This occurs even though the foreign party contributes the major part of the capital.

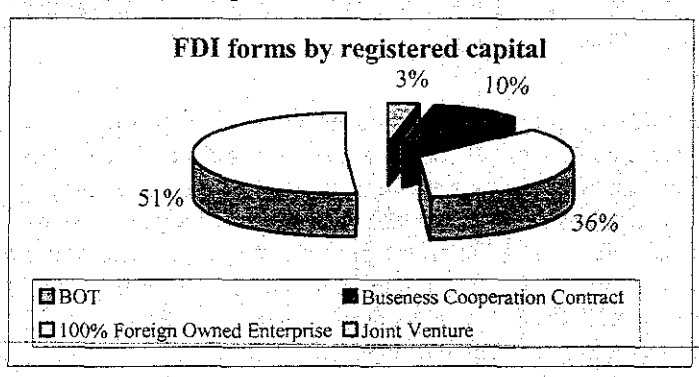
*Build – Operate – Transfer (BOT)*

BOT is not a new form of investment. It is a type of investment project whereby the project will be transferred at no cost to the Government after a given period. A BOT company can take the form of a joint venture or FOE. Due to its specific nature, BOT is reflected separately in the statistics.

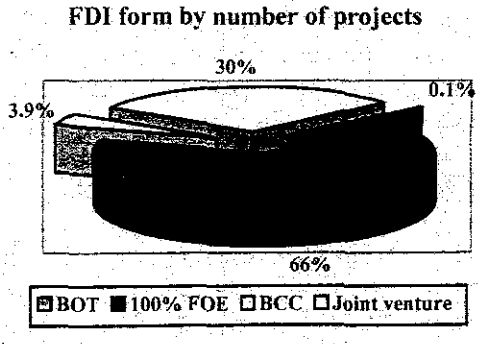
To date, there are only 6 foreign BOT projects with a total registered capital of US$1.3 billion. All foreign BOT projects are in the power and water supply industry.

**Figure 2: Distribution of FDI in investment forms**

**a) by registered capital**




**b) by number of projects**




Source: Ministry of Planning and Investment

Distribution of FDI in Vietnam by sectors

In terms of economic structure, FDI is concentrated in the manufacturing

*FDI pattern shows a large concentration in the manufacturing and processing sector.*

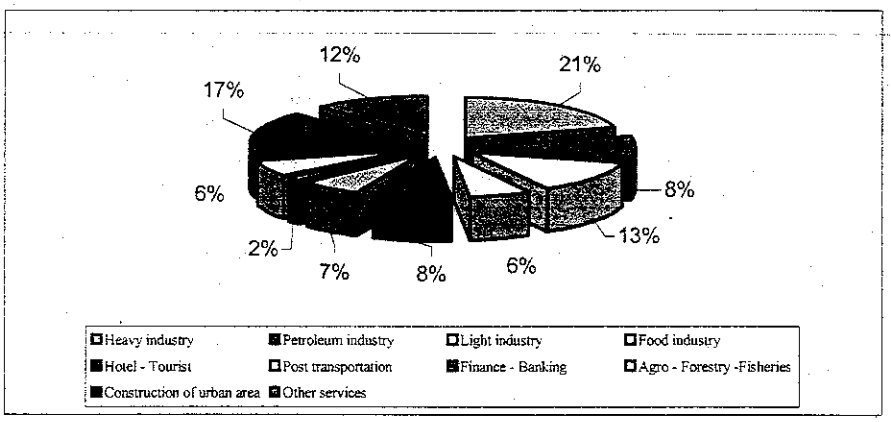
sector. Heavy industry ranks in first place, with around 21% of total registered FDI, followed by the construction and hotel-apartment sector.

Agriculture, fishery and forestry only account for around 6% of total committed capital, although the Government of Vietnam has introduced various incentive measures to encourage FDI in these sectors.

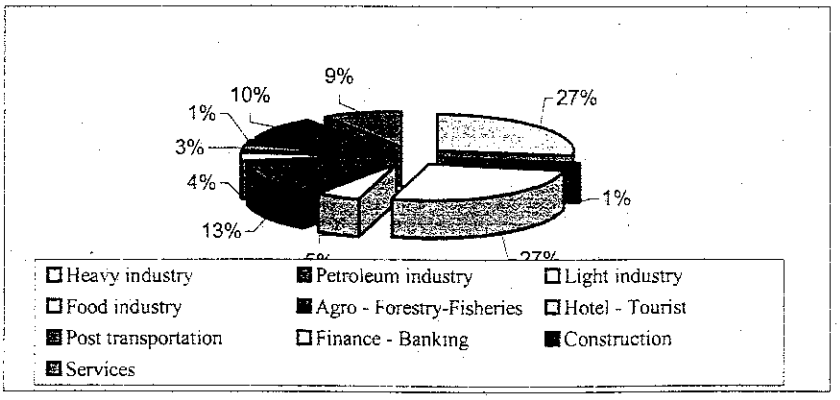
The distribution of FDI still indicates a fairly low portion in the services sectors due to high entry barriers. These sectors include banking, telecommunications, advertising, culture, health, and education. With a concern that opening these sectors would cause major disruptions to the current local companies or put these sectors out of Government control, the Government has issued the regulations restricting FDI in these sectors (particularly 100% foreign invested project in telecommunications, advertising, etc). These rules may need to be changed due to the Bilateral Trade Agreement and Vietnam's accession into WTO.

**Figure 3: Distribution of FDI by sectors up to 2002**

***a) by registered capital***




**b) by number of projects**




Source: Ministry of Planning and Investment

The sectoral distribution of FDI showed a changing pattern over the last 10 years. At the initial period, the emphasis of FDI inflows seemed to be placed on servicing domestic markets such as construction, hotel & apartment, construction material, banking and finance, and telecommunication. Over time, more FDI activity relating to production for export for example garment, electronics, became more apparent. This trend led to a shift from capital-intensive to labour intensive industries. This could easily be recognised by the continuous reduction in the average size of the investment project. This trend reflects the change of the FDI policies from import-substitution to export-oriented industries. Based on market conditions, this is not a negative sign.

An important factor resulting from the change in FDI pattern is the growing number of foreign investors being small and medium sizes enterprises (SMEs).

Regional Distribution of FDI

*Southern provinces account for over 60% of the FDI project and 53% share in the total FDI.*

Although FIEs are now present in all 61 provinces and cities of Vietnam, the majority of FDI is concentrated in the key economic areas in the South such as Ho Chi Minh City, Dong Nai, Binh Duong, Ba Ria Vung Tau, and in the key areas in the North such as Hanoi, Hai Duong, Hai Phong, and Quang Ninh. The central region only attracts a very modest share of FDI.

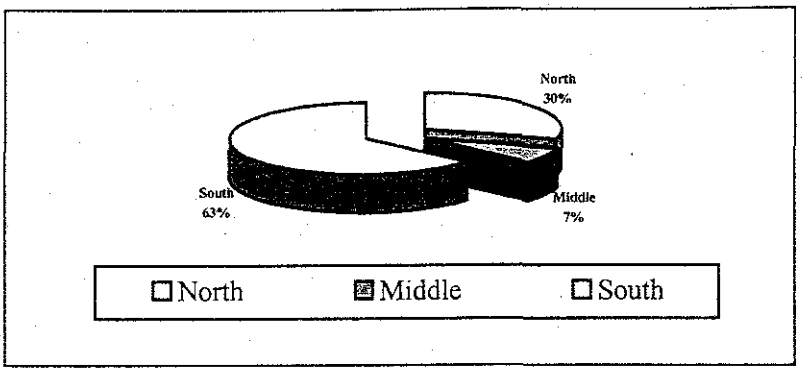
Southern provinces attracted approximately 73% of the licensed projects and 60% of the total registered capital, whereas the Northern provinces accounted for 19.4% of the licensed projects and 26.4% registered capital.

Apart from Ho Chi Minh City and Hanoi as the top cities, Dong Nai ranks in third place with 409 projects worth US$5.4 billion, followed by Binh Duong with 618 projects worth US$2.9 billion and Ba Ria Vung Tau with 79 projects worth US$1.8 billion.

The Government has realized the growing gap between coastal regions and the interior, as well as the economic disparities between rural and urban areas, and has tried to encourage foreign investors into the central and other remote areas of Vietnam. Special incentives such as longer tax holidays and exemption, import duty exemption for raw materials, land rental reduction are introduced to attract foreign investment in the regions with difficult socio-economic conditions. However, the success is limited.

The main competitive disadvantages of the central region include lack of basic infrastructure, small market size and a shortage of skilled labour. The incentives provided by the Government cannot outweigh the additional costs incurred.

**Figure 4: Distribution of FDI by region in realised capital**




Source: Ministry of Planning and Investment

Distribution of FDI by source countries

*Investors from over 50 countries are present in Vietnam, but the top 5 countries accounts for over 50% of the total FDI stock.*

By the end of 2002, foreign investors from over 50 countries and territories have invested in Vietnam. Asia accounts for 60.8%, Europe 23%, America 7%. The top five foreign investors are all Asian countries –i.e. Singapore, Taiwan, Japan, Hong Kong, and South Korea accounted for over 59% of the total registered capital. The ten largest investors accounted for over 80% of the total registered capital in Vietnam.

In 1996, when investment was flourishing, the major investors were Singapore, Hong Kong, Taiwan, South Korea and Japan. These countries accounted for 32.5%, 14.3%, 9.6%, 9.5% and 7.7%, respectively of the US $8.6 billion FDI flow in the year.[8] It should also be noted that in the first half of 1990s many multinational companies, in particular US companies, invested in Vietnam through their affiliates located in Singapore and Hong Kong due to the US embargo. The statistics do not reflect the ultimate source of investment.

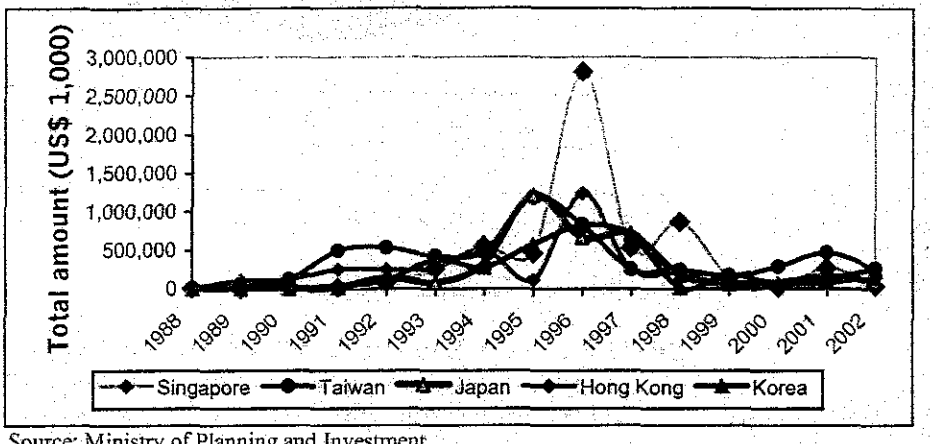
During the Asian crisis, the investment flow from East and Southeast Asian countries, notably Singapore fell sharply. The share of investment from European and North America in total FDI inflow showed a growing pattern. Particularly, the United States moved up to 4th place in 2002, but still ranks 11th in terms of FDI stock. Although this is a promising result, it is still below expectations. After the ratification of the US-Vietnam Bilateral Trade Agreement (US-VN BTA), politicians and economists expected/predicted a significant FDI inflow from US companies. However, this has not happened.

The Government implemented more liberalised policies towards foreign investment such as the new enterprise law that lifts the entry barriers to

[8] Ministry of Planning and Investment

domestic private investment, the amendments to the Foreign Investment Law, and the opening of the new stock exchange. In addition, Vietnam is committed to reducing tariffs below 5% for imports from other ASEAN countries under the AFTA, and has been accelerating reforms to prepare for the WTO membership.

**Figure 5: Registered capital trend by 5 largest investors from 1988-2001**




Source: Ministry of Planning and Investment

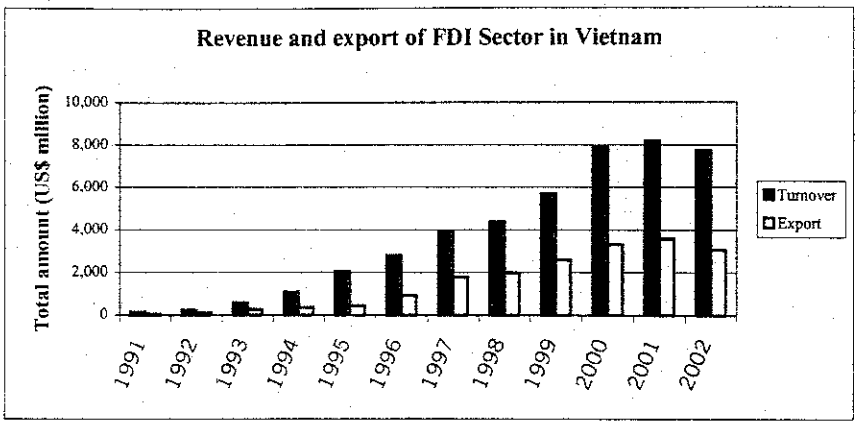
Contribution of FDI to Vietnam's economy

It has been widely and officially recognised in Vietnam that FDI has played more and more of an important role in the development of Vietnam in many aspects: capital, technology, improving the balance of international payment, export growth, access to international markets, etc. The amended Constitution of Vietnam from 2001 highlights that FDI is an integral part of the national economy, and attracting FDI should be a long term and consistent policy of Vietnam.

The foreign invested sector has seen rapid growth, gradually asserting itself as a dynamic component of the economy, and has made an important contribution to enhancing the competitiveness and efficiency of the economy. In recent years, the foreign invested sector has accounted for a quarter of the country's total investment, 23% of the national export (excluding oil and gas), and 13% of the GDP of Viet Nam. FDI has accounted for 34% of the total industrial output with an average annual growth rate of 20% compared with the country's average annual growth rate of 11%-13%.

In the last few years, many foreign invested enterprises (FIEs) started making profits. This is an encouraging factor.

**Figure 6: Revenue and export of FDI Sector in Vietnam**




Source: Ministry of Planning and Investment

FDI has helped Vietnam to develop many new industries and products. Currently, FDI represents 100% of oil exploration, car production, washing machine, refrigerator, air-conditioner, office equipment, etc. FDI also accounted for 60% of output for laminated steel, 28% for cement, 33% for electricity/electric products, 76% for medical equipment.

FDI helped Vietnam to have greater access to international markets, and improve the exporting potential of Vietnam. FDI accounts for a significant percentage of the key exporting industries of Vietnam, i.e. 42% in shoes industry, 25% in garment and 84% in electronic, computer and components.

