

**Foreign Direct Investment and Economic Development:  
Lessons From Vietnam**

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## Abstract

FDI inflows have substantially declined in recent years, ignited by the Asian financial crisis. A number of foreign-invested firms withdrew from Vietnam. Long before the FDI retreat happened, the number of jobs in the foreign-invested firms had been small. The FDI sector has experienced a substantial trade deficit. The disbursement rate is low. The prices of utilities and land-use right are high. The personal income tax rate applied to foreigners is ranked top in the Asian region. The auto industry is near bankruptcy. These are strong indications that the FDI policy is not right. Academia, business community, international agencies, and foreign governments have carried out numerous studies on FDI in Vietnam and a number of host countries in Asia and South America. Long lists of recommendations have been sent to the Vietnamese government for consideration. They point out numerous problems that Vietnam encounters: FDI has been concentrated in import-substitution, capital-intensive industries rather than export-oriented and labor-intensive industries; the FDI legislation is vague, restricting and outdated; and market access is rather limited. After a decade, Vietnam is still struggling to determine what FDI policy is right for the country.

## Introduction

Foreign direct investment (FDI) has been one of the important stimulating factors of the Vietnamese economy in the last ten years. It grew steadily until the Asian financial crisis began to affect Vietnam in 1998. FDI not only brought into Vietnam foreign capital, technology, and management skills Vietnam needs, but it also helped open up the Vietnamese economy, a tightly closed and highly inefficient economy near the brink of famine in the early 1980s. The FDI demand has put tremendous pressure on the Vietnamese policy makers to adopt substantial economic reforms in order to attract needed foreign capital.

Private foreign investment comes in various forms: private lending, portfolio investment, and foreign direct investment. After a series of serious debt crises facing the third-world countries in the 1970s, 1980s and early 1990s<sup>1</sup>, private lending lost its popularity for foreign investors. Portfolio investment provides little or no control over the money invested and is fairly risky if it takes place in a developing country with inadequate business experience and management skill. FDI, the focus of this study, has become a dynamic tool for foreign investors. FDI is defined as "*...investment that involves a long-term relationship reflecting a lasting interest of a resident entity in one economy (direct investor) in an entity resident in an economy other than that of the investor. The direct investor's purpose is to exert a significant degree of influence on the management of the enterprise resident in the other*

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<sup>1</sup> World debt crisis in 1982 and Mexican debt crisis in 1994.

*economy*"<sup>2</sup>. In recent years, Vietnam has begun to invest in fishery, sea transport, wood processing, and information technology in neighboring countries. The amount of FDI outflows from Vietnam is still insignificant but rose to about \$13 million as of April 2000<sup>3</sup>. This paper discusses FDI inflows only and is structured as follows: The first section describes the scope of the study, followed by an analysis of the FDI trend in Vietnam. The third section will examine the auto industry in Vietnam. Section 4 will debate the FDI climate. Section 5 will present views on the FDI and the U.S. - Vietnam bilateral trade agreement (BTA). Section 6 will address the contribution of FDI to the Vietnamese economy. The last section will provide some suggestions to improve the FDI environment in Vietnam.

### FDI Trend in Vietnam

Vietnam issued the Foreign Investment Law for the first time in 1977, two years after the country's reunification. However, this effort to draw in foreign capital failed due to Vietnam's military intervention in Kampuchea in December 1978, followed by its border war with China in February 1979. After the severe food shortage began to spread in Vietnam in 1985, following the collapse of the farm collectivization program, Vietnam was forced to transform its centrally planned economy into a market-oriented system in 1986 under the Renewal (Doi Moi) Program. In the following year, the new Foreign Investment Law was promulgated in an attempt to bypass an economic boycott imposed by the international community. FDI began to flow into Vietnam gradually after the Hanoi government withdrew its troops from Kampuchea in 1989, concurrent with the collapse of the Communist regimes in Eastern Europe.

FDI inflows increased from a total of \$168 million during 1988-91 to \$2.1 billion in 1997. The bulk of FDI disbursement took place during the high growth period 1992-96. It peaked at \$2.3 billion, which is equivalent to 11.3 percent of GDP in 1995. FDI inflows declined sharply to \$800 million in 1998 and around \$700 million in 1999 when Vietnam began to feel the effect of the Asian financial crisis (table 1, figure 1). Total FDI commitment in 1999 is \$1.5 billion or about 90 per cent of the 1998 figure of \$1.7 billion. The total FDI committed during the first eight months of this year amounted to \$488 million, a 46% decrease from the same period last year. Therefore, it is expected that the FDI disbursement will continue to decline further in 2000 and even in 2001. Slow economic reforms in Vietnam and increased competitiveness in other Asian countries in the past few years have partly contributed to the reduction of FDI inflows to Vietnam. The signing of the BTA with the United States in July of this year was too late to reverse this trend, at least in the short-term.

