82.8	84.5	35.4	64.6
	Total Imports	8,196,213	2,939,513	5,256,700	100.0	100.0	100.0	35.9	64.1

Table 3.3: Vietnam's Top Imports, 1995 (ranked by imports from ASEAN)

SITC	Description	Import Values ($000)			Shares of Regional Totals		
		From World	From ASEAN	Non-ASEAN	World	ASEAN	Non-ASEAN
33	Petroleum	769,284	652,817	116,467	9.4	22.2	2.2
12	Tobacco & products	417,092	224,845	192,247	5.1	7.6	3.7
56	Fertilizer	327,827	219,205	108,622	4.0	7.5	2.1
78	Road vehicles (incl. motorcy.)	723,986	163,912	560,074	8.8	5.6	10.7
65	Yarn & fabrics	734,859	120,194	614,665	9.0	4.1	11.7
72	Indust. & agric. machinery	525,919	116,287	409,632	6.4	4.0	7.8
77	Other electric. mach. & appl.	350,013	112,789	237,224	4.3	3.8	4.5
74	Gen. ind. mach. & eqpt.	361,482	111,368	250,114	4.4	3.8	4.8
58	Resins & plastic materials	275,758	104,916	170,842	3.4	3.6	3.2
76	Telecomms. & recording app.	378,277	93,757	284,520	4.6	3.2	5.4
69	Other metal mfrs.	206,027	77,693	128,334	2.5	2.6	2.4
51	Organic chemicals	143,764	70,946	72,818	1.8	2.4	1.4
66	Other non-met. min. mfrs.	194,123	53,492	140,631	2.4	1.8	2.7
67	Iron & steel	266,885	48,563	218,322	3.3	1.7	4.2
89	Misc. Mfg.	184,477	40,560	143,917	2.3	1.4	2.7
59	Other chemicals (pest., etc.)	107,913	37,335	70,578	1.3	1.3	1.3
68	Non-ferrous metals	136,042	37,186	98,856	1.7	1.3	1.9
54	Medicines & pharmaceuticals	243,309	35,752	207,557	3.0	1.2	3.9
64	Paper & paperboard	115,071	33,801	81,270	1.4	1.1	1.5
04	Cereals	140,513	32,797	107,716	1.7	1.1	2.0
71	Power gen. mach. & eqpt.	164,313	23,622	140,691	2.0	0.8	2.7
87	Prof. & scientific instruments	107,637	21,117	86,520	1.3	0.7	1.6
	Subtotal Above	6,874,571	2,432,954	4,441,617	83.9	82.8	84.5
	Total Imports	8,196,213	2,939,513	5,256,700	100.0	100.0	100.0

4. Summary and Conclusions

General

Vietnam stands at an important crossroad in its process of economic renovation, and especially in its integration with the world economy.

It has made considerable progress in replacing a centrally planned and controlled economic system with market-based trading environment based on international market prices. In the sphere of international trade, which is an important key to this transformation, trading monopolies and licensing systems have been relaxed or removed. The use of quotas and more complex non tariff barriers (NTBs) to trade has been reduced. Many very high rates of import tariffs have been reduced, and export taxes have been gradually removed. The relative absence of protection of capital intensive upstream producers of basic industrial raw materials, is an especially attractive feature of Vietnam's import policy regime.

The main result of the reforms to date has been the avoidance of a serious economic crisis due to the collapse of the centrally planned economies in the former Soviet Union. The agricultural sector, and to a lesser but still significant extent, the manufacturing and service sectors have responded with rapid growth, and more importantly, considerable competitiveness in world markets, as witnessed by strong export growth of a number of products throughout the 1990s.

The principal beneficiaries of this remarkable transformation have been Vietnamese workers, who now face growing wages and incomes, increased and diversified job opportunities, and, as a result, improved living standards and reduced poverty incidence for themselves and for their children.

As a signal of its commitment to a completion of the reform process, Vietnam has acceded to AFTA, and has indicated its desire to join both APEC and the WTO. The economic justification for Vietnam's commitment to these agreements should be based on a) their international public service role, and, most importantly, Vietnam's self-interest in trade liberalization. The principal beneficiaries of Vietnam's trade liberalization have been and will be its own citizens. Commitments to international agreements can help to ensure that special interests do not deprive Vietnamese people of the enjoyment of these benefits.