Another important contribution of FDI is encouraging the application of advanced technology by domestic enterprises, which are their suppliers or customers of the FIEs. This helps to increase the competitiveness of domestic enterprises.

The contribution of FDI to the State budget in the period of 1996-2000 was approximately US$ 1.45 billion and accounted for 6-7% of the total State Budget (nearly 20% if taking into account the oil & gas industry). It is predicted that contributions to the State budget by the FIE sector will increase rapidly since more and more projects are moving to a profitable position.

FDI also helps to improve the management and technical skills of Vietnamese nationals. The FIE sector has attracted 350,000 direct labour and millions of indirect jobs. This brings higher income to the workers, increasing their purchasing power and market demand.

FDI has actively assisted Vietnam in expanding the external economic relations for Vietnam to join ASEAN, to sign the framework EU agreement, normalisation of relations and bilateral trade agreement with the US.

Overview of Japanese FDI inflows to Vietnam

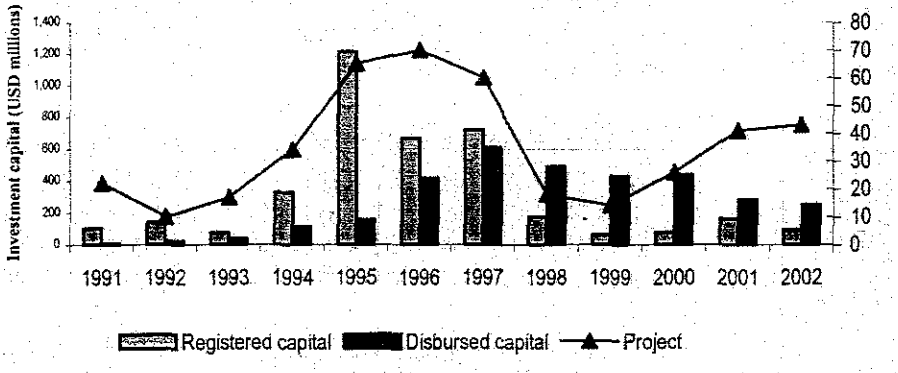
*Japan ranked at 3rd place for registered capital, but 1st place for realised capital.*

By 2002, Japan ranked in third place for registered investment, but in first place for implemented investment. According to the statistics of the MPI, the total realised capital by Japanese investors reached US$4,284 million in 2002. Japanese FDI flows into Vietnam increased up to 1997, then fell sharply by 75% in 1998 to US$178.41 million due to economic difficulty in the home country and the Asian crisis. In 1999, the total registered capital from Japan only accounted for US$ 62.06 million, which was less than 10% of the 1997 level. It picked up again 2001 whereby the amount of registered capital from Japan in 2001 was double the size of 2000, but declined sharply in 2002 to US$ 95 million.

Although the amount of implemented capital during 1998 to 2001 was higher than the amount of registered capital, it also showed a downward pattern. The average size of the project has been continuously declined. In 1997, the average size of a new Japanese project was US$12 million. In 2002, the average size of a new project was only US$2.2 million. This pattern could be explained by the fact that in the earlier years, investment was concentrated more in the real estate and infrastructure sectors such as hotel, apartment, IZ infrastructure, which are capital intensive sectors.

At the latter stage, the investment flows largely into the manufacturing and processing sectors, which require smaller amounts of investment. It seems also to indicate a shift in the pattern of investors from multinational companies to small and medium sizes companies.

**Figure 7: Japanese FDI inflows to Vietnam, 1991 –2002**

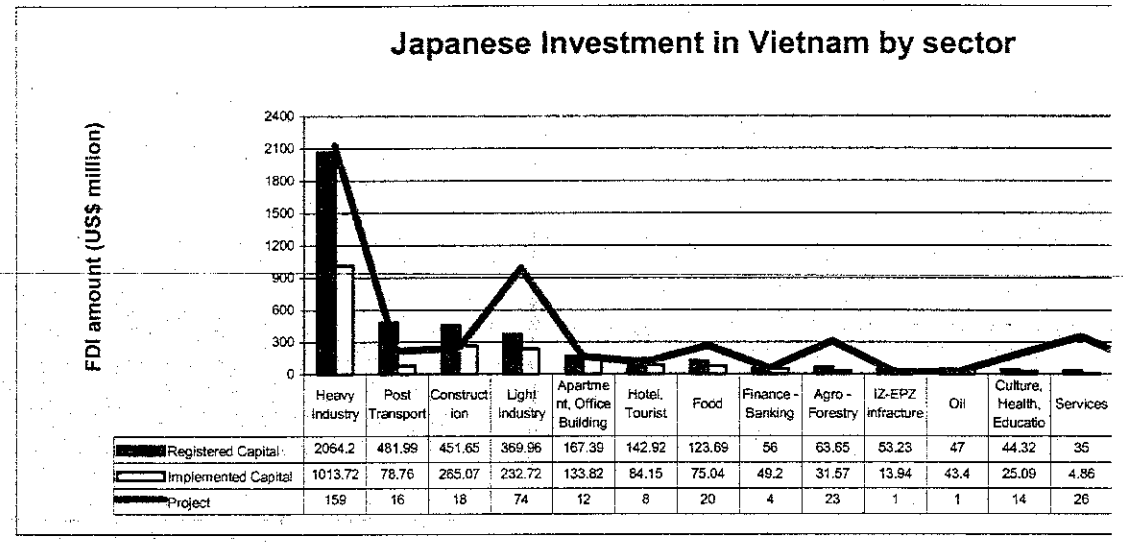


*Manufacturing and construction accounts for over 70% total Japanese FDI.*

Distribution of Japanese FDI by sectors

Japanese FDI in Vietnam is concentrated in all the important industrial sectors of Vietnam such as telecommunication, automobile assembly, motorcycle production, electronics, construction materials, and infrastructure. The total share of Japanese FDI in manufacturing and construction sector accounts for 71.8% in terms of number of projects and 75.2% in terms of registered investment. The service sector accounts for 21.1% in terms of number of projects and 23% in terms of registered investment.[9]

**Figure 8: Distribution of Japanese FDI by sectors**




| | Heavy Industry | Post Transport | Construction | Light Industry | Apartment, Office Building | Hotel, Tourist | Food | Finance - Banking | Agro - Forestry | IZ-EPZ infracture | Oil | Culture, Health, Educatio | Services |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Registered Capital | 2064.2 | 481.99 | 451.65 | 369.96 | 167.39 | 142.92 | 123.69 | 56 | 63.65 | 53.23 | 47 | 44.32 | 35 |
| Implemented Capital | 1013.72 | 78.76 | 265.07 | 232.72 | 133.82 | 84.15 | 75.04 | 49.2 | 31.57 | 13.94 | 43.4 | 25.09 | 4.86 |
| Project | 159 | 16 | 18 | 74 | 12 | 8 | 20 | 4 | 23 | 1 | 1 | 14 | 26 |

Source: MPI

*Japanese investors in Vietnam reported continuous sales growth.*

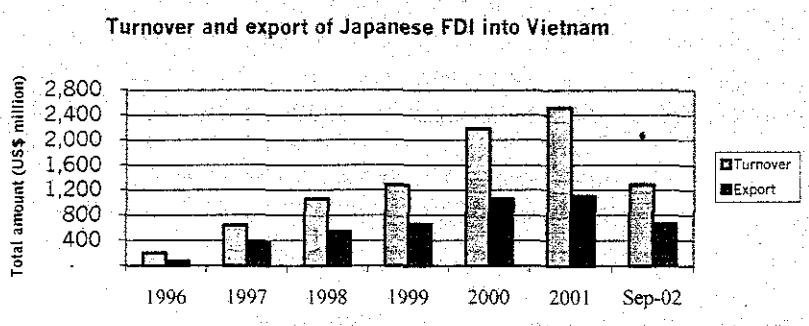
*Business performance of Japanese affiliates in Vietnam*

In general, the performance of most Japanese FIEs is optimistic. According to a survey on the business activities of Japanese affiliates in Asia, 74.7% of Japanese affiliates in Vietnam reported a sales growth in 2000 while this rate for the rest of Asia was 73.4%. An interesting point was that 64.8% of Japanese affiliates in Vietnam reported no decline in sales during the crisis, while this rate was only 35.4% for the whole of Asia. In 1998, 30.6% Japanese affiliates in Vietnam reported a profit, while 50.6% of the companies surveyed expected profits in 2000.[10] The total revenue of Japanese affiliates in Vietnam in 2001 almost doubled the level of 1999. The export revenue of Japanese companies in Vietnam also increased steadily.

[9] Ministry of Planning and Investment

[10] JETRO – Survey of the Business Activities of Japanese affiliated manufacturers in Asia (1999-2000).

**Figure 9: Revenue and export growth of Japanese affiliates in Vietnam**




Source: Ministry of Planning and Investment

### *1.1.2 China*

Overview of FDI inflows

*After 23 years of implementing the "open door" policy, China ranked at the top of the most favourable destination of foreign investor.*

China's open door policy started in 1979 with Deng Xiaoping's assumption of power and the Party's focus on economic development. First steps included the introduction of a basic joint venture law, to be followed shortly with the approval of the establishment of four Special Economic Zones (SEZs) in Guangdong and Fujian Provinces. The establishment of SEZs was based on the successful experience of "export processing zones" and "free trade zones" found in other countries. China used them to create a "laboratory" for experiments with inbound investment, controlling the risk of major disruption to the largely State-owned economy.

In the early years of reform, inbound foreign investment was slow, and projects were developed on a 'one-off' basis, with negotiations and approval steps carefully monitored by the top leaders. Even before reforms began, China had begun to invite the world's top industrialists, bankers, economists, and planners for official visits, and the top leadership explored ways of introducing foreign capital into China's economy and also built cornerstone relationships.

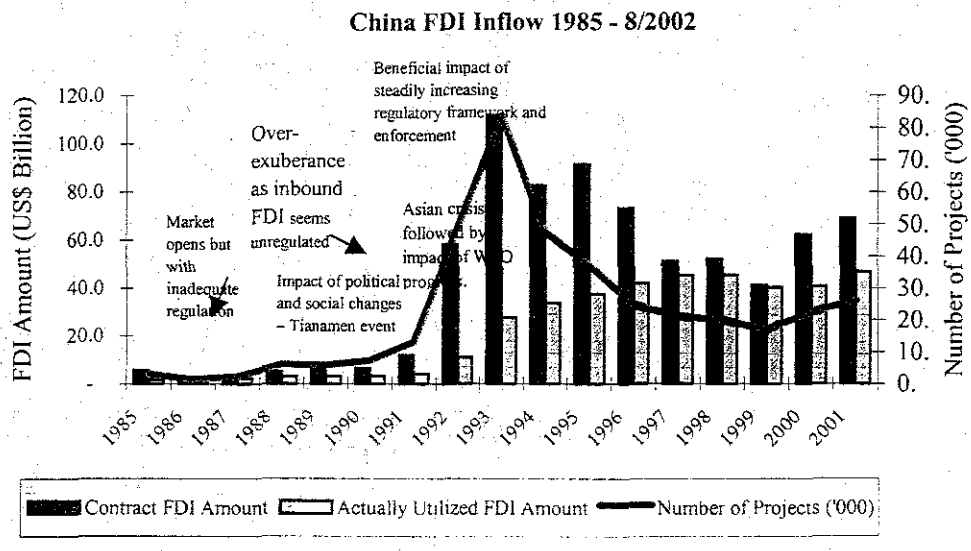
The number of projects and the total inflows remained modest throughout the 1980s. Joint venture laws and regulations and the economic contract laws were refined to integrate the lessons learned in the early projects. One objective of the refinement process was to assure that China got the maximum benefit from the FDI activity. Toward that end, changes in the regulations in the 1980s prompted a focus on technology transfer, localization of as much of the value chain as possible, transfer of scientific management processes and skills, and expansion of export trade.

Since the opening up of the economy to foreign investors, FDI flow into China increases steadily, if slowly at first. The slowness of the early years suited the leadership because it prevented China from being disadvantaged in the newly permitted commercial relationships. Not only the process of setting

up JVs but the process of making them work well proved very difficult. Chinese partners and foreign partners did not share strategic objectives, differed greatly in the approach to management, differed greatly in their investment capability, and overall had to devote much of their management resources to dealing with each other rather than the challenges of developing their businesses. China was obliged to deal with some negative publicity assaults in the global media, often calling into questions their treatment of foreign investors. The early years were not smooth and trouble free.

After the first decade of reform, the Tiananmen incident stalled the steady growth in FDI levels. It was only after Deng Xiaoping made a historic and widely publicized trip to Shenzhen, announcing that China was committed to moving ahead rapidly with economic reform and the open door agenda, that foreign investors became very active. The pivotal years that changed China's FDI program from an experiment to an integral part of China's development were 1992 and 1993, when actual utilized FDI leapt from US$4.4billion to US$11billion and then US$27.5 billion. This began the steady and rapid growth of FDI that recently put China in the number one position globally as recipient if foreign direct investment. Within 8 months of 2002, the amount of committed and realized FDI reached a record of US$62.3 billion and US$34.44 billion respectively, and utilized FDI is expected to reach a record US$51billion by the end of the year.[11] For the first time, China overtook the United States in terms of attracting FDI.

**Figure 10: FDI inflows in China, 1985- August 2002**




Source: MOFTEC, September 2002

[11] He Manquing and Zhang Changchun – Foreign Direct Investment in China – Achievements, experiences and lessons,

Investment forms of FDI in China

*The share of wholly foreign owned enterprises increased rapidly after relaxing the restriction.*

There are essentially three vehicles for FDI into China:

- Contractual Joint Ventures (CJV);
- Equity Joint Ventures (EJV); and
- Wholly Foreign Owned Entities (WFOE).

CJV's correspond to Business Cooperation Contract in Vietnam, EJV's correspond to Joint Ventures in Vietnam. CJV's and EJV's are commonly referred to as Joint Ventures or JV's.

The investors' vehicle of choice for FDI is the WFOE in the majority of cases. Initial restrictions on the sphere of operations for WFOE's meant that many early investments were in the form of joint ventures. Over the last 20 years as the economy has opened up the pattern of China's FDI has changed notably - shifting from a majority of JV investment to a majority of WFOE investment.

Sectoral distribution of FDI

*China's FDI Is concentrated in manufacturing and real estate and utilities.*

From the beginning of the open door policy, China's top leadership took a strong interest in directing FDI into specific sectors and regions, adopting a policy designed to maximise the benefit of FDI to China.

A catalogue was maintained of sectors, dividing them into encouraged, open, restricted, and prohibited investment sectors. Initially this only an internal document - it was first published as a draft in 1995. These categories indicated the amount of official support or impediment any given initiative would likely have from government. Prior to publication and whilst an internal document, the contents were generally made known to potential investors.