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<sup>2</sup> International Monetary Fund, "Balance of Payments Manual – Fifth Edition", Washington, DC 1993.

<sup>3</sup> The Economist Intelligence Unit, "Country Report – Vietnam", London July 2000.

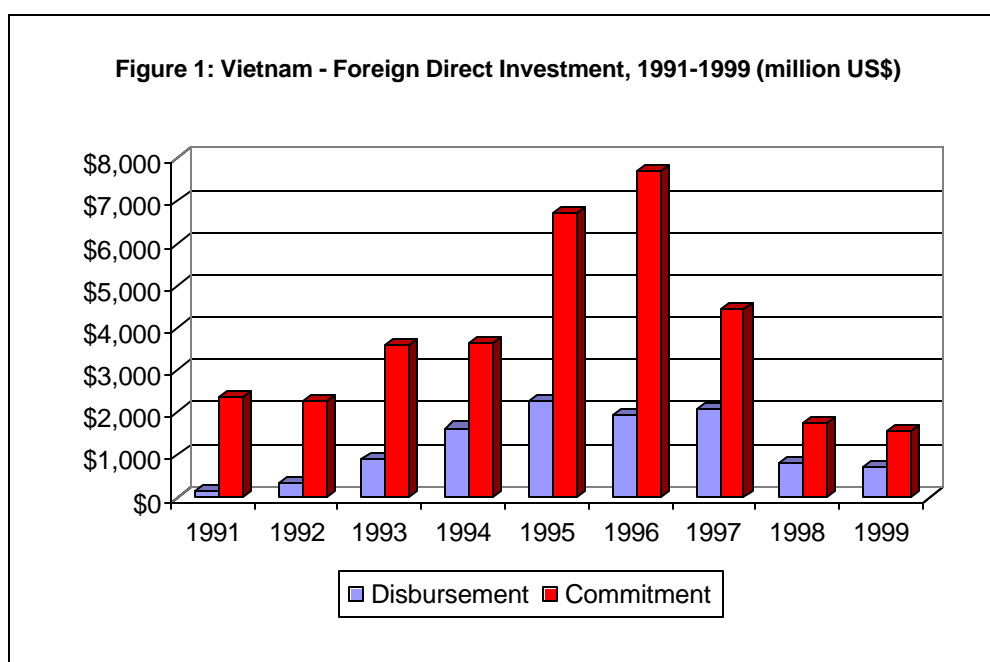
Table 1. Vietnam: Disbursement of Foreign Direct Investment by Sector, 1988-99 1/  
(As % of total unless specified otherwise)

	1988-91	1992	1993	1994	1995	1996	1997	1998	1999 2/
Industry	17.8	15.2	28.8	36.1	32.6	43.0	46.8	41.3	41.6
Heavy Industries	10.1	6.3	8.0	18.7	13.1	16.9	20.3	12.8	26.0
Economic Processing Zones	0.0	1.0	0.3	0.6	1.7	6.3	3.6	3.1	3.2
Light Industries	5.9	3.2	4.9	9.1	10.3	16.5	17.6	15.4	7.1
Food	1.8	4.8	15.6	7.7	7.6	3.3	5.2	10.0	5.3
Oil & Gas	41.3	23.2	40.6	37.7	25.7	15.3	0.0	6.2	12.6
Construction	0.0	1.9	4.8	2.3	5.0	14.0	7.3	31.3	7.8
Transportation and Communication	17.4	6.0	2.9	3.0	7.0	4.1	3.7	1.9	6.4
Real Estate	16.7	16.8	12.2	17.1	19.2	18.6	20.4	14.1	20.4
Hotels and Tourism	11.3	13.7	9.0	12.8	11.2	11.2	14.3	9.1	8.2
Office Property and Apartment	5.4	3.2	3.3	4.3	8.0	7.4	6.1	5.0	12.2
Agriculture, Forestry, and Fishery	8.6	3.8	3.5	2.3	5.3	3.8	13.7	5.1	6.3
Services	-1.8	33.0	7.2	1.6	5.1	1.2	8.1	0.3	4.9
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Memorandum Items:									
Total Disbursement (US\$ million)	168	315	923	1636	2262	1962	2074	800	700
as percent of GDP (%)	2.0	3.9	7.8	11.2	11.3	7.7	8.1	3.2	2.4
Total Commitment (US\$ million)	2,381	2,293	3,585	3,664	6,722	7,702	4,456	1,738	1,563

Sources: International Monetary Fund (IMF), Ministry of Planning and Investment (MPI), and State Bank of Vietnam (SBV).