A continuation of strong economic performance will require an acceleration of the reforms that have been made so far. There are some potential impediments to this.

- Some vested interests will be threatened. This is especially true of some state-owned enterprises (SOEs) which have benefitted from protection (domestic and international), and which are unable or reluctant to adjust to new opportunities made available by continued reform. Alliances between the management of such SOEs and important ministries and government agencies are potentially powerful opponents of further reform.

- There are indications of some fundamental misunderstandings of the domestic benefits of reforms. These misunderstandings are apparent even in statements from ministries that are responsible for fostering and implementing the reforms. Public discussion of AFTA, WTO and APEC often stresses the "obligations" and even worse the "costs" of Vietnam's membership, as if the required trade and investment liberalization measures are concessions being made to other countries, or to the international community in general. While framing membership in terms of its obligations might sometimes be necessary to win over opponents of reform, the rhetoric can also distort general understanding of Vietnam's self-interest in trade policy reforms.

- There have been delays and backsliding in reform of trade and related policies. New quotas and tariff and tax surcharges, confusion and delays in tax reform, and public statements about the need for new kinds of NTBs have created uncertainty and increased perceived risks by investors.

The strategy Vietnam develops in conjunction with AFTA membership could play a major role in overcoming these difficulties and in shaping the future of its economic reforms.

The role of AFTA in Vietnam's economic development is likely to be played out at several different levels. At one level, AFTA, as the first post-CMEA international trading agreement in which Vietnam is a full participating member, will be a prototype and a proving ground for Vietnam on the world's economic stage. As such, it will be seen both domestically and in the world community as setting the tone and style of Vietnam's participation in other regional and multilateral organizations, especially APEC and WTO.

The speed and extent of Vietnam's liberalization of trade and investment with respect to its ASEAN partners, and the manner in which these policies are coordinated with the country's overall strategy for integrating with the wider world economy, will send important signals to economic agents in Vietnam and to the international trade and investment communities. This will have implications for the extent to which Vietnam will be welcomed into other international trading agreements and organizations. And they will certainly affect short and longer term decisions of domestic and international investors designing their business strategies in Vietnam. All of these effects -- direct and indirect, short term and long term -- will be important in determining the course of Vietnam's development.

Integration with AFTA is one part of trade policy reform, which in turn, is a part of overall system reform and deregulation. Vietnam's economic development will depend on both "hardware" and "software". The hardware is the investment in capital, human skills, natural resources and environment, and physical infrastructure. The software is the regulatory and service environment, including trade policies, in which this hardware is utilized. Trade policies are one of the most important parts of the regulatory environment because they provide basic signals about opportunity costs of investment alternatives and because trade and investment are the principal mechanisms through which knowledge, skills and technology are transferred from abroad. However, all parts of the "software package" have to operate properly, and in a consistent fashion. Liberalizing trade through tariff reductions will not have the desired effect, for instance, if the tariffs are replaced by NTBs or by complex and discriminatory changes in domestic sales taxes. They will also have less than their desired effects if Customs or port clearance barriers impede the free flow of imports and exports, or if domestic monopolies succeed in restricting domestic access to imported goods.

Vietnam's Trade Policy Options: Regional and Global

To meet long term policy goals of sustainable development for its people over the coming decades, Vietnam must integrate with and take advantage of the opportunities available in the global economy. This requires, most importantly, that Vietnam find and exploit niches in which it can compete in the global market place. These niches will initially include raw and processed agricultural goods which capitalize on Vietnam's agricultural potential, and labor intensive manufactures. In the long term, the successful development of manufactured export industries will be a major key to Vietnamese economic performance. This will require continued investment in Vietnam's rich human resource base, the development of adequate supporting infrastructure, and measures to ensure that growth will be environmentally sustainable.

In order for these human, infrastructure and environmental investments to yield reasonable returns, however, it is essential that Vietnam reform its trade policy regime to give the Vietnamese people maximum access to global opportunities. The many ways in which import and other regulatory policies can impede and distort the development of a competitive manufacturing sector have been described above. Further trade policy reforms are required to ensure that such barriers do not persist in Vietnam.