The contents of this catalogue were based on a calculus of long-term development costs and benefits. Sectors that were actually or potentially highly profitable and were believed to be manageable by the SOEs were prohibited. Examples are telecommunications services and commercial aviation.

Sectors where market potential was significant, State-owned assets were at risk, but foreign know-how and capital were deemed useful, like pharmaceuticals and automotive, were restricted.

Prohibiting and restricting investment in certain areas has proved a highly effective policy in many regards for China. By limiting access to economic sectors, China has created an environment where access by concession for example to the retail, distribution and insurance markets has increased the price of investment. Short supply and high demand has maximised FDI flow pricing in these sectors.

Sectors where export potential was deemed significant, State-owned interests

were limited, and foreign capital was most useful were encouraged. These included basic manufacturing of commodity and low-tech goods, new technology manufacturing like optical fibre and digital telecom switches, and projects that would localize critical component supplies, like diesel engines.

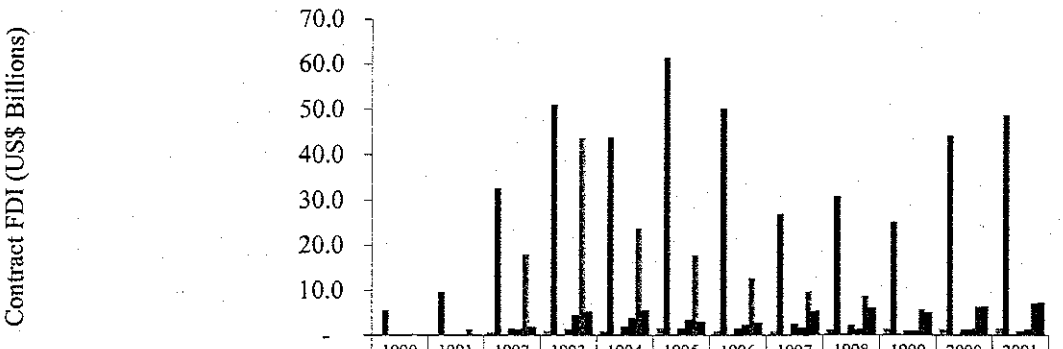
The chart below sets out FDI by sector. By far the largest recipient has been the manufacturing sector.

Although China has always given priority to agriculture, new and high technology industry, limited success has been achieved in attracting FDI to these sectors. Comparative advantage, market access and protection of intellectual property rights are the key considerations for FDI in technology-intensive industries.

FDI in China's key services sectors such as banking and telecommunications accounts for only small part of all FDI. This was mainly due to the entry barrier introduced by the Government of China to restrict FDI in these sectors. There is a concern that opening up these sectors could cause major disruptions to domestic companies that currently dominate these markets. This is now changing following China's WTO membership.

**Figure 11: Distribution of FDI in China by sector**

**China FDI Sector Distribution**




| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Agriculture | 0.1 | 0.2 | 0.7 | 1.2 | 1.0 | 1.7 | 1.1 | 1.1 | 1.2 | 1.5 | 1.5 | 1.8 |
| Manufacturing | 5.6 | 9.6 | 32.7 | 51.2 | 43.9 | 61.6 | 50.5 | 27.1 | 30.8 | 25.3 | 44.3 | 48.8 |
| Construction | 0.2 | 0.1 | 1.8 | 3.9 | 2.4 | 1.9 | 2.0 | 3.1 | 1.8 | 1.1 | 0.8 | 1.8 |
| Transportation, Postal & Telecom Service | 0.0 | 0.1 | 1.5 | 1.5 | 2.0 | 1.7 | 1.6 | 2.6 | 2.3 | 1.1 | 1.4 | 0.9 |
| Wholesales & Retail Trade & Catering Service | 0.1 | 0.2 | 1.4 | 4.6 | 3.9 | 3.4 | 2.3 | 1.8 | 1.3 | 1.2 | 1.4 | 1.4 |
| Real Estate & Utilities | 0.5 | 1.5 | 18.1 | 43.8 | 23.9 | 17.8 | 12.9 | 9.9 | 8.6 | 5.8 | 6.5 | 7.2 |
| Other Sectors | 0.1 | 0.2 | 1.9 | 5.3 | 5.6 | 3.0 | 2.9 | 5.4 | 6.1 | 5.2 | 6.5 | 7.3 |

Source: MOFTEC

Regional distribution of FDI

There are various ways of analysing China's spatial economy, and they relate to regional economic centres that have deep historical roots. Reforms themselves were begun in Sichuan, China's breadbasket, where Deng Xiaoping first liberalized the private marketing of agricultural production. Industrial and manufacturing reform were undertaken in the coastal regions, mainly Shanghai and Guangdong at first, but spreading quickly to other coastal areas from south to north.

*Three Southern provinces attracted more than 50% of the total FDI in China.*

For this discussion, China can be divided into five major geographical regions, or natural economic territories (NETs)

(a) Northeast—this is the industrial heartland of the legacy socialist economy, including China's major producing oil reserves, substantial coal reserves, a substantial rail infrastructure, and a huge asset base in basic industrial capacity.

(b) Western—this is the bulk of China's landmass and about 2/3 of China's population, including the major agricultural provinces and remote mountainous provinces, and the second tier industrial clusters like Xian, Wuhan, and Chongqing

(c) Bohai region—The area encompasses Beijing and Tianjin, arguably Dalian and Qingdao, and has a focus on high tech and knowledge based industries, food processing and services. Most large investing entities will have some presence in Beijing, where the government and Party are centered and most regulatory issues are discussed and decided.

(d) Yangtze river Delta (Huadong)—With Shanghai as the Metropole, the Huadong area is the centre of China's modern heavy industry and State-owned development. Boshan Steel, for example, is the most modern steel-making facility in China. The region encompasses a vast span of development areas, some in basic industries, some in high tech industries, some in services. Huadong has enjoyed high levels of investment from Asian as well as North American and European sources. It is considered one of the best regulated and administered of the popular investment regions.

(e) Pearl River Delta (Guangzhou/Fujian)—Closely tied to historic relationships with Hong Kong and Taiwan, this region is characterized by a very large number of non-State small and medium scale enterprises, largely focused on manufacturing and assembly of low to medium tech products.

According to the National Bureau of Statistics, the three southern provinces and one municipality (Guangdong, Jiangsu, Fujian and Shanghai) have attracted more than 50% of China's FDI. Please refer to Figure 12 below.

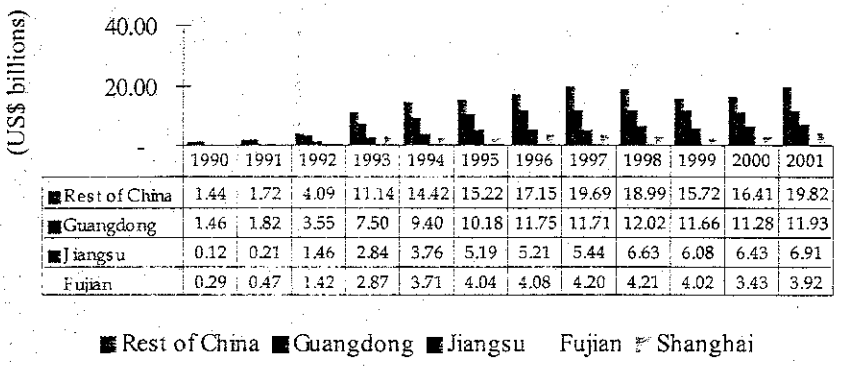
Observers have commented that China's initial FDI strategy of targeting a small number of areas for FDI at the beginning was commendable as:

(a) foreign investors require good infrastructure. Focusing the FDI into specific areas minimises the initial spend on infrastructure improvement;
(b) creating a cluster FDI allows a community to develop that in-turn brings in more investment;
(c) segregation of FDI minimises social agitation arising from differences in culture and ideology; and
(d) these areas provide a testing bed so that the most successful strategies and techniques for attracting FDI in accordance with domestic policy can be rolled out across a larger area.

This successful strategy of initially targeting designated areas is one that Vietnam may be able to employ to enhance FDI promotion and achieve FDI policy goals.

**Figure 12: Distribution of FDI in China by region**

**China FDI Regional Disbursement**




| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Rest of China | 1.44 | 1.72 | 4.09 | 11.14 | 14.42 | 15.22 | 17.15 | 19.69 | 18.99 | 15.72 | 16.41 | 19.82 |
| Guangdong | 1.46 | 1.82 | 3.55 | 7.50 | 9.40 | 10.18 | 11.75 | 11.71 | 12.02 | 11.66 | 11.28 | 11.93 |
| Jiangsu | 0.12 | 0.21 | 1.46 | 2.84 | 3.76 | 5.19 | 5.21 | 5.44 | 6.63 | 6.08 | 6.43 | 6.91 |
| Fujian | 0.29 | 0.47 | 1.42 | 2.87 | 3.71 | 4.04 | 4.08 | 4.20 | 4.21 | 4.02 | 3.43 | 3.92 |

Source: MOFTEC

The recent development of China's FDI

*The experimental phase is marked by the introduction of the Joint Venture Law.*

**1979 – 1985**

This initial phase was one of experimentation with the introduction of the Joint Venture Law and the establishment of the four Special Economic Zones ("SEZs"). The success of the four SEZs led to the establishment of further 14 Open Coastal Cities (OCCs) in 1984.

Although China's Government continued to encourage FDI, foreign investors faced various difficulties during this period. The difficulties resulted from

various restrictions that were imposed on foreign invested enterprises including limited access to domestic market, self-balancing of foreign exchange receipt and payments and restrictions on nationality of senior administrators of joint ventures. These operational difficulties led to a reduction in contracted FDI in 1985.

**1986-1991**

*Serious measures were undertaken to improve the business environment.*

To address the operational difficulties faced by FIEs and address the decline in contracted FDI, China improved the business environment for foreign investors with a series of measures. The key changes in this period include:

- The opening of a foreign currency "swap market" in 1985;
- The promulgation of "The provisions of the State Council on the Encouragement of Foreign Investment" in October 1986, which was commonly known as the "Twenty –two Articles"; and
- In April 1986, the first "Law on Wholly Foreign Owned Enterprises" was introduced, which marked an important change in the China's FDI policy.

Preferential investment incentives were spread to new areas. The most important development was the development of the Pudong New Zone in Shanghai in 1990.. Foreign investors responded favourably to the improved business environment and the expansion of preferential policy to new areas. .

Unfortunately, in late 80s, China was facing serious macroeconomic imbalance and double-digit inflation. Political uncertainty following the Tiananmen event diminished the FDI flow from western countries. However, the total FDI inflow continued to increase due to high FDI inflow from Asian countries.

**1992 – 1997**

*China's Government is committed to continuing reform and an open door policy.*

In early 1992, China's Government announced that China would continue its reform and open-door policy with the goal to build a "socialist-oriented market economy".

The government sought to expand the FDI promotion policy to the entire country not just the coastal areas. This period saw the delegated authority of central government to provincial government. Provinces and cities were given the freedom to create their own investment incentives. As a result many of Economic and Technological Development Zones were established, perhaps over two thousand, and investment started to increase significantly.

**1998-2002**

*More liberalised monetary policy is adopted.*

In the second half of 1997, the global economy experienced the devastating Asian Financial Crisis, which had immediate effects on investment from the East Asian economies. The decline in global demand and devaluation of East Asian currencies put substantial pressures on the China's export business. In

*China's entry into WTO.*

response China decided to adopt a more liberalized monetary policy to boost domestic demand, fight deflation and to continue its effort to attract FDI.

In fact China's utilised FDI rose during this period, a demonstration perhaps of the long-term confidence investors have in China. China's WTO accession has put a timetable in place for the complete opening of the economy. The coming years are likely to see further regulatory development, the effective enforcements of regulations and increased more sectorial diverse FDI

Contribution of the FDI sector to China's economy

The contribution of the FIE sector to China's GDP is widely recognised. The correlation between FDI growth and China's GDP growth is presented in Figure 13 below.

Significant FDI has bought many tangible benefits to China including:

- *Increased industrial output.* In the industrial sector, which has the highest concentration of FDI, the contribution of FIE's to the total industrial output has increased continuously from 2.28% in 1990 to 28.05% in 2001. Please refer to Table .. below.

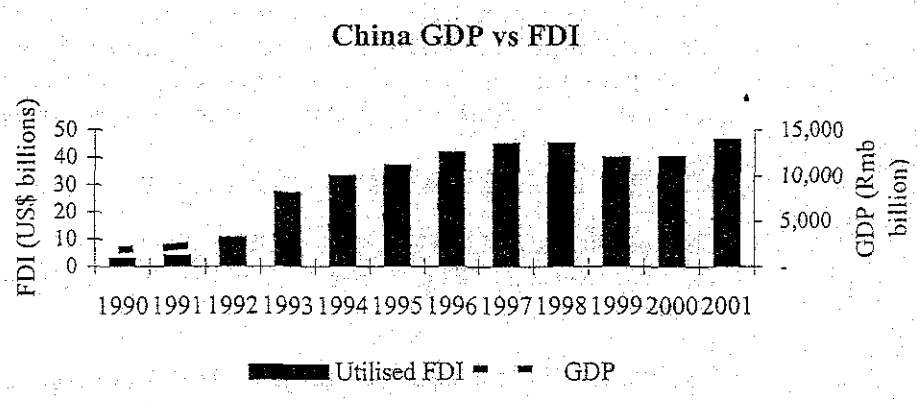
- *Increased tax revenues.* In 2001 the FIE sector increased by 30% compared with 2000 and accounted for 19% of the total tax revenue of China. (MOFTEC, 2002). Foreign investors generally comply with tax regulations, perhaps more so than domestic businesses that have a long history of negotiating locally to minimise or eliminate tax burden. FDI has not only increased the tax revenues for the government arising from FIE corporate profits but also provides a tax compliant business model with which to assist with reform of domestic entity tax compliance.

- *Increased exports.* The FIE sector also has made a significant contribution to China's foreign trade sector. In 2001, the total export revenue of the FIE sector accounted for 50.8% of the total China's exports and has helped to elevate China from the world's 32nd largest exporter in 1978 to the 6th largest exporter in 2001.

- *Technology and know-how transfer.* FDI has stimulated the transfer of technology and know-how to domestic businesses and Chinese employees. In recent years, many multinational companies including Microsoft, AIG, Motorola, General Motor, and Siemens have set up R&D centres and manufacturing plants in China. According to a survey conducted by UNCTAD, 400 out of 500 largest TNCs have invested in China.

- *Source of employment.* The FIE sector also creates more than 2.3 million direct jobs for China. .

**Figure 13: Correlation between GDP and FDI inflows in China**




Source: MOFTEC

### *1.1.3 Thailand*

*FDI flows into Thailand increased substantially during the 1980s, remained stable in the first half of the 90s and fluctuated significantly in the second half of the 90s.*

Overview of the FDI inflows

Before the economic crisis in 1997, Thailand achieved continuous economic development with an average economic growth of nearly 8% per annum from 1960 to 1996. Despite the world recession of the mid 1980s, Thailand's economy grew at double-digit rates during 1988-1990 and by over 8% per annum from 1991 to 1995.[12] Largely growing FDI inflows and exports drove this rapid growth.

The FDI inflows into Thailand increased substantially in the second half of the 1980s after the Plaza Accord, which resulted in currency appreciation in Japan and NIEs such as Taiwan, Hong Kong and Korea. From 1986 to 1989, Thailand attracted on average US$0.9 billion per year of net FDI inflow. From 1990 to 1996, FDI inflows were around over US$2 billion per year with a slight drop to US$1.7 billion in 1993 and US$1.3 billion in 1994 due to political uncertainty.

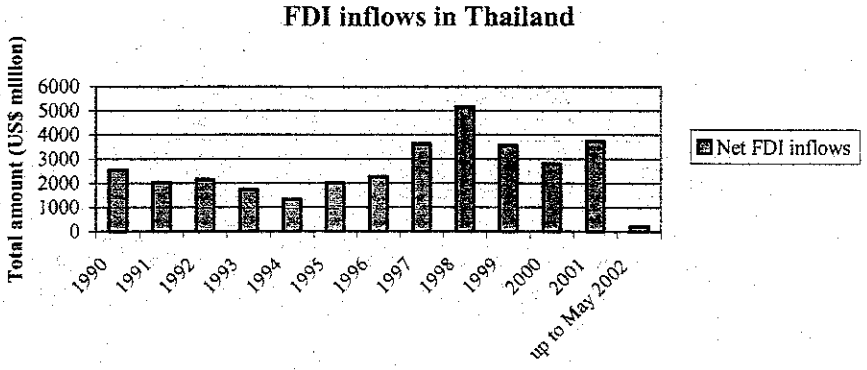
Following the depreciation of the baht in 1997, FDI inflows showed a dramatic increase to US$5.1 billion in 1998, but then fell to US$2.8 billion in 2000. Initial indications from the first 8 months of 2002 are that FDI experienced a dramatic fall.

Based on the analysis, the dramatic growth of the FDI post-crisis period was characterized by a dramatic increase in merger and acquisition (M&A) as foreign firms took over Thai companies that faced severe debt and liquidity problems. According to the World Investment Report 2000, cross border M&A FDI in Thailand increased sharply from US$0.6 billion in 1997 to US$3.2

[12] Thai BOI statistics

billion in 1998, than fell to US$2.0 billion in 1999 and raised again to US$2.6 billion in 2000[13].

**Figure 14: Net FDI inflows in Thailand, 1990-May 2002**




Source: Bank of Thailand

Sectoral distribution of FDI

*Manufacturing and trading accounted for approximately 70% pf FDI stock.*

The manufacturing sector has been the largest recipient of FDI in Thailand. Its share in the total FDI increased from an average of 37% during 1970-1995 to 57% in 2001. The share of the trade sector also increased but at lower space from an average of 17% during 1970-1995 to between 20 and 30% in the past few years. However, in 2002 the share of the trade sector only accounted for 2% of the total FDI before increasing again to 24% in 2001.

The FDI flow into the banking and financial sector reached its peak in 1998 with 16%, but fell 3% - 5% in the following years due to the restriction of foreign participation in the banking and financial market. Another popular sector for FDI in the early to mid-1990s was the real estate sector with a peak of 33% in 1996. However when the property bubble burst in 1996 and 1997, there was almost no FDI inflow into the real estate sector.

Within the manufacturing industry sector, the electronics industry relatively attracted large volumes of FDI amounting to 17.6% in 2001. However, during 1998-2000, electronics was overtaken by machinery and transportation equipment, in particular the automotive industry. This was because many Japanese parent companies injected capital into Thailand to assist their subsidiaries and suppliers following the crisis.

FDI inflow by sourced countries

The source of FDI in Thailand is quite diversified. Japan had been the largest

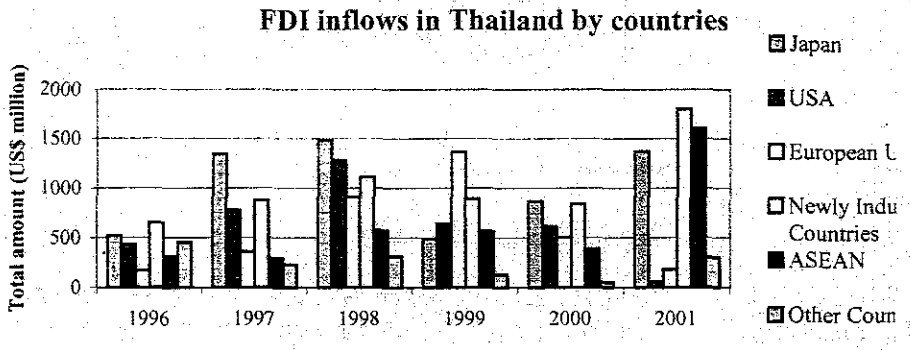
[13] Bank of Thailand statistics

*Japan has been one of the largest foreign investors in Thailand.*

foreign investor in Thailand since late 1970 with the exception of being overtaken by the US in 1999 and by Singapore for the year 2001.

Japanese FDI dropped sharply in 1999 as a result of weak economic condition in the home country but increased again in 2000 and 2001. Since 1998, Singapore gained a higher profile in Thailand with increased investment in banking and telecommunication sector. European investment rose strongly in 1998 and 1999, but fell off rapidly in 2000 and 2001. The FDI inflow from the US also experienced the same dramatic fall for this period.

**Figure 15: FDI inflows in Thailand by source countries**




Source: Bank of Thailand, by Economic Research Department

### *1.1.4 Philippines*

Overview of the FDI.

*The FDI inflows to Philippines showed a diversified pattern during 1992 to 2002*

The amount of FDI recorded in the Balance of Payments almost tripled between 1992 and 1994 and then went on to increase by 45% between 1994 and 1995 before falling in 1997.[14] The increase of FDI was seen as part of a larger expansion of FDI to other emerging markets and not really unique to the Philippines. Compared with other countries in Asia, the FDI inflow to the Philippines for this period was relatively low.

After the sharp decrease of FDI in 1997 due to the Asian economic crisis, FDI inflows picked up and reached US$1.75billion in 1998. This allowed the Philippines to reduce its dependence on borrowing to fund its current account deficit. FDI inflows decreased sharply in 1999, reflecting the impact of the Asian financial crisis and deterioration in the Philippines business environment and political uncertainty. FDI inflows for 2000 reflected an encouraging trend as FDI, with an impressive recovery to US$1.48billion together with the boom in electronic exports.[15]

[14] Florian A Akburo, the Philippines in a global investment environment.
[15] Florian A. Alburo, Foreign direct Investment in the Philippines amidst crisis and a new global environment., page 14.

Total annual FDI flows into Philippines

| *Year* | *FDI inflow (US$ million)* |
|---|---|
| 1996 | 1,520 |
| 1997 | 1,249 |
| 1998 | 1,752 |
| 1999 | 737 |
| 2000 | 1,489 |

Source. BOI statistics

Based on the statistic of the Securities and Exchange Commission, registered FDI reached 6.8 billion Peso in 2001 and 1.56 billion Peso in the first half of 2002, an 18.83% growth over the registered capital of the same period of previous year. The main investors come from Taiwan and Japan and 80% are concentrated in manufacturing. The investment inflow from the US and Europe, however, is declining.

To maintain the positive environment for FDI, the country's ability to tackle security issues remains critical in enticing more foreign investors. According to the World Investment Report of the United Nations, for the period 1998-2000 the Philippines slipped from number 38 to 89 in the list of preferred investment sites.

*The share of manufacturing sector reduced substantially during 1992-1997, and then grew sharply from 1998.*

Sectoral distribution of FDI

The composition of FDI stocks changed during the period from 1992-1997. For example, the manufacturing sector lost its dominant share in both BOI approved FDI and in the actual amount of investment flow recorded by the Balance of Payment (i.e. 10.9% share in 1997 compared with a 74% share in 1992). In the actual recorded FDI inflows, the decline started in 1995. As a result, by 1997, the share of manufacturing sector was 16%. The share of FDI in manufacturing sector picked up again in 1998. The share of 2000 FDI share reached 91% of the total registered FDI.[16]

Overall, there has been a noticeable increase in FDI inflows into the non-tradable sectors of public utilities and construction and 72.6% of the 1997 FDI inflows went into banks and other financial institutions, public utilities and construction. In addition, commerce (and within it real estate) gained an increase in flows of FDI.[17] As result of the Asian crisis, almost no FDI went into banking, financial and commerce.

[16] Virtual Philippines, Philippines statistics, Biz Pack.

[17] Florian A. Alburo, Foreign direct Investment in the Philippines amidst crisis and a new global environment, page 16

### *1.1.5 Malaysia*

Overview of FDI Inflows.

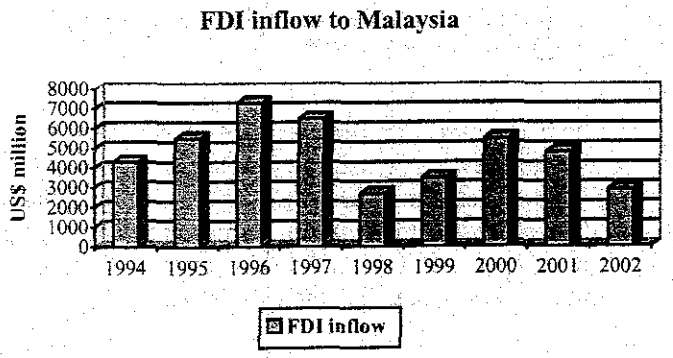
Malaysia has always maintained a liberal foreign investment regime and the government recognizes the contribution of FDI to industrial economic performance and international competitiveness. FDI is sought, not only as a source of capital funds and foreign exchange, but more importantly, as a means of securing the much needed industrial technology, managerial expertise, and marketing know-how and network to achieve higher levels of growth, employment, productivity and export performance.

FDI has contributed significantly to the economic development of the economy not only in terms of GDP growth, but also in terms of structural changes that have transformed Malaysia from basically a primary producer to an industrialised economy.

For the period 1985 to 1995, the average annual FDI inflow was close to US$3 billion and in the later part of the 1980s, FDI inflows amounted to an average of 5% of GDP. At its peak in 1992 and 1993, FDI amounted to 8.7% of GDP. Following the economic crisis of 1997, FDI inflows decreased dramatically in 1998, but picked up the following two years. Malaysia recorded a slight contraction in approved foreign direct investments, from US$5.5 billion in 2000 to US$4.8 billion in 2001. The drop was due to cutbacks in multinational companies' investments as a result of lower global economy growth prospects.

In 2002, the downturn in FDI worsened and Malaysian approved FDI were only worth US$2.9 million, down 41% from that recorded in 2001.

**Figure 16: FDI inflows to Malaysia (in US$ millions)**




Source: MIDA statistics

Sectoral distribution of FDI

In the early 1960s, foreign investors were largely involved in developing

*Beginning from the early 1990s, the investment and industrial policies were geared towards encouraging capital and technology intensive industries.*

import-substitution industries such as food, beverages and tobacco, printing and publishing, building materials, chemicals and plastics.

In the late sixties, as the limited domestic market placed constraints on continued rapid industrial development, and with the increasing number of school leavers entering the labour market, the economy was faced with a growing unemployment problem.

To overcome these problems, the development of export-oriented and labour-intensive industries was encouraged. The 1970s saw an influx of foreign investments primarily in the electrical, electronics and textile industries, utilising Malaysia's abundant labour, free zone and other facilities. This launched Malaysia into an era of export-orientation. In the late 1980s, following the further liberalisation of foreign investment policies, provision of attractive incentives/facilities, intensification of promotional efforts and favourable external factors, (of which the increasing production costs in Japan and the Asian newly industrialised economies (NIEs) was a major push factor), FDI flows into the manufacturing sector increased significantly

Beginning from the early 1990s, the investment and industrial policies were geared towards encouraging capital and technology intensive industries. In recent years, with strong competition from the labour-rich emerging markets of Indochina and China, and labour supply constraints leading to escalating wage pressures on the domestic front, Malaysia has sought to channel investment more into high technology, capital intensive manufacturing operations.

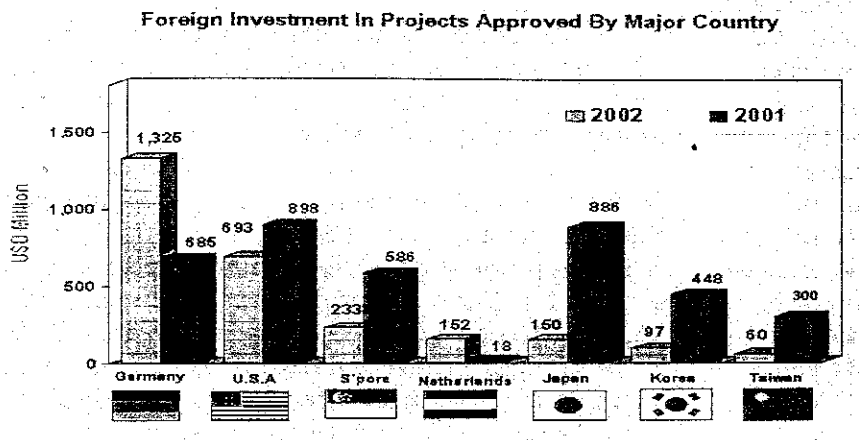
The ultimate goal of Malaysian investment strategy is to sustain increasing wage costs by managing the transition of the manufacturing base of the Malaysian economy from one which is primarily an assembly operation with low levels of value added, to one which is capital intensive, uses more intellectual capital and generates a higher level of value-added per employ Towards this end, projects which embody high technology, high value-added and skill intensity which create industrial linkages and which have greater export potential, are being promoted. Focus is now on the development of specific industry clusters.

FDI inflow by sourced countries

The United States, Taiwan, Japan and Singapore have been the leading foreign investors in Malaysia. In 2002, Germany was ranked number one, but that was due to one large project. Investment from in Japan declined in 1999 due to the slowdown in Japan's domestic economy, but picked up in the last few years. This was due to continued reinvestments in the electronics industry.

Investments from Singapore were mainly in small to medium sized projects in a broad range of industries such as machinery manufacturing, plastic products, basic metal products, and wood and wood products.

**Figure 17: FDI Inflows to Malaysia by Country**




Source: MIDA

### *1.1.6 Conclusion*

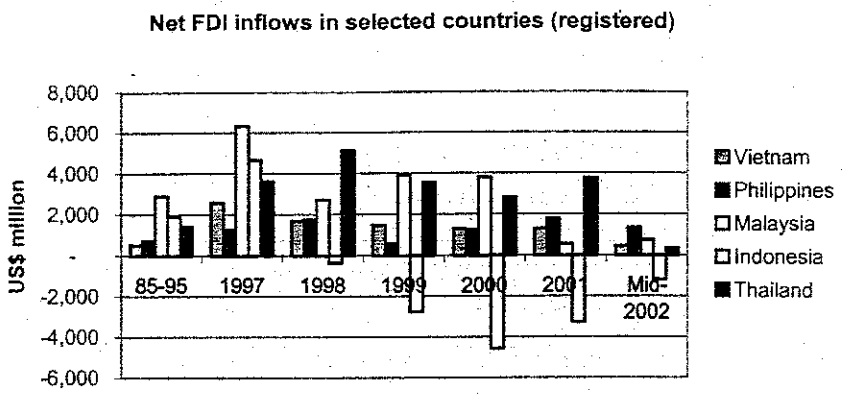
The annual FDI inflow to Vietnam is small compared to other ASEAN countries such as Thailand, Malaysia and China. Compared with the Philippines, Vietnam was more attractive during the Asian crisis, but lost its competitive position in the recent three years. In 2002, most countries experienced a sharp decline in FDI inflow. The main reason could be the global economic slow down.

Vietnam has effectively opened its market for FDI for over 10 years, while other countries such as Malaysia, Thailand and the Philippines have done this for almost 30 years. China has implemented the open policy for almost 20 years. These countries have already set up a more developed infrastructure, have more established market and more comprehensive legal framework, which are important factors for attracting FDI.

The economy of these countries has been recovering after the Asian crisis. As part of the recovery strategies, their governments have implement more aggressive strategies toward FDI promotion including more liberalised policies, additional bilateral investment protection agreements, reducing business cost, reducing the entry barrier etc. These countries have become great competitors of Vietnam in attracting FDI.

It should however be admitted that the success Vietnam achieved in the last 10 years in terms of FDI promotion has been quite impressive.

**Figure 18: Net FDI inflows in selected countries**




Source: various sources

## 1.2 Global and regional FDI trends for the next years

### *1.2.1 Global trends in FDI inflows*

Overview

*The global economic down turn has negative effects on global FDI flow.*

At the global level, the collapse of the high-tech bubble in the United States in mid 2000 resulted in an economic recession in the United States and in the world. The world recession coupled with persistent recession in Japan has particularly affected countries in Asia. The terrorist attack in the United States on 11 September 2001 further exacerbated the global recession. These factors have significantly impacted on world FDI inflow, which are an indicator of global economy health and stability.

In 2000, global FDI inflows increased by 18% over 1999 levels to US$1.3 trillion. However, they then declined sharply by around 51% to US$0.7 trillion in 2001[18] reaching only the 1998 level. This was the first drop in FDI inflows since 1991. FDI inflows to developed countries declined by 50% while FDI inflows to developing countries fell by 14%.

The decline in world FDI inflows in 2001 reflects a slowdown in the world economy. More than a dozen countries, including the world's three largest economies, fell into recession in 2001. It is expected that the lowered FDI flow will continue in 2003 for most countries.

[18] UNCTAD - *World Investment Report 2000 and 2001.*

**Figure 19: Outlook of World FDI outflow**

| | 1991-1995 | 1996-2000 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|
| | (Billions of U.S. dollars) | | | | |
| World | 1224.2 | 4626 | 1320.4 | 1632.7 | 851.9 |
| United States | 349.1 | 647.1 | 155.4 | 152.4 | 156 |
| Japan | 103.4 | 127.9 | 22.3 | 31.5 | 38.5 |
| Europe | 642 | 2660.2 | 762.4 | 1011.7 | 394.1 |
| Newly industrialised Asian economies | 34.3 | 72.1 | 12.6 | 16 | 8.1 |

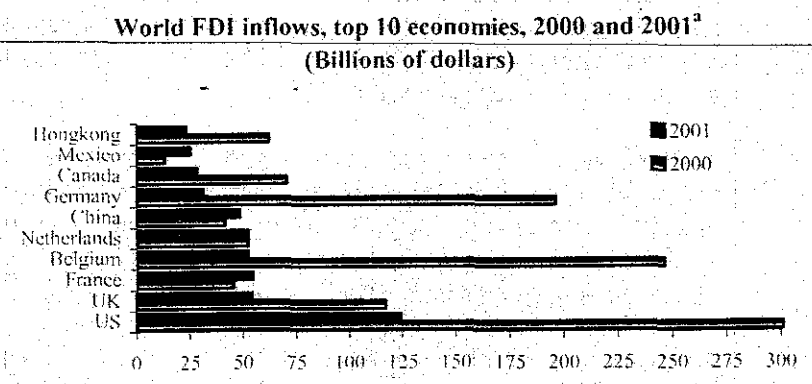
Source: World Investment Report 2002

*Economic slowdown could drive FDI flow into low-cost countries*

The economic slowdown has intensified competitive pressures, forcing companies to search for cheaper locations. This could result in increased FDI in sectors that benefit from relocation to or expansion in low-cost economies. FDI outflows could also increase from countries in which domestic markets have been growing slower than foreign markets.

According to the *World Investment Report 2002* issued by UNCTAD, there has been a redistribution of FDI towards developing countries and Central and Eastern Europe (CEE) where the growth has recently been higher than in the developed countries. The shares of developing countries and CEE in global FDI inflows reached 28% and 4% respectively in 2001 compared to an average of 18% and 2% in the preceding 2 years.[19]

**Figure 20: World FDI inflows, top 10 economies, 2000 and 2001**




*Source:* UNCTAD, FDI/TNC database.

[a]: Ranked on the basis of the magnitude of FDI inflows in 2001

[19] UNCTAD - *World Investment Report 2002*

**Figure 21: 10 winners and losers in FDI flows in 2001**

| | FDI inflows (US$ billion) | | | |
|---|---|---|---|---|
| | Winners | | Losers | |
| | Economy | Increases in absolute value | Economy | Decreases in absolute value |
| 1 | Mexico | 10.0 | Belgium & Luxembourg | -194.6 |
| 2 | France | 9.7 | United States | -176.5 |
| 3 | China | 6.1 | Germany | -163.3 |
| 4 | South Africa | 5.8 | United Kingdom | -62.8 |
| 5 | Singapore | 3.2 | Canada | -39.2 |
| 6 | Morocco | 2.5 | Hong Kong | -39.1 |
| 7 | Turkey | 2.3 | Denmark | -25.3 |
| 8 | Saudi Arabia | 1.9 | Spain | -15.7 |
| 9 | Chile | 1.8 | Ireland | -14.3 |
| 10 | Italy | 1.5 | Sweden | -10.6 |

*Source:* UNCTAD – World Investment Report 2002

Prospects of global FDI flows

*Despite the economic recession, TNCs are still interested in foreign expansion.*

Despite the dampening impact of weak demand in the largest economies, the medium-term (three-year) prospects for FDI are still promising. Major TNCs (according the to UNCTAD surveys) plan to continue their international expansion with a focus on both production and distribution. The preferred mode of expansion will continue to be cross-border M&A in developed countries and green-field (i.e. setting up new facility) in developing countries.

The survey conducted by the Multilateral Investment Guarantee Agency (MIGA) in 2001 indicated the same results. Despite the slowing global economy, 79% of the MIGA's surveys respondents indicated plans for overseas investments. Manufacturing companies are more interested in foreign expansion than service companies.[20]

The Japanese Bank for International Cooperation (JBIC) survey in July/August 2001 also conveyed the same message. Seventy two percent of the Japanese TNCs surveyed said that they would strengthen and expand their foreign operations compared with 55% in previous years.[21]

*Developing countries have become more attractive investment*

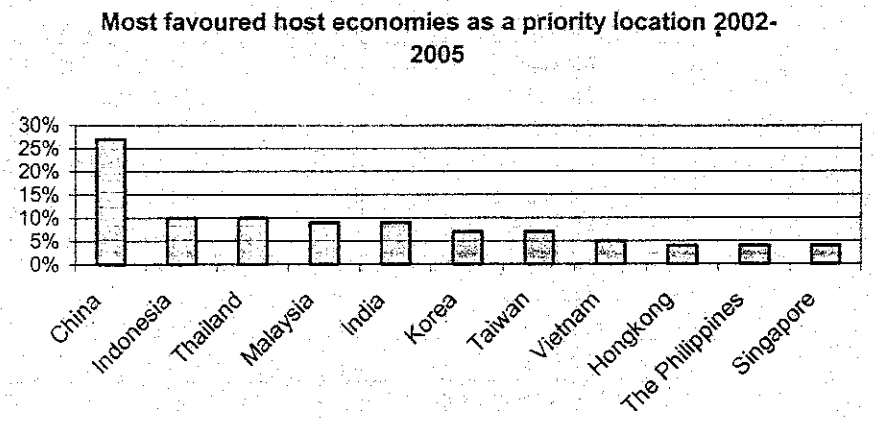
Developing countries and emerging markets attracted a higher interest among investors and account for over half of countries on the top 20 locations. Vietnam is also on the list. United States and Western Europe remain highly regarded as favourable location for many foreign investors.

[20] MIGA, Foreign Direct Investment Survey, January 2002.
[21] Koichi Kosumi, The trends in Japanese Foreign Direct Investment , 2000.

*destinations.*

Figure 22 below lists 10 developing countries which were selected by TNCs as most favoured locations for 2002-2005.

**Figure 22: Most favoured host countries as priority locations 2002-2005**



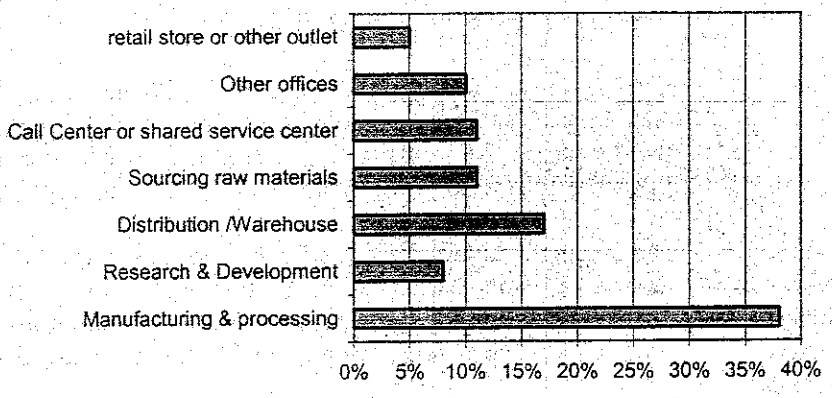

Source: UNCTAD – World Investment Report 2002

Type of facility

*Companies in the manufacturing sector are more interested in foreign expansion.*

According to the MIGA survey, manufacturing and processing facilities are the most commonly cited facility for expansion. For manufacturers, warehousing and distribution facilities rank second, followed by raw materials sourcing. Even for the service industry, manufacturing and processing are also considered the number one type of expansion.

**Figure 23: Type of facility planned for foreign expansion (%)**




Source: MIGA – Foreign Direct Investment Survey – January 2002

### *1.2.2 Regional trends in FDI flows*

*Asia overtook Latin America to become the 3rd most attractive region.*

The Asian region is playing a more and more important role in FDI attraction. In 2002, Asia overtook Latin America to become the third most attractive region for FDI following North America and Europe. According to the A.T.Kearney survey, half of the top 10 countries ranked with the most positive outlook improvement compared with a year ago are in the Asia-Pacific region.

Asia's prospects are mixed. On the one hand, investor sentiment has improved toward China, Japan, Australia and Hong Kong. On the other hand, the remaining Asian markets maintain or even saw a deterioration in their overall attractiveness. Although the investors indicate more optimistic view of many of these Asian countries than they did last year, they are still reluctant to commit FDI to these markets.

*China ranks first in the FDI Confidence Index in 2002.*

According to a survey conducted by A.T.Kearney in September 2002, China tops the list of attractive investment destination worldwide ousting United States from the first time in the FDI Confidence Index's five year history.[22]

More than any other country, investors have more optimistic about the Chinese market today compared with previous years. Many companies are expected to commit for first-time investment in China over the next 3 years. The key factors driving China's impressive boost among investors include its relatively stable political environment, robust economic growth and recent entry into WTO.

*FDI confidence index remain low in the rest of Asia and ASEAN. Vietnam moves up one position.*

Major ASEAN countries including Singapore, Malaysia, Thailand and the Philippines continue to loose their attractiveness to investors. Vietnam is the only country showing an exception to this negative trend and moved up one position in the overall ranking.[23]

With regard to Indonesia, part of the reason was the continued divestment in Indonesia (US$ 3 million in 2001) where divestment has exceeded inflows since late 1998.

Lack of market opportunities and high production cost have diminished the competitive position of Singapore in the heavy and light industry (in particular the electronic sector). Thus, Singapore has fallen from 13th to 22nd position in the FDI Confidence Index. However, Singapore remains a desirable destination for investors from the electronic sectors and non-financial sectors. In particular, Singapore is still the preferred location for regional headquarters for global investment. FDI in Singapore increased by 59% to US$9 billion, the first time since 1998.

[22] A.T.Kearney – *FDI Confidence Index – Global Business Policy Council* – September 2002, Volume 5
[23] A.T.Kearney – *FDI Confidence Index – Global Business Policy Council* – September 2002, Volume 5.

Faced with the erosion of its competitiveness in electronics, Singapore has designated biomedical sciences as the next pillar of its manufacturing growth and has been improving infrastructure and targeting high-potential companies in that industry through various investment funds and venture capital. As a result, leading biotechnology companies in Europe and Japan have indicated plans to relocate to Singapore.

Malaysia experienced a significant drop in country ranking this year moving out of the top 25 most favourable destinations. Political uncertainty, fears of terrorism and complex relationships between politics and business are the main causes for the lost of investor confidence. In response to the stagnation in FDI, the Malaysian Government introduced a number of incentives including extension of the reinvestment allowance period from 5 to 15 years and tax incentives to benefit the machinery and equipment industry.

The survey also indicates that Vietnam entered the top 25 list for light manufacturing. An interesting point noted by the survey is that China's entry to the WTO would make ASEAN and other Asian countries more attractive (this was the response from 48% respondents to the survey).

## 1.3 Trends in Japanese Foreign Direct Investment

### *1.3.1 Overview*

*Japan is the leading investor in Asia in terms of FDI value.*

Among foreign investors in ASEAN, Japanese companies take an important position. In many ASEAN economies, Japan has been a leading investor in terms of FDI value. For example, Japanese FDI accounts for around 30% of total FDI inflows in Thailand, close to 20% in Indonesia and Malaysia and more than 10% in the Philippines. Although Japanese FDI in China accounts for less than 10% of the total FDI inflows, China has become a more and more an attractive destination for Japanese investors.

In Vietnam, Japan is the third largest foreign investor with total registered investment of US$4,215 million US$ (by 20/8/2002) and total implemented capital of US$3,074 (by 20/8/02), accounting for 11% of the total FDI inflows.

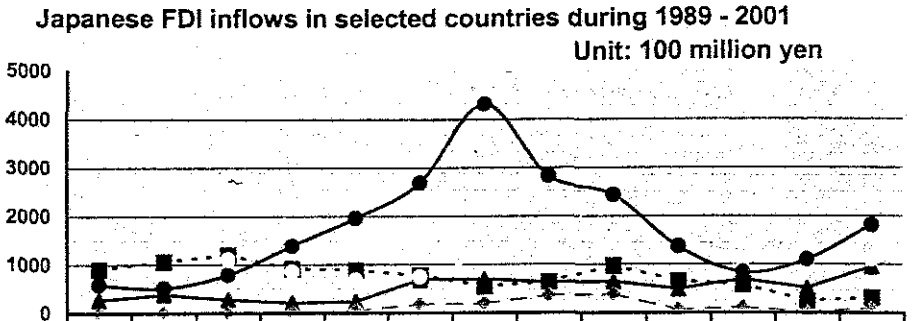
*Japanese FDI inflows to Vietnam remain low compared with other East Asian countries and China.*

Compared with other ASEAN countries, the amount of Japanese FDI in Vietnam is still very low. As indicated in Figure 8 below, during the period from 1989 – 2001, Japanese FDI inflow to Vietnam only accounted for 16% of that of Malaysia, 9% of Thailand and 6% of China.

The figures for 2000 and 2001 do not show a more positive signal for Vietnam. The amount of registered capital from Japan has not only been reduced in absolute value, but also in relation to other East Asia countries. After the crisis, many East Asia countries have implemented a more aggressive plan to attract FDI, in particular Japanese FDI, which has been the main the key foreign investor in Asia. This places more pressure on Vietnam in competing with these countries in attracting Japanese investors.

in competing with these countries in attracting Japanese investors.

**Figure 24: Japanese inflows in selected countries during 1989-2001**




| | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Malaysia | 902.5 | 1067 | 1202 | 918.7 | 891.7 | 771.8 | 554.6 | 643.8 | 970.8 | 658.1 | 586.2 | 256.2 | 320 |
| Philippines | 269.3 | 383.1 | 276.5 | 210.4 | 235.6 | 683.4 | 691.9 | 629.7 | 642.5 | 485 | 687.9 | 505.8 | 945.9 |
| Thailand | 1703 | 1696 | 1107 | 848.9 | 679.6 | 749.2 | 1196 | 1581 | 2291 | 1755 | 909.9 | 1029 | 1102 |
| Vietnam | 0.23 | 0.63 | 0.32 | 12.69 | 51.73 | 177.3 | 192.4 | 359.1 | 381.4 | 65.25 | 110 | 23.64 | 97.45 |
| China | 586.8 | 511 | 786.9 | 1381 | 1954 | 2683 | 4319 | 2828 | 2438 | 1363 | 837.5 | 1099 | 1802 |

Source: MITI

### *1.3.2 Outlook of Japanese FDI outflow before and after the crisis*

*The share of Japanese FDI to Asia nearly doubled in the four years from 93-97.*

Japanese outward FDI has shown a strong correlation with the upward movement of the yen-dollar exchange rate.

Before the Crisis

Japanese FDI increased gradually and steadily since the early part of the 1990s and reached its peak in 1997 with 6.6 trillion yen. The steady increase in Japanese FDI was largely attributable to the yen appreciation and economic development in foreign countries. With the appreciation of the yen, which resulted in a decline in price competitiveness of production in Japan, Japanese firms with export-oriented motive shifted their production from Japan to foreign countries. In addition, the FDI liberalization policies adopted by a number of economies also contributed to the expansion of Japanese FDI to these economies.

The pattern of Japanese FDI also changed notably in the 1990s. Japanese FDI to Asia increased sharply compared with other regions. According to a report by JBIC, Japanese FDI to Asia almost doubled in four years from

[24] Shijiro Urata, Japanese Foreign Direct Investment in East Asia with particular focus on ASEAN4, August 2002.

1993 to 1997 while the overall FDI increased only 60%[24].

*ASEAN4 and China experienced substantial growth in Japanese FDI before the crisis.*

The ASEAN 4 saw a large increase in Japanese FDI from 1993 to 1997. Indonesia and Thailand experienced a sharp increase while the magnitude of the increase in Malaysia and the Philippines was relative smaller compared to Indonesia and Thailand.

Japanese FDI to China increased notably in early 1990s, but started to decline in 1998 - two years before the decrease of Japanese FDI in NIE4 and ASEAN4. In the 2000 survey conducted by JBIC, the following are identified as key contributors to the substantial expansion of Japanese FDI in Asia:

- Favourable economic performance by East Asia countries made these countries more attractive for companies with local market-oriented focus.
- For companies with export –orientation, favourable exchange rates compared to the US dollar increased their cost competitiveness in comparison with production in Japan.
- Many Asian countries introduced more investment and tax incentives to attract FDI.

After the crisis

*Strong decline in Japanese FDI outflow during the crisis.*

The statistics showed an overall reduction in Japanese FDI in 1998 but rose again in 1999 before a continuous decline in 2000 and 2001.[25] The continued decline in Japanese FDI in 2000 and 2001 was largely attributable to poor the financial situation of Japanese firms and banks. In Asia, Japanese FDI declined sharply from 1.5 trillion yen in 1997 to 800 billion yen in 1998 and continued through 2000 before starting to increase in 2001. Although Japanese FDI to Asia remains low in the recent years, its share in overall Japanese FDI increased because of sharp decline in its FDI to North America and Europe.

Japanese FDI in ASEAN4 declined remarkably after the crisis from 699 billion yen in 1997 to 225 billion yen in 2000 before increasing to 294 billion yen in 2001. Among ASEAN4, Indonesia experienced the most dramatic drop in Japanese FDI. Thailand also recorded a substantial decline from 229 billion yen in 1997 to 91 billion yen in 1999.[26]

The decline in Japanese FDI in these countries was largely due to a reversal of optimistic economic prospects and the weak financial and corporate sectors of these economies. Political instability was also an important factor discouraging Japanese FDI in Indonesia.

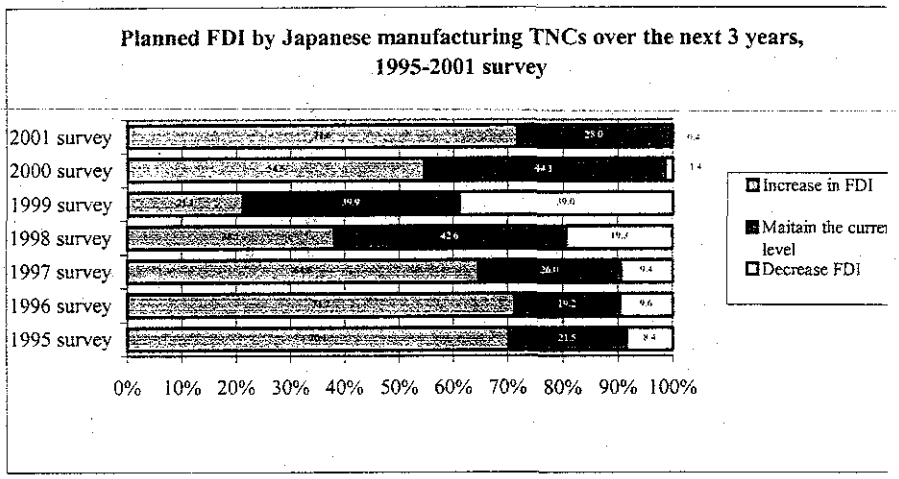
[25] Japan Bank for International Cooperation – Summary of FY 2001 JBIC Survey on Japanese FDI
[26] Shijiro Urata, Japanese Foreign Direct Investment in East Asia with particular focus on ASEAN4, August 2002.

Japanese FDI inflow to China continued to decline through 1999 after reaching its peak in 1997. However, it started to increase in 2000. China has gained the increasing interest of Japanese investors.

### *1.3.3 Future prospects of FDI by Japanese firms in the coming years*

According to a survey conducted by JBIC in 2001, 71.6% of Japanese firms having operations in foreign countries indicated that expanding and strengthening their overseas operation is one of the most important agendas in their strategic business plan compared to 21% in 1999 and 55% in 2000. Over 54% of almost 500 companies surveyed indicated that they have plans for foreign expansion.

**Figure 25: Planned FDI by Japanese manufacturing TNCs over the next 3 years, 1995-2001 surveys (%)**




Source: Japan Bank for International Cooperation, various surveys

*China has become more attractive than ASEAN4 for Japanese investors.*

The survey also indicates a change in the choice of investment location. China was quoted by 76.3% of the respondents as the intended destination for their investment and ranked in first place as the most preferred location for investment, while only 51.5% of the respondents indicated their intention to expand their operation to ASEAN5. The Japanese investment gap between China and the ASEAN5 has narrowed since 1999.[27]

Within ASEAN5, Thailand was viewed as the most favourable investment location due to better infrastructure, stable social and legal systems. Thailand was indicated as a preferred place to locate production facilities for Japanese and global markets.

[27] JBIC – 2001 survey.

Among the most promising economies for Japanese investors in the mid- and long-term, Vietnam was ranked in 6th place after Thailand and Indonesia but above Malaysia and the Philippines in the 2001 survey. It is worth noting that the percentage share of respondents indicating China as a preferred location increased sharply.

### *1.3.4 Problems faced by Japanese firms in East Asia*

*Japanese reported more difficulties in Vietnam when doing business than in China and ASEAN4.*

Understanding the problems facing by investors is very important for host country governments to design their FDI promotion strategy. Based on the surveys conducted by JBIC, Japanese firms are faced with various problems in doing their business. Figure 27 below indicates the results of the JBIC survey on the problems faced by Japanese firms in selected Asian countries.

It can be noted from the summary that Japanese firms face more problems in Vietnam than in Thailand, Indonesia or Malaysia. Among these problems, infrastructure (reliability and quality of infrastructure and utilities), legal system (lack of transparency, instability, underdevelopment), difficulty in procuring parts and components are indicated by many Japanese investors as serious problems in Vietnam. An unstable exchange rate, difficulty in recruiting managers and underdevelopment of supporting industries are also pointed out as problems of Vietnam.

The problems in China are the legal system (lack of transparency, instability, underdevelopment), tax system (instability, lack of transparency), complicated administrative procedures, political and social instability. Restrictive FDI regime, political instability, unstable exchange rates, difficulties in recruiting managers are pointed out by many Japanese firms as problems in Malaysia.

**Figure 26: Problems faced by Japanese firms (%)**

| | Thailand | Indonesia | Malaysia | Vietnam | China |
|---|---|---|---|---|---|
| Underdeveloped infrastructure | 14.9 | 24.1 | 14.3 | 38.6 | 27.3 |
| Legal system (underdevelopment) | 17.2 | 25.9 | 7.1 | 36.4 | 43.8 |
| Legal system (lack of transparency) | 14.9 | 16.7 | 7.1 | 20.5 | 53.3 |
| Legal system (instability) | 5.7 | 16.7 | 3.6 | 15.9 | 52.1 |
| Tax system (complicated system) | 4.6 | 7.4 | 3.6 | 2.3 | 16.8 |
| Tax system (lack of transparency, instability) | 13.8 | 7.4 | 7.1 | 11.4 | 36.5 |
| Tax system (high tariff rates) | 10.3 | 5.6 | 0 | 9.1 | 17.5 |
| Restriction on equity participation | 10.3 | 7.4 | 32.1 | 11.4 | 20.3 |
| Complicated administrative procedure | 5.7 | 3.7 | 17.9 | 15.9 | 34.9 |
| Political and social instability | 11.5 | 94.4 | 32.1 | 25 | 34 |
| Unstable exchanges rates | 48.3 | 57.4 | 32.1 | 22.7 | 15.2 |
| Difficulty in procuring local parts | 19.5 | 11.1 | 17.9 | 34.1 | 20.6 |
| Underdevelopment of supporting industry | 10.3 | 13 | 0 | 22.7 | 10.2 |
| Difficulty in obtaining finance | 11.5 | 11.1 | 17.9 | 9.1 | 16.2 |
| Tough competition | 29.9 | 20.4 | 21.4 | 13.6 | 23.8 |
| Difficulty in recruiting managers | 23 | 11.1 | 28.6 | 20.5 | 19.7 |
| Difficulty in recruiting workers | 13.8 | 11.1 | 14.3 | 9.1 | 10.5 |
| Increase in wages | 20.7 | 11.1 | 21.4 | 6.8 | 14 |

Source: Japan Bank for International Cooperation

## 1.4 Factors influencing foreign direct investment and site selection

### *1.4.1 Factors influencing foreign direct investment*

*Market access and reducing operating cost top the list of determinants for foreign expansion.*

Market size and market growth in the various countries or regions that are actual or potential investment locations for production activities of TNCs are the most important economic determinants of FDI flows. The evidence has shown that weakened demand and economic recession in some of the largest economies have immediate effects on FDI flows.

Based on MIGA's survey in January 2002, improving market access is rated as the most important objective for foreign expansion strategies by a majority of manufacturing and services sectors. Reducing operating cost and sourcing raw materials were ranked in second and third place by manufacturing companies. Services companies, however, rank developing new products as the second most important objective for their international expansion strategies.

**Figure 27: Most important objectives for international expansion (%)**

| | |
|---|---|
| Improve market access | 55% |
| Reduce operating cost | 17% |
| Source raw materials | 6% |
| Consolidate operation | 4% |
| Develop new product lines | 4% |
| Improved productivity | 2% |
| Develop new technology | 2% |
| Improved labour force access | 1% |
| Reduce risks | 1% |

Source: MIGA – Foreign Direct Investment Survey, January 2002

### *1.4.2 Motives and determinants of Japanese FDI in East Asia*

*Low production cost is the key reason for increase of Japanese FDI in East Asia.*

Several reasons are attributed to the increasingly importance of FDI for Japanese firms. Facing pessimistic future prospects of the Japanese economy, many Japanese firms have found overseas markets more attractive. Some Japanese firms consider overseas production as an effective way to reduce production costs in order to compete in increasingly competitive markets.

Responding to local market demand is also a key determinant for increasing interest in foreign expansion. This is particularly important for their future FDI plans in China, while the expansion of investment to ASEAN4 aims to respond to regional integration. Other factors for expanding and strengthening their operations in China and ASEAN countries include using low-wage labour, supplying parts to business partners, using cheap materials, exploring new markets and developing new products for the local markets.[28]

In any case, maximizing profits is the underlying objective of Japanese FDI. When expanding the investment to foreign countries, Japanese firms expect to expand sales to local markets. Based on the survey conducted by JBIC, local sales motive is indicated as a major factor for investment in developed economies such as North American and NIEs in comparison with Japanese FDI in China and ASEAN4 where low cost production is a very important determinant.

A number of respondents also indicated that they undertook FDI in Asia to follow their business partner. This is due to the low level of development of supporting industries and parts-supplying industries in ASEAN countries. Underdevelopment of efficient supporting industry in ASEAN countries requires Japanese assembling firms to request their business partners or part-

[28] Shijiro Urata, Japanese Foreign Direct Investment in East Asia with particular focus on ASEAN4, August 2002.

supplying firms to undertake FDI in ASEAN. This is an important issue for identifying target investors by host country.

The free trade among the ASEAN countries under AFTA is also a factor contributing to increases of Japanese FDI in ASEAN4 since this offers the opportunities for affiliates of Japanese firms in ASEAN4 to expand sales to other ASEAN countries. On the other hand, Japanese firms tend to utilize the low cost production in China to expand sales in Japan.

Figure 28 shows the motives and determining factors for Japanese FDI in ASEAN4 and China. It can be seen that they are very similar. This finding indicates that ASEAN4 and China are competitors for Japanese FDI. Since Vietnam is competing with ASEAN4 in attracting Japanese FDI, these are very important factors to be considered in investment promotion.

**Figure 28: Motives of Japanese FDI (%)**

| | Asia | ASEAN4 | China | NIEs | World |
|---|---|---|---|---|---|
| Access to natural resources | 3.9 | 3.6 | 4.6 | 3.4 | 4.2 |
| Achieve low cost of production | 16.9 | 18.6 | 17.7 | 12.9 | 12.4 |
| Reduce cost of production | 12.6 | 13.6 | 14.1 | 9.4 | 9.1 |
| Follow business partners | 9.5 | 12 | 7.5 | 8.7 | 8.3 |
| Expand local sales | 24.9 | 22.5 | 24.5 | 28.5 | 28.2 |
| Expand regional sales | 9.7 | 9.5 | 7.9 | 13.1 | 11.8 |
| Expand exports to ROW | 5.7 | 5 | 5.8 | 7 | 6.7 |
| Expand exports to Japan | 6.4 | 6.2 | 7.8 | 5 | 5.2 |
| Obtain earnings | 6.9 | 6.1 | 6.7 | 7.5 | 7.8 |

Source: MITI(2001)

**Figure 29: Determinants for Japanese FDI (%)**

| | Asia | ASEAN4 | China | NIEs | World |
|---|---|---|---|---|---|
| Industry promotion policies by host government | 9.5 | 10.4 | 9.5 | 7.5 | 7.5 |
| Availability of low-wage labour | 20.2 | 22.8 | 21.5 | 14.4 | 14.6 |
| Availability of engineers | 2.8 | 2.2 | 2.7 | 3.8 | 3.4 |
| Availability of locally produced parts | 3.9 | 3.1 | 4.0 | 5.3 | 3.8 |
| Availability of cheap land/finance | 5.6 | 6.6 | 6.0 | 3.2 | 4.9 |
| Capability to increase in local demand | 5.6 | 4.8 | 7.2 | 4.9 | 4.6 |
| Prospects of increase in local demand | 21.4 | 19.9 | 21.5 | 23.2 | 24.2 |
| Prospects of increase in regional demand | 10.2 | 10.1 | 8.7 | 12.8 | 11.6 |
| Good infrastructure | 6.8 | 4.7 | 5.6 | 12.0 | 9.9 |
| Presence of other Japanese firms | 11.6 | 13.5 | 10.5 | 10.8 | 11.3 |

Source: MITI (2001)

### *1.4.3 Factors determining the selection of investment location*

*Access to customers is the key factor affecting site decision.*

Various surveys conducted by MIGA suggested that the majority of investors said that "access to customers" is rated as the most critical location factor. The second most often cited factor is a stable social and political environment, followed by ease of doing business and reliability and quality of utilities.[29] Many other economic factors such as the quality of infrastructure, availability of skills and technological capacity available in host countries are also considered important for site decision.

**Figure 30: Top 10 critical factors determining investment location decision (% cited as very influenced)**

| | |
|---|---|
| Access to customer | 77% |
| Stable social and political environment | 64% |
| Ease of doing business | 54% |
| Reliability and quality of infrastructure and utilities | 50% |
| Ability to hire technical professionals | 39% |
| Ability to hire management staff | 38% |
| Level of corruption | 36% |
| Cost of labour | 33% |
| Crime and safety | 33% |
| Ability to hire skilled labour | 32% |

Source: MIGA – Foreign direct investment Survey – January 2002

## 1.5 Investment cost analysis

*High cost of doing business diminishes Vietnam's attractiveness.*

As noted in the above section, high cost of doing business is one of the main disadvantages of Vietnam. In the recent Business Forum conducted on 9 December 2002 in Hanoi, the investors (both foreign and local) complained that various critical inputs for businesses are still too expensive compared to regional benchmarks. This includes land, technology, energy, tele-communications, transportation and taxes. Even though prices have been falling, those in neighbouring countries have been falling even faster.

JETRO has regularly published a comparison of business costs among regional countries. The following section illustrates the analysis of operating costs in selected areas. The analysis is based on the results of JETRO studies and PwC's own study and research. The analysis does not just focus on the cost but also the quality of the goods and services.

### *1.5.1 Utilities*

Power supply

Until recently, power production was the sole responsibility of Electricity of

[29] MIGA – Foreign direct investment Survey – January 2002

*Dual pricing system and unreliable energy supply are the main problems of investors.*

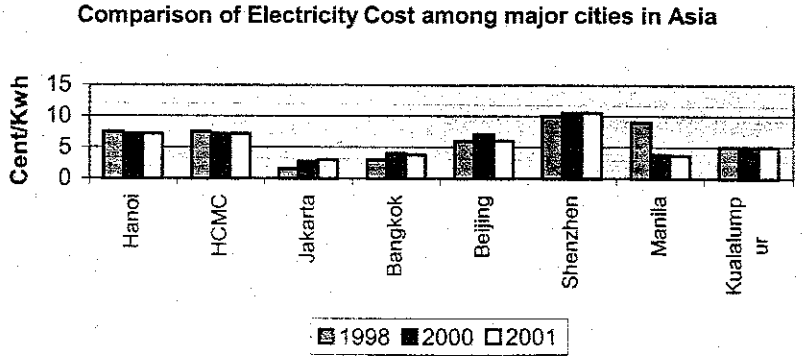
Vietnam (EVN). Private participation in the energy production has been allowed in the past few years, however, power distribution still rests with EVN. The energy price is set by the Government and differs among users and regions. Foreign and domestic users are subject to different tariff although this dual pricing system is gradually being phased out.

The power supply in Vietnam is insufficient and unreliable. Most FIEs have to make additional investment to upgrade their power supply (i.e. building transmission system or purchasing generators).

The fact that many FIEs have to invest in their own power generators or to upgrade the power supply shows how seriously the operation of FIEs are affected by the unreliability of the power supply. However, according to various surveys and interviews, this was not perceived as an important issue by foreign investors. Most complaints from foreign investors are in the area of dual pricing system and high-energy cost. Currently, FIEs are paying on average 14% higher than domestic enterprises.[30]

It can be noted from Figure 31 below that the energy cost in Vietnam is higher than that of Thailand, Indonesia, Malaysia, the Philippines and also China. The energy cost of Vietnam will continue to increase due to the inefficiency in power generation and distribution. According to the agreement signed with the World Bank, the energy price in Vietnam should increase to 7.5 Cent /Kwh by 2003. The high energy cost does not only diminish the cost competitiveness of Vietnam, it also creates an negative image to investors who believe that they have to subsidize the inefficient operation of the Vietnamese firms.

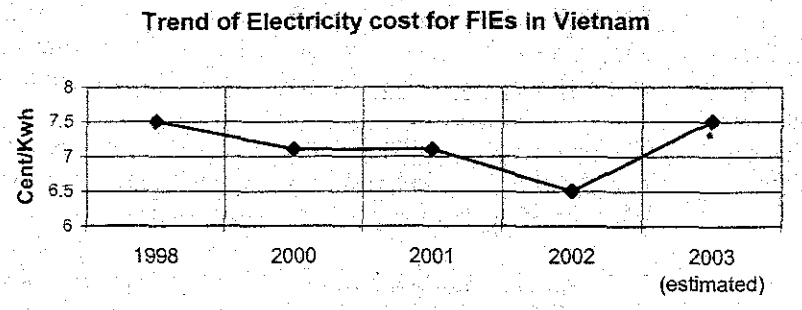
**Figure 31: Comparison of Electricity cost among major cities in Asia**




Source: JETRO, 12th survey, March 2002

[30] Using price quoted by Electricity of Vietnam.

**Figure 32: Trends of energy cost for FIEs in Vietnam**




Source: Electricity of Vietnam

It must be note that the reduction in energy price in 2002 shown in the above chart was due to the reduction of energy price for FIEs as a measure to close the gap between the domestic and foreign sector. It does not mean an overall reduction in energy price.

Fresh water supply and sewerage systems

*Access to clean water and quality of water supply and sewerage system remain low compared to the regional standard.*

Both access to clean water and the quality of water are inadequate. Most water supply systems are in poor condition. In urban areas, only 70% of the population have access to clean water. In the rural area, this rate is 11%. The water supplied is often polluted and distribution losses are very high. The average distribution loss is 40%. In certain provinces, this rate could increase to over 50% mainly due to old and outdated water distribution system.[31]

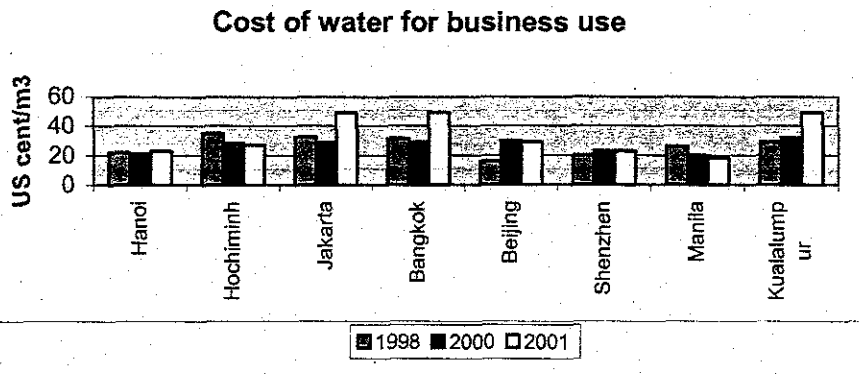
Most cities and urban areas do not yet have a sewerage and waste water treatment system. As a result, some companies have to make extra investment in water supply and sewerage system. The lack of adequate sewerage systems poses growing sanitation problems, particularly in large cities such as Hanoi and Ho Chi Minh City.

The cost of water supply in Vietnam is relatively low compared to other countries in the region because the water price is based on affordability. As a result, many provinces set the water price for business use substantially higher than for private use to cover the cost. In certain cases, the water price for business use is 4 times higher than those for private users. However, according to the reports of most water supply companies, the water tariff cannot cover the operation cost therefore the companies have no funds to invest in maintenance and rehabilitation of the water supply system.

[31] Report of the Vice Minister of Construction at the Seminar on Mechanism and policy reforms on the management of public services for urban water supply. Sewerage and sanitation in Vietnam, December 2002.

Improvement of the water supply, sewerage and sanitation system has been a targeted policy of the Government of Vietnam. A reform of the water supply, sewerage and sanitation system is in the process with the assistance from other multinational and bilateral donors. Among various proposed measures, increase in water price and reduction of distributions losses via additional investment in the water distribution system are considered the key tools. According to estimate by experts in the water supply sector, the water price will increase substantially in the next 5 years.

**Figure 33: Cost of water for business use**




Source: JETRO report, 12th Survey, March 2002

Telecommunication

*Telecommunication cost is extremely high. The quality of services is not adequate.*

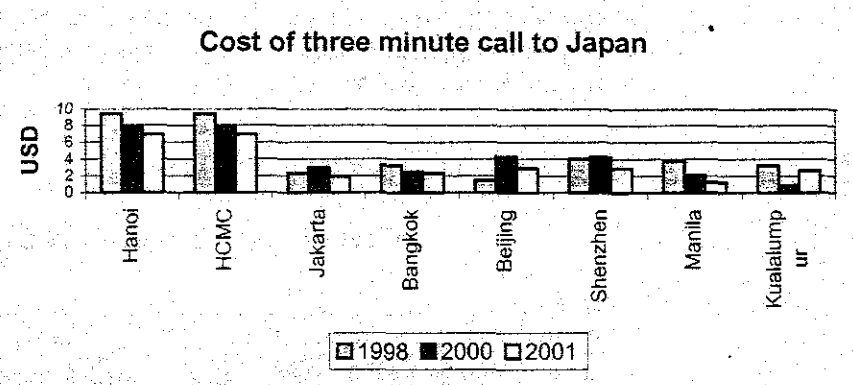
Over the last 10 years, Vietnam achieved tremendous improvements in the telecom industry. However, access to telecommunication system in Vietnam is still below the regional average. At the current stage, only 2.6 out of 100 persons have access to fixed telecom network in Vietnam, while this figure in Thailand is 7.9 (three times higher). The access to Internet has only recently been allowed, but still restricted. The network is not reliable and the quality is not adequate. The range of services is still very limited.

The telecom industry is highly regulated. Vietnam Post and Telecommunications (VNPT) retains its monopoly position in the telecom industry. Foreign companies are not yet allowed to participate in providing telecommunication services. To date, foreign companies are only allowed to invest in telecom infrastructure and restricted to the form of BCC whereby the foreign party contributes in equipment and technology. However, the operation and management of the network remains with the Vietnamese party.

Only since 2000 has Vietnam allowed domestic companies other than VNPT to enter the telecom market. This has driven the cost of international calls in 2001 down by 20% compared to that of 2000. However, rates are still the highest in both the region and the world. According to a survey conducted by JETRO in 2001, the cost of international calls in Vietnam is

still three times higher than that of Bangkok and Jakarta, and more than double that of Beijing and Kula Lumpur.

**Figure 34: Comparison of the cost of international call among major cities in Asia**




Source: JETRO, 12th Survey, 2002

According to the master plan of the telecom industry approved by the Government, the telecommunication cost will be steadily reduced with the goal to bring the telecom cost down to the regional average by 2003.

The underlying reason for high cost and low quality in the telecom industry is due to the lack of competition, which leads to low productivity and ineffective operation. Abolishing the monopoly of the telecom industry is therefore seen as an effective way to resolve this matter.

### *1.5.2 Infrastructure*

Road network

*Quality of physical infrastructure is very low compared to the regional standard.*

The road network is relatively large, but in poor condition. Only 10% of Vietnamese roads could be classified as of high quality. Vietnam has only a few expressways, and only 26% of national highways have two lanes or more. The vast majority of bridges are in varying stages of deterioration. In recent years, the Government has spent significant amounts of money in upgrading the highway system with financial support from international lending agencies. The capacity of the national highways, however, only meets 60% to 70% of the transport demand. With assistance from the World Bank, ADB and other bilateral donors, there have been significant improvements in the road network of Vietnam. However, it is still below the regional standard.

Access to the rural areas is also problematic due to dilapidated, small and poor quality bridges. Urban road transport is a major constraint for enterprises in Ho Chi Minh City and Hanoi due to high traffic and the lack of public transport.

Railways

Railway is not a commonly used transportation means by FIEs due to the lack of logistic standards such as facilities for handling containers and freezing cargo and inflexible schedules and outdated network and rolling stock. The railway system in Vietnam is mostly single-track lines without electrification.

Airways

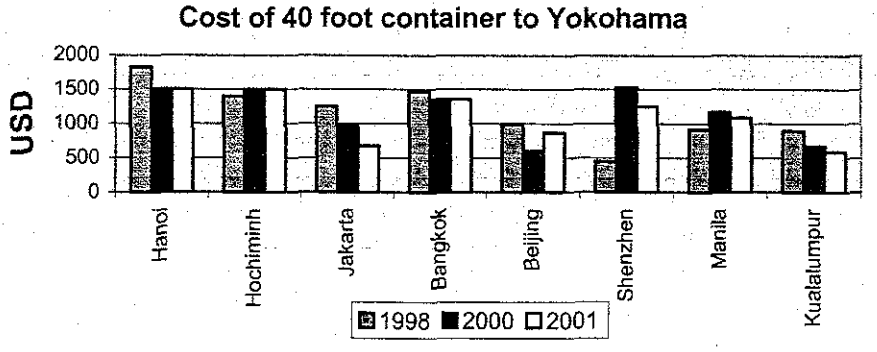
Although the air transport system achieved the fastest growth rate among all transportation sub-systems, the capacity and the state of the Vietnamese air-fleet do not meet the demand for transportation of goods and commodities. Vietnam has three international airports and has connections to major cities in the region. Unreliable and tight schedules, insufficient fleet capacity and high prices are perceived as the key problems of Vietnamese airline industry. The biggest issue is the existence of the dual pricing system, which creates negative impressions for foreign investors.

Maritime transport

Following road transport, seaways are the second most commonly used transport mean by FIEs. Lack of proper facilities is the main weakness of seaport and waterways. Most seaport facilities are old, outdated and operated inefficiently. This creates operational congestion, increases the waiting time and leads to cost increase.

Compared to other cities in the region, the cost for maritime transport in Vietnam is relatively high. Please refer to the comparison table below. As indicated in the comparison, the transportation cost for a 40 foot container to Yokohama from Beijing and Kuala Lumpur is about two thirds of the cost from Hanoi or Ho Chi Minh City.

**Figure 35: Comparison of transportation cost of 40 foot to Yokohama**



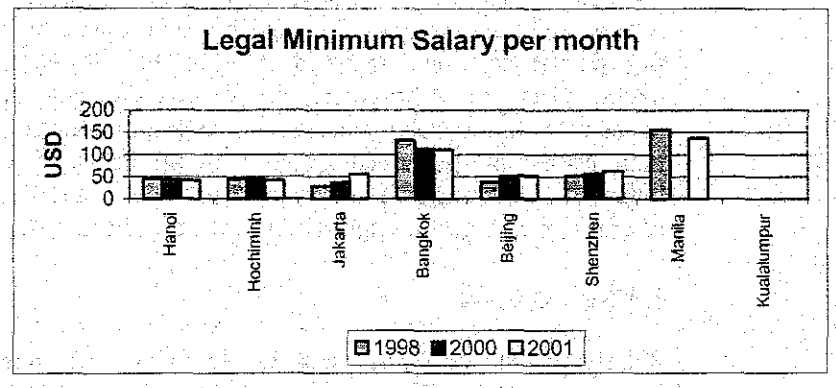

Source: JETRO – 12th Survey, March 2002

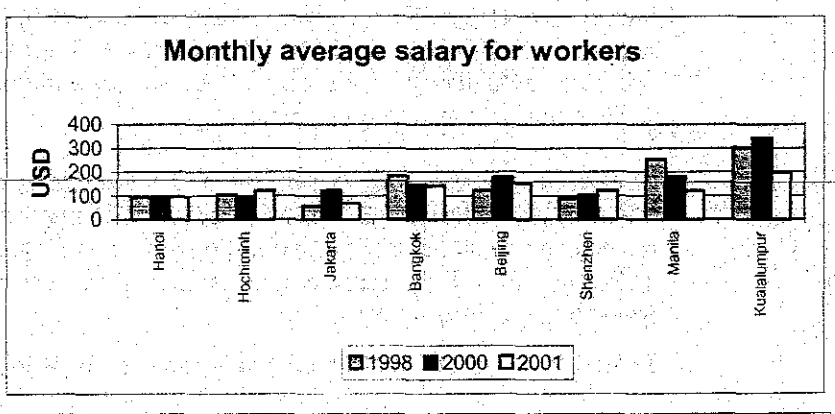
### *1.5.3 Labour cost*

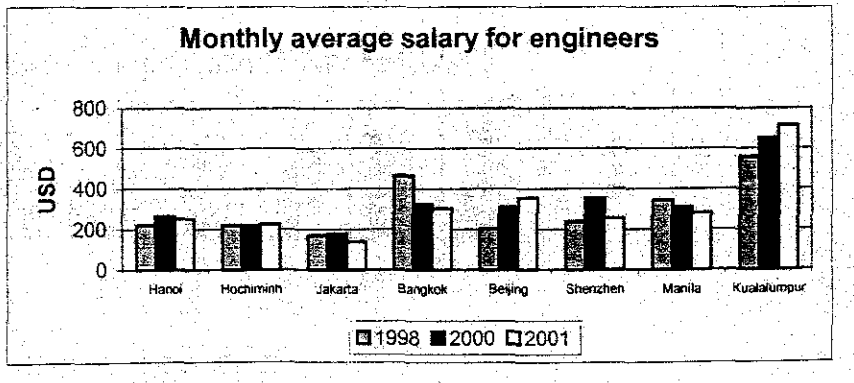
*Cost of unskilled labour is relatively low, bu productively problems remain.*

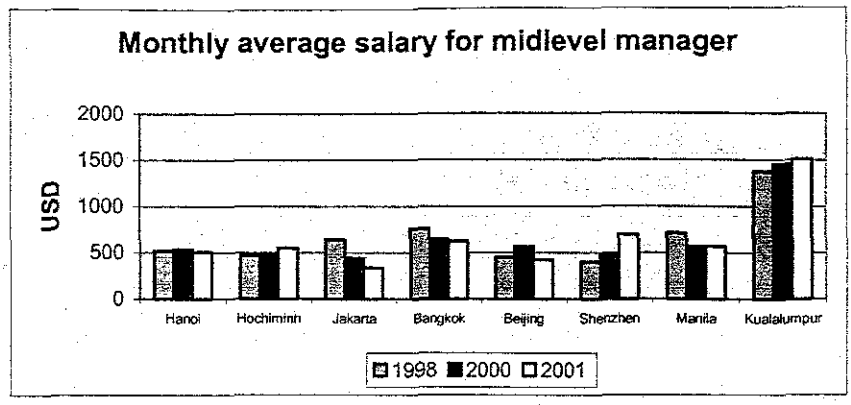
The cost of unskilled workers in Vietnam is relatively low in comparison with other ASEAN countries. This is one of the competitive advantages of Vietnam in attracting FDI in labour intensive industries such as textiles. However, low productivity and discipline of the Vietnam workers have counter effects on the competitive advantages of the labour force.

**Figure 36: Comparison of labour cost among major cities in Asia**






Source: JETRO – 12th Survey- March 2002

It can be seen from the above charts that although the legal minimum salary in Vietnam is lowest compared to other cities, the average worker wage does not show a large gap. For trained workers, the labour cost of Vietnam is no longer competitive due to the shortage of qualified technical and managerial workers. This could be seen from the comparison of salary cost for engineers and midlevel managers, where the cost in Vietnam is higher than Jakarta and Beijing. The cost of senior managers is even higher in Vietnam due to the very high personal income tax rates.

### *1.5.4 Rental cost*

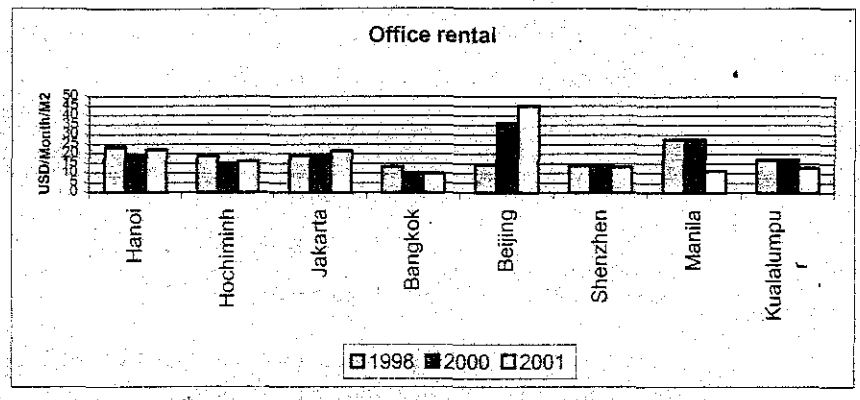
Office rental

*Office rental has been reduced over the last years, but remains high relative to other Asian cities.*

In early 1990s, the official rental in Vietnam was very high due inadequate supply of high quality office. Over the last few years, the investment (both domestic and foreign) in office building increased dramatically. During the Asian crisis, Vietnam suffered an over-supply of high quality office space, which was mainly due to companies implementing cost cutting measures and using private houses as offices. In addition, many foreign representative offices closed down and there were no new investors or foreign companies setting up offices in Vietnam. This drove down the rental price in 1999-2000. The rental price increased again in 2001 when the economy showed signs of recovery.

Compared with other countries, the office rental cost in Vietnam is relatively high, but is not expected to decrease over the next few years. The quality of office buildings has improved substantially over the last few years, but remains diversified. Buildings owned by foreign investors are of better quality than those owned by domestic investors.

**Figure 37: Comparison of office rental cost among major cities in Asia**




Source: JETRO, 12th Survey, March 2002

Land rental in Industrial Zone (IZ) and Export Processing Zone(EPZ)

*Land rental price is competitive, but the quality is low.*

There is no private ownership of land in Vietnam. The investors can rent the land from the Government or infrastructure developers. The local governmental authorities generally set the land rental price. To encourage foreign investment in IZs and EPZs, land rental has been reduced substantially over the last 10 years. In addition, many local governmental authorities also offer exemption and reduction of land rental for certain areas.

Compared with other countries in the region, Vietnam has the lowest land rental rate in IZs and EPZs. The key issue of Vietnam is not the land rental rate, but the quality of the infrastructure. Most IZs and EPZs (in particular those owned by domestic companies) do not have waste water treatment and environmental protection facilities. Only a few IZs and EPZs meet the regional standard.

Since the Vietnamese Government imposes certain requirements on environment protection, the lack of the facilities offered by the infrastructure developers means that the investor has to make additional investment to comply with the Government regulations.

### *1.5.5 Other cost of doing business in Vietnam*

*Unofficial cost and high tax ratest reduce the attractiveness of Vietnam.*

Other factors contributing to the high cost of doing business in Vietnam include various administrative fees and unofficial costs. Although the Government and the Ministry of Finance issued regulations on elimination of unreasonable fees, it remains a problem for not only foreign investors, but also domestic investors.

Taxes are one of the most important factors for investment decision since it

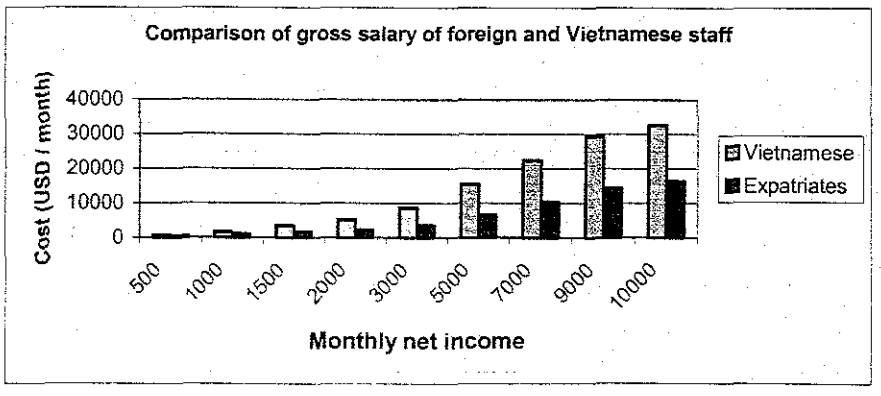
affects the cost of doing business. During the Vietnam Business Forum on 9 December 2002, there were various comments on the tax regime, including its high cost compared to regional economies, its narrow base and disproportionate burden on the taxpayer. This results in an uneven playing field for the foreign investor.

Although the corporate income tax rate applicable to FIEs in Vietnam is lower than other countries in the region, the effective tax rate is much higher because all gains and income are taxed, but not all expenses are deductible. The deductibility cap imposed on advertising, promotion and marketing expenses is a major problem for many companies.

The treatment of losses also another issue. Currently, tax losses can only be carried forward for maximum 5 years. For companies operating in the real estate sector or heavy industry, this period is too short because they would incur substantial losses in the early stage of operation before any profit can be made. The loss carry forward policy diminishes the benefits of tax holidays and incentives granted by the Government.

Vietnam has the highest personal income tax rate in the region, although it has been significantly reduced over the last few years. The top marginal rate applicable to foreigners is 50% while the top marginal rate applicable to Vietnamese nationals is 65%. The high PIT rates lead to increases in labour costs, in particular the cost of highly qualified Vietnamese. From a cost perspective, companies are not encouraged to train and promote Vietnamese staff since it is cheaper to hire foreigners than senior Vietnamese staff. The figure below illustrates the cost of foreign and local employees for the same net take-home income (benefits in kind are not included in the comparison).

**Figure 38: Comparison of the gross salary of foreign and Vietnamese staff for the same monthly net income**




Note: The comparison is made for same monthly net income without taking into accounts other benefits (2002 tax rates).
Source; PwC's calculation