1/ Includes investments by domestic joint venture partners.

2/ Preliminary



The total of FDI commitments during the period 1988 - 1998 was about \$32.5 billion, and the total FDI disbursement during the same period was about \$10.3 billion (table 2). The implementation rate, as measured by the disbursement to commitment ratio, was about 31 percent. This figure is quite low even though the FDI Law required that FDI projects start to be implemented within six months after they are approved. The analysis of detailed data shows that the FDI project implementation rate has been improved in recent years as the government has gradually simplified the FDI review procedure. The implementation rate is better regarding more active sectors such as oil and gas (80%), and services (63%). Other sectors do not score well, especially office property and apartments (13.5%), transportation and communication (14.7%). There were a number of reasons for low implementation rates<sup>4</sup>. Some projects require land-use permits, construction permits, population removal, site clearance, equipment import permits, etc. Each project has to be approved by different agencies. In addition, about 15% of the approved projects were later withdrawn due to various reasons.

In earlier years, between 1988 and 1991, most of FDI was poured in off-shore oil and gas projects, which were exposed to minimum political and economic risks, followed by hotels and tourism projects, which were easily carried out and managed. In the second stage, FDI expanded to production areas. During 1988 – 98, foreign investments concentrated in the following sectors as measured in terms of total FDI disbursements: oil and gas (20 %), real estate (18%), heavy industry (15 %), and light industry (12 %). At present, foreign investors have very limited access to the service sector. Their participation in this area is only 5 percent. The BTA with the U.S. once approved by the U.S. Congress will allow American firms to invest more in a broad array of services. FDI flows to manufacturing and export sectors are also very limited.

Like China, the majority of FDI projects in Vietnam during 1991-98 are joint-ventures with state-owned enterprises (SOEs), which accounted for 65 percent in terms of commitments. Joint-ventures with private companies (PCs) account for only 2 percent since PCs were new in Vietnam and were allowed to join a partnership with foreign investors after the Foreign Investment Law was amended in 1992. Fully foreign-owned projects accounted for 22 percent of total commitments. Two other forms of FDI projects, namely BCC (business cooperation contract) and BOT (built, operate, and transfer) accounted for 12 percent. In terms of FDI disbursement, joint-ventures with SOEs accounted for only 52 percent, as compared to its 65 percent share in total commitment. The share of PCs joint-ventures remained 2 percent, while BCC and BOT combined accounted for 24 percent. These statistics suggest that for a number of FDI projects, joint-ventures were converted to BCC or BOT<sup>5</sup>.

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<sup>4</sup> Le Dang Doanh in Tran van Hoa, ed., "Economic Development and Prospects in the ASEAN – Foreign Investment and Growth in Vietnam, Thailand, Indonesia, and Malaysia", St. Martin's Press, Inc., New York 1997.

<sup>5</sup> IMF, "Vietnam: Selected Issues", IMF Staff Country Report No. 99/55, Washington DC July 1999.

Table 2: Distribution of Foreign Direct Investment by Country of Origin, 1988-98 1/  
(In millions of US dollars unless specified otherwise)

	Commitment	Disbursement	Disbursement Ratio (%)	Equity Disbursement	Foreign Loans	Undisbursed Commitment
Singapore	5,857	998	17.0	564	434	4,859
Taiwan	4,028	1,375	34.1	913	462	2,653
Japan	3,266	1,197	36.7	683	514	2,069
Korea	2,903	941	32.4	491	450	1,962
British Virgin Islands	2,772	352	12.7	241	111	2,420
Hong-Kong	2,671	982	36.8	583	399	1,689
France	1,489	328	22.0	190	138	1,161
Malaysia	1,182	763	64.6	308	455	419
USA	1,059	270	25.5	171	99	789
Thailand	994	334	33.6	164	170	660
Australia	873	398	45.6	286	112	475
UK	693	586	84.6	260	326	107
Switzerland	653	303	46.4	127	176	350
Other	4,102	1,436	35.0	863	573	2,666
Total	32,542	10,263	31.5	5,844	4,419	22,279

Sources: International Monetary Fund (IMF), Ministry of Planning and Investment (MPI), and State Bank of Vietnam (SBV)

1/ including investment by domestic joint-venture partners.

Taiwan, Japan, Singapore, Korea and Hong Kong are major investors in Vietnam. Total FDI from the Asian region, including Malaysia and Thailand, accounted for about two-thirds of FDI inflows. This explains why the total FDI commitment to Vietnam fell sharply from \$7.2 billion in 1996 to \$ 4.2 billion in 1997 when the financial crisis hit Asia, and FDI disbursement declined substantially from \$2.1 billion in 1997 to only \$800 million in 1998. The delayed effect on FDI disbursement was due to a low implementation rate that is explained above. Other important sources of FDI for Vietnam are the British Virgin Islands, France, Australia, the U.K., the U.S., and Switzerland. The modest participation of American investors was due to the U.S. trade embargo imposed against Vietnam until 1994 and the lack of the U.S. - Vietnam BTA until July 13, 2000, which is still subject to the U.S. Congressional rectification.

After the United States lifted the trade embargo in February 1994, U.S. firms began to invest in Vietnam. As of June 10, 2000, the U.S. was ranked ninth among foreign investors in Vietnam with 90 projects amounting to \$1.2 billion. The U.S. investment increased from \$120 million in 1994 to its peak of \$392 million in 1995. Since 1996, it has been on the decline and

reached the lowest point in 1999 with committed capital of \$96 million. The prospect appears worse for 2000. There is only one project in oil and gas approved so far this year. The U.S. investment projects with 100 percent American-owned capital account for 55 percent of the number of projects and 49.6 percent of total investment capital. The corresponding figures for U.S. joint-ventures are 39 percent and 50.1, respectively. The U.S. presence in Vietnam has been relatively new but highly visible due to a number of world-renowned firms <sup>6</sup>.

### FDI and the Automobile Industry in Vietnam

Mekong Corporation established in 1991 in Vietnam was the first car assembly company and produced Korean 4WD Sangyong vehicles and light trucks and buses in cooperation with the Italian car manufacturer Fiat. Two years later the Vietnam Motor Corporation (VMC) was set up and started assembling Korean Kia and Japanese Mazda as well as light commercial vehicles in a joint-venture with Kia's Filipino Associate Colombia Motors. In 1995, VMC expanded its operations to assemble German BMW cars. During the next few years, other car makers entered the Vietnam market, including Mitsubishi, Daewoo, Mercedes-Benz, Toyota, General Motors, Daihatsu, Isuzu, Ford, Suzuki, Chrysler. Together, these international automobile manufacturers formed 14 car assembly joint-ventures with Vietnamese counterparts. Their total capacity was 75,000 vehicles a year. Another estimate was 150,000 vehicles as compared to the market demand of about 15,000 new vehicles a year prior to the Asian financial crisis <sup>7</sup>.

What went wrong? Foreign investors over-estimated the domestic demand for automobiles. Yes, Vietnam has a large population and experienced high growth during the period of 1992-97. However, the annual national income per capita is still below the one dollar-a-day threshold. A person with that much income, assuming he had free shelter and meals daily, would have to save his full salary for 63 years to be able to buy a Mitsubishi Pajero sold in Vietnam with a price tag of \$22,000 <sup>8</sup>. Currently, there is no real demand for car in Vietnam. According to some experts on the auto industry, cars and trucks remain in people's wish list until the annual national income per capita reaches the minimum \$6,000 level.

When the Vietnamese economy was hit by the Asian financial crisis, the vehicle sales went down from 15,000 vehicles to only 6,000 in 1997 and 1998, and 5,200 in 1999. The import of 13,500 cars valued at \$100 million in 1998 aggravated the disaster of the vehicle assembly sector in the middle of the Asian crisis. In addition, the Hanoi government decided to limit the use of cars by state-run administrative offices and businesses. Moreover, foreign invested firms cut back their expenditures as a result of the financial crisis and the demand for

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<sup>6</sup> For a list of U.S. firms in Vietnam, visit VIAM Communications' website, "American Companies in Vietnam", Vietnam Business Journal, April – June 2000 issue, New York April 2000.

<sup>7</sup> The Economist Intelligence Unit, "Spectacular Foolishness in Vietnam – The Sorry, Sorry Tale of the Auto Industry in Vietnam", London February 7, 2000.

<sup>8</sup> Asia Pulse, "Vietnam Auto Market Dampened by Imports." Hanoi December 28, 1999.

cars by taxicab companies also diminished <sup>9</sup>. Vietnam Motor Corporation (VMC), the second largest vehicle-assembly company, collapsed. Chrysler withdrew from Vietnam. At present, there are 11 operational automobile joint-ventures. More carmakers will likely pull out since the cost of staying in Vietnam is too high. Toyota is the only profitable one. Its sales have been the highest in Vietnam. During the first eight months of this year, Toyota has sold about 2,200 cars, accounting for 37 percent of total cars assembled in Vietnam, while Ford has sold only 500 cars. During this period, Vietnam also imported 7,261 cars. According to one estimate, the total demand for cars and trucks slightly increases from 15,000 to 20,000 in 2000, which is equivalent to only 26 percent of the total capacity of the auto industry in Vietnam. Foreign investors failed to look into the issues of consumers' income, distribution and road networks, the financing, and the motorcycle market. Most of people in Vietnam move around in cities by motorcycles and bicycles and between cities, they take buses. Old cars and trucks from the former Soviet Union, French and Japanese era are still running and dominate the public transportation market. All 14 carmakers kept their plan secret in hope for being the first presence in Vietnam and they all came over a five-year period.

## FDI Climate in Vietnam

*Uncertain Environment.* The top priority of the Vietnamese leaders is to maintain political stability rather than radical economic reforms. Despite Doi Moi, Vietnam still favors SOEs over the private sector. A small group of liberal and well-educated political leaders inside the government, who favor economic reforms, have recently gained more influence due to economic difficulties during the last three years. The recent implementation of a number of economic reform measures has improved the investment climate. More importantly, the approval of the bilateral trade agreement with the U.S. in July 2000 indicates a major change in Vietnam's economic policy, which will likely encourage foreign investment in the country.

*Legal System.* The legal structure in Vietnam is based on the Communist legal theory and French civil law system. The Constitution is the source of government and legislative authority of Vietnam. The laws passed by the National Assembly bear the highest form of legislation. The lower legislative levels include ordinances passed by the Council of State, followed by decrees enacted by the Council of Ministers, and Ministerial circulars. In addition, there are many important decisions made by the People's Committees at city, province, and district levels. In reality, an administrative decree can change a substantial law as in the case of the land-use rights applied to FDI <sup>10</sup>.

The legislative branch consisting of the National Assembly and People's Courts in reality is not a separate and independent body of the national government structure as seen in any Western democratic country. This is what foreign investors fear most. Economic courts handle

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<sup>9</sup> See footnote 8.

<sup>10</sup> Pham Van Thuyet, "Vietnam's Legal Framework for Foreign Investment", *The International Lawyer*, vol. 33, No. 3, Fall 1999.

economic and business disputes. Lay assessors, together with professional judges, are permitted by law to rule on both questions of rules and facts. The laws are on the books, but their enforcement is weak and varies depending on the area of law and the parties involved<sup>11</sup>. Commercial disputes do happen from time to time. The fairness of the court system is a major concern of foreign investors in Vietnam. As business laws are not always applied or constantly changing, the volatile and unpredictable legal framework adds more uncertainty to the investment environment.

*Purchasing Power and Customer Preference.* There are two broad reasons for multinational companies (MNCs) to invest in Vietnam: the cost-push factors and the attraction-pull factors. Vietnam has been viewed by foreign investors as a source of abundant, hard working, loyal, literate but cheap labor. The Vietnamese population is relatively young. The national income per capita is \$350 per annum as compared to \$2,160 for Thailand, \$750 for China, and \$440 for India. The minimum wage is currently set at \$50 per month in Vietnam<sup>12</sup>. Secondly, Vietnam is rich in natural resources (offshore oil and gas deposits, phosphates, coal, manganese, bauxite, chromate, and timber). Thirdly, with 78 million people, Vietnam is the second largest country in South-East Asia and the 13<sup>th</sup>-largest in the world. Vietnam is a potential market for foreign products and services. It is quite noticeable that Vietnamese consumers have discriminating tastes in favor of foreign products made abroad, especially in Japan, France, Germany or the United States.

*Dual Pricing.* Vietnam has adopted a dual pricing policy like China. Under this policy, Vietnam charges foreigners at double prices for almost everything including water and housing as compared to prices applied to locals. For example, advertising rates are six times higher than those of local competitors<sup>13</sup>. A train ticket from Hanoi to Saigon costs \$254 for foreigners and only \$50 for local people<sup>14</sup>. An airfare ticket for the same cities costs a foreigner \$350 as compared to \$135 for a local. With that amount of money, in America, one could fly from Washington, DC to Los Angeles, the distance five times longer than Hanoi to Saigon. The higher the level of foreign investment activities is, the more foreigners come to Vietnam and absorb higher prices to subsidize local consumers and industries. Therefore, the dual pricing policy indirectly adds more cost to foreign investment and effectively undermines the low cost factor and chases foreign investors away.

*Land-Use Right.* During the last 10 years, the land prices have skyrocketed. This is due to the fact that money sent back to Vietnam from overseas Vietnamese and exported workers, estimated at more than 1.5 billion US dollars a year, has been ultimately used to purchase the land-use right and housing. In addition, many approved FDI projects have been looking for land to build plants, offices, and houses. As mentioned earlier, 65 percent of FDI

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<sup>11</sup> See footnote 10.

<sup>12</sup> Pham Van Thuyet, "Vietnam's Legal Framework for Foreign Investment", *The International Lawyer*, vol. 33, No. 3, Fall 1999.

<sup>13</sup> *The Economist*, "Foreign Direct Investment – Goodnight, Vietnam.", London January 8, 2000.

<sup>14</sup> Truong Duy Nguyen, "Foreign Investment in Vietnam", Macquarie University, Sydney, Australia 1997.

projects are joint-ventures between foreign investors and SOEs. Typically, foreign investors contribute 70 percent of the capital to joint-ventures in terms of machinery, equipment and cash. SOEs contribute the remaining 30 percent in most cases in the form of land, no matters how large a piece of land is. Even though the new Land Law promulgated in 1993 sets the rules on the land-use right, to inherit and to transfer it and establishes a basic rent schedule for six types of land for different regions, SOEs tend to inflate the prices of land to match at least 30 of the required capital for the joint-ventures. Some SOEs try to value their contributed land up to 50 or 51 percent of the assets of the joint-venture<sup>15</sup>. As a result, the practice of using the land-use right as a contributed asset to joint-ventures has pushed up the price of land and has created an unproductive land speculation market in Vietnam. This is harmful to the FDI policy and the economy.

To make the land matter worse, the government of Vietnam later issued a circular that set very high fees for land-use rights, which effectively paralyzed the real estate market. In February 1995, the government of Vietnam issued a decree, which transformed the land-use rights on commercial properties into land leases, effectively terminates the quasi-ownership of land under the long-term land-use rights. This latest decision has created two serious problems. First, under the new law, the rent for using land must be paid by Vietnamese business partners and is much less than the value of the long-term land-use rights. For this reason, foreign investors want to revise downward the equity contribution of local partners to joint-ventures, but they have not been successful so far. Second, banks no longer accept the land-use rights as collateral for loans. Some banks even want to cancel loans approved earlier<sup>16</sup>. These typical examples indicate the volatility and unpredictability of the legal system in Vietnam.

*FDI Incentive Package.* Vietnam presents a newly opening market for all types of consumer goods. The current national income per capita of \$350 per annum is quite low. However, it is rising steadily. Vietnam has been an attractive host country for foreign investors since Vietnam started the renewal program in 1986 and issued a new Foreign Investment Law in 1987, which has been amended several times: 1990, 1992, 1996, and most recently in June 2000. The attraction-pull factors include tax regime, economic policies, infrastructure, business environment, and political stability.

Table 3 : Foreign Investment Incentives in Selected Asian Countries

	Vietnam	China	Thailand	Philippines
Profit tax	15% 20% 25%	15% 20%	20% 25%	20% 25%
Tax holidays	2-year tax holiday plus 2-year tax exemption at 50%	2-year tax holiday	3-5 year tax holiday	5-8 year tax holiday
Import duty exemption <sup>15</sup> See footnote 12.	machinery raw materials	machinery raw materials	machinery selected raw materials	machinery selected raw materials
<sup>16</sup> See footnote 12.				

Like many other host countries, Vietnam designed and kept changing its FDI incentive package including tax holidays, import duty exemption, and favorable corporate profit tax to lure foreign investors as shown in table 3. Generally speaking, what Vietnam offers is quite competitive with its neighboring countries. But foreign investors seem more concerned about the high costs of land and utilities, undeveloped infrastructure, primitive banking and legal systems, opaque laws, murky tax regime, wide spread corruption, inequitable playing field among local, especially state-owned, and foreign-invested companies, and most importantly unresponsive bureaucracy. *'Most of us know from early contact with overseas Vietnamese that the work force – given training – is world class and this has proven true in-country. What creates the problem is the complex matrix of governments intertwined with State owned-Enterprises that investors and other foreign-based business people must deal with on a daily basis. The time needed to manage these relationships is simply too costly...There are simply too many toll gates, ministries, customs officials, tax collectors, inspectors, People's Committees, quotas, licenses, chops, etc. than many managers can manage and still run a profitable business. Too much control over too few businesses.'* observes Jules Carlson, Country Manager for Cargill Inc., the Minneapolis-based agriculture company, and former Chairperson of the American Business Community in Saigon and the American Chamber of Commerce, Saigon Division.

*Infrastructure.* Table 4 compares the prices of land and utilities in Vietnam with selected countries. Vietnam is one of the countries with the lowest national income per capita in the region. However, the prices of land and utilities in Vietnam are unfortunately among the highest. According to an estimate, Vietnam experiences a seasonal electricity shortage of 250-450 mw, about 10 percent of total generating capacity, during the month of May <sup>17</sup>. A telephone call from Hanoi to Washington, DC costs about \$3 per minute, (\$4 - \$5 at the hotels), while a call originated from Washington, DC costs about 75 cents per minute. Vietnam Post and Telecommunications, the state monopoly, charges Internet service providers one of the world's highest connection fees of \$1,500 a month for a 64K leased line. Home surfers are charged \$1.24 an hour <sup>18</sup> while Vietnam's average income per capita is less than one dollar a day. Vietnam has an outdated road system of 105,00 km, only one-fourth of which are paved but poorly maintained. The railroad system of 2,600 km is also obsolete. About 87 percent of total railroad has a narrow gauge (one meter). Most of locomotives have surpassed their maximum lifetime. The navigable waterways have 17,700 km. Of which, only 5,149 km are navigable at all times by vessels up to 1.8 m. draft <sup>19</sup>. Vietnam has 36 paved airports. Of which 16 are major ones. But only three airports handle international flights. Table 5 compares some basic infrastructure indicators of Vietnam with selected Asian countries. Vietnam does not

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<sup>17</sup> See footnote 3.

<sup>18</sup> Cohen, Margot, "Information technology – Calling for Change", Far Eastern Economic Review, September 21, 2000.

<sup>19</sup> Central Intelligence Agency, "The World Fact Book, 1999", McLean, Virginia 2000.

score well in terms of paved highways per capita and falls far behind its neighboring countries in terms of electricity production per capita.

*Personal Income Tax.* Vietnam has a progressive personal income tax system. For those foreigners working in Vietnam with annual incomes between D360 million and D600 million (about \$25,700 - \$43,000), the personal tax rate is 40 percent. For annual incomes

Table 4: Prices of Land, Electricity, and Water for Industrial and Export Processing Zone in Selected Asian Countries, April 1997

Country	Land (\$/sq. Meter)	Electricity (\$/KWh)	Water (\$/cub meter)
China	.06-3.2 (per year)	0.015-0.037	0.02-0.06
Thailand	39.5-66.7 (for project life)	0.100	0.36
Malaysia	6.3-22.2 (for project life)	0.620	0.35-0.46
	45.0-61.7 (for project life)	0.050	0.42
Philippines	0.20-0.24 (per month)	0.037-0.073	na
Vietnam	65-150 (for 50 year)	0.080	0.45
	1.3-3.0 (per year)		

Source: World Bank

exceeding Dong 600 million (about \$43,000 dollar) the tax rate of 50 percent is applied<sup>20</sup>. In addition, the full gross income is taxable, since tax deductibility does not exist in Vietnam. As a result, personal income tax is quite high by both regional and world standards. In Thailand for example, the 30 percent and 37 percent tax rates apply to annual personal incomes between Bath 1,000,000 and Baht 4,000,000 (\$25,000-\$102,000) and those exceeding Bath 4,000,000 (\$102,000), respectively. Moreover, the tax system in Thailand does permit tax deductions with respect to personal allowance, contribution to provident funds, interest payments on mortgage loans, contribution to the Social Securities Fund. There is no distinction between resident or non-resident, local and foreigners. China's personal income tax rates are even lower than those in Thailand<sup>21</sup>. Vietnam's income per head is one-sixth of Thailand and half of China. One wonders if the tax authority has ever studied the tax regimes of neighboring countries.

*Banking System.* As a transitional economy, Vietnam's banking system has been facing numerous problems: government intervention, weak supervision, non-performing loans, weak capital base, low profitability, heavy debt overhang, and ineffective management. In addition, the local currency (Dong) is not convertible while foreign exchanges are limited. The banking

<sup>20</sup> Vietnamese Embassy, "Foreign Investment Environment", Washington DC August 2000.

<sup>21</sup> Ma, Jun, "The Chinese Economy of the 1990s", St. Martin's Press, Inc. New York November 1999.

system in Vietnam is still in the infant stage. Almost all business transactions must be carried out in cash since checks and credit cards have not been widely accepted. The government of Vietnam has authorized check writing since 1997. However, the lengthy procedure has made checks unusable. More importantly, the check is valid for only 15 days <sup>22</sup>. The above over regulation and the rudimentary status of the

Table 5: Estimates of Infrastructure Indicators in Selected Asian Countries 1/

	Vietnam	Thailand	Philippines	India	China
Electricity Production per capita (kWh)	193	1,388	528	458	936
Paved Road per 1,000 persons (meter)	0.00	0.00	0.00	0.00	0.00
Telephone main lines per 1,000 persons 2/	26	84	37	22	70
Aircraft Departures per 1,000 persons	0.39	1.54	0.83	0.20	0.41
Paved Road/Total Road (%)	25.1	97.5	19.8	45.7	22.4
Electricity Production (billion kWh)	14.9	85.0	39.6	448.6	1,160.0
Paved Road (1,000 Km)	23	63	40	1,517	271
Total Road (1,000 Km)	93	65	200	3,320	1,210
Aircraft Departure (,000) 2/	30.0	94.0	62.0	196.0	511.0
GNP per capita (US\$) 2/	350	2,160	1,050	440	750
Population (million) 2/	77.0	61.2	75.0	980.0	1239.0

Notes:

1/ Available data are most recent ones. They are not necessary for the same year for all countries..

2/ World Bank, "World Development Indicators, 1998", Washington, DC 1999.

Source: based on data published by CIA in "The World Fact Book, 1999", Virginia.

banking system in Vietnam discourage people to use checks and banking services as a means to deposit their excess cash. People save by hoarding US dollars and gold. It is estimated that the amount of hoarded gold is worth about \$10 billion. Consequently, the saving rate excluding hoarded gold is about 15 percent of GDP, one of the lowest in East Asian countries, and the share of bank deposits in broad-money supply in Vietnam is among the lowest in the world <sup>23</sup>.

### FDI and U.S. – Vietnam Bilateral Trade Agreement

Vietnam and the United States finally reached the BTA last July. It is expected that the agreement will pass the U.S. congress, despite some opposition from a number of lawmakers, who support labor unions and human rights groups. This agreement will improve the FDI climate

<sup>22</sup> The Economist Newspaper, "Chequemate", Hanoi May 3, 1997.

<sup>23</sup> The Economist Newspaper, "On Your Bike: Vietnamese Banking", Hanoi July 22, 1995.

in Vietnam substantially. The implementation of the agreement will lead to long-awaited further economic reforms, which will have strong positive effects on growth and increase in FDI inflows. *"During ten days in July, the Vietnamese government did more to promote economic growth in Vietnam than it has done over the previous ten years"*, observes Reed Irvine <sup>24</sup>. Among important economic measures that the government of Vietnam is expected to take are:

- (1) Privatize many ailing SOEs, promote fair competition among all local private, state-owned, and foreign-invested firms;
- (2) Allow all Vietnamese firms and in three to seven years, US persons and firms import and export freely (subject to some exceptions), agree to substantially lower import tariffs on all US agricultural and industrial products, phase out all non-tariff measures, adopt WTO standards with respect to customs, import licensing, state trading, and sanitary measures;
- (3) Adopt WTO standards of intellectual property rights protection within 18 months;
- (4) Allow American investors to have access in a broad array of the service sector. The implementation of the agreement on the service sector will be done within three to five years;
- (5) Protect US investment from expropriation; eliminate local content and export performance requirements for US investment projects; phase out licensing regime;
- (6) Adopt a fully transparent regime with respect to free trade of agricultural and industrial products, intellectual property rights, market access for services, and investment provisions <sup>25</sup>.
- (7) Implement a simple registration regime for investment licensing within two to nine years for all types of projects <sup>26</sup> (with some exceptions subject to the evaluation regime<sup>27</sup>). This procedure requires only basic information on the investor and the proposed investments and