AFTA might be thought of as the “thin edge of the wedge” in moving towards the necessary reforms of Vietnam’s trade policies. Full participation in AFTA will certainly create opportunities for Vietnam. Possibilities of expanding labor intensive exports to ASEAN markets on a preferential basis will be of some assistance to Vietnamese producers, for instance. However, as ASEAN countries continue their liberalization programs with respect to global trade (see box on Indonesia and Philippines) preferential margins available to Vietnamese producers will disappear. The major markets for Vietnam’s emerging manufactured export industries are and will remain outside of ASEAN.

Will ASEAN assist Vietnam in accessing world markets in other ways? There is growing recognition within ASEAN that AFTA is unlikely to lead to substantial trade creation (or diversion) among its members in final products. However, it also being suggested that intra-industry trade in intermediate products might permit specialization and efficiency gains in manufacturing of relatively sophisticated final (or intermediate) products that would enhance ASEAN countries’ global manufacturing competitiveness. The automotive sector is one which both Japanese and American producers have been promoting as having such characteristics. Unfortunately, narrowly based protectionist policies for this sector in Indonesia, Malaysia, and even Vietnam make the realization of this potential highly unlikely at the moment.

In the event that policies were adjusted to permit relatively free intra-industry trade in ASEAN, Vietnam would be very well placed to participate in the more labor intensive parts of the relevant production chains.

In summary, the effects of AFTA, in and of itself, on the competitiveness of the Vietnamese economy will be positive but are likely to be relatively modest. Participation in AFTA should be looked at, therefore, not as a major end of trade policy in itself, but rather as part of Vietnam’s global strategy. If AFTA can be used as a vehicle to promote the general cause of trade policy reform in Vietnam, as APEC has been used by Indonesia and the Philippines, for instance, then it is worth pursuing vigorously. But if even the modest effects of full participation in AFTA are seen as dangerous and difficult to achieve, then there are serious dangers ahead for Vietnam’s industrial development strategies.

Vietnam’s first best strategy is to liberalize its trade with respect to *all* countries — that is, to remove barriers to trade, not just to the select group of countries that happen to make up ASEAN, but rather on an across-the-board basis. If it is possible and if it makes sense to set up a "green lane" to eliminate unnecessary customs clearance barriers to imports from ASEAN, for instance, why not do so for *all* imports? The same question applies to (and the same obvious answer should be apparent for) all other import restrictions such as tariffs, quotas, import licenses and "technical" barriers.

To the greatest extent possible, any liberalization done in the context of ASEAN should be done on an MFN basis.[32] Vietnam should take full advantage of the "thin edge of the wedge" provided by AFTA. *The benefits of general MFN liberalization will be far greater than from preferential liberalization with AFTA alone*. Preferential liberalization with AFTA will impose some inevitable costs in the form of trade diversion; such trade diversion is avoided with MFN liberalization. Preferential liberalization also imposes extra burdens on import administration because of the need to apply different rules depending the country of origin of imports.

For many of the same reasons, Vietnam's MFN-based trade and investment liberalization should not be held up pending granting of its WTO membership. The main beneficiary of Vietnam's trade liberalization is Vietnam. WTO membership will bring some additional benefits, including MFN treatment from all WTO members, participation in the MFA and its phasing out, and access to WTO dispute settlement procedures. There is no strategic gain from delaying Vietnam's unilateral liberalization in the hope of ensuring or improving the additional benefits of WTO membership.

The focus of trade policy reform should be on trade liberalization and global market integration *for the benefit of Vietnam*. Participation in AFTA, APEC, WTO and other bilateral and plurilateral agreements is a means to achieve this. There is a danger, however, of "trade *policy* diversion" which might arise from concentration on the details and negotiations related to some particular agreement, including AFTA.[33] To avoid this, Vietnam might be well served by a central, high level office responsible for coordinating inter - ministerial issues related to economic integration. This could be achieved, for instance, by broadening the responsibilities of the Office of the

---

[32] In general, AFTA is committed to WTO-consistency. Many elements of AFTA are, by their nature, MFN-based — e.g. the adoption of a common HS code and the GATT valuation system. Other features, such as the ASEAN "green lane" for Customs and the CEPT, however, are not MFN-based.

[33] On the one hand, there is the danger that policy makers become blinded by the details of particular trade agreements; on the other, they can use such agreements to strategic advantage in accomplishing more general trade policy objectives. At the recent Manila APEC Leaders' Meeting, Indonesia and the Philippines both showed how a regional agreement could be skillfully used to achieve high priority national trade policy objectives. (See box above.)

Government's Bureau of the National Committee for ASEAN to include *all* trade liberalization issues. Based on a mandate and a firm commitment to integrate Vietnam with global markets in the most effective and beneficial manner possible, this Bureau would play a strategic and a coordinating role over all unilateral, bilateral, plurilateral and multilateral economic integration initiatives.[34]

Other ASEAN countries are making rapid progress on global, MFN trade liberalization. (See box on Indonesia and Philippines.) Vietnam will have to do the same if it wishes to catch up.

Specific Proposals

A number of specific proposals emerge from this report. The following is a consolidation of some of the more important ones. Only a small number of these are AFTA-specific. *The importance of AFTA lies in its connection with Vietnam's overall strategy for trade liberalization and integration with the global economy. Most of the measures proposed here can be implemented unilaterally. To do so as rapidly as possible will ensure that global opportunities are passed on in the most effective and immediate way to the people of Vietnam.*

Import quotas and other NTBs

- Eliminate all import quotas and other NTBs which are not required for reasons of national security or public health. Make a public commitment not to introduce new quotas, licensing schemes or other NTBs.

CEPT import tariffs

- Classify the status of "missing" items which have not been included on any of Vietnam's CEPT lists.
- Determine and *publicly announce* the schedule of tariff reductions of all items included on Vietnam's CEPT list.
- Remove the items from the general exclusion list whose imports are not related to national security, public health or cultural protection.

[34] In addition to providing general strategic leadership in all issues related to trade liberalization, specific activities that might be coordinated by such an office might include procedures for reviewing any proposed new measures, especially increases in protection, and conducting an annual "trade policy review" which regularly assesses and reports on achievements and updates targets for trade liberalization.

General tariff reform

- Set long run goals with respect to simplification of the import tariff structure. This would include specification of the number of rate categories (no more than three) and the maximum rate (preferably 5 or 10 percent, but no more than 15%). Maintain uniform rates among broad categories of similar goods. Do not use import taxes or other restrictions to protect producers of basic industrial raw materials. Abolish the use of split HS categories according to type of end use, end user, etc.

- Publish a schedule for achieving this new tariff structure, preferably using rules which specify rate reductions according to the level of existing rates.

Trade policy procedures

- Abolish the use of *ad hoc*, made-to-measure protection for new firms or industries. Make it clear to all new investors that they will receive import protection that is no more or less than that set out in the tariff schedule. Establish a high level authority to be responsible for enforcing this procedure and for providing overall strategic leadership in reviewing proposed changes, participating in international agreements, and evaluating the government's performance in implementing its trade policy agenda.

Duty drawbacks for exporters

- Review the system of duty drawbacks to exporters to ensure that it will continue to operate effectively after the government improves its Customs procedures for collection of import taxes. (See earlier box on duty drawbacks.)

Exchange rate

- Closely monitor the exchange rate to ensure that it has not and does not become overvalued, and thus threaten the success of trade policy reforms. Refrain from using exchange controls as an expedient to deal with more fundamental exchange rate issues. As part of the program of trade liberalization, examine ways to relax capital controls and foreign exchange regulations.

SOEs

- Abolish the use of protections which are used to honor the (implicit) guarantee of survival of SOEs. Allow workers and firms greater flexibility to adapt to economic change. Weaken the link between the security of enterprises and that of their workers. Improve other social mechanisms to provide security to workers who are not able to benefit sufficiently from expanded opportunities due to higher income and employment growth.

REFERENCES

Peter Baldwin, (1997) “Planning for Asean: How to take advantage of South-east Asia’s free-trade area” Hong Kong: The Economist Intelligence Unit, April

Centre for International Economics (CIE) (1997) “Vietnam’s Trade Policies 1997", April

Donovan, Peter and Adam McCarty (1997) “Vietnam’s Integration with ASEAN: The Revenue Implications of Tariff Obligations” Office of the Government, ASEAN Project Research Report, April

Kokko, Ari (1997) “Managing the Transition to Free Trade: Vietnamese Trade Policy for the 21st Century” Mimeographed Report for Embassy of Sweden, Hanoi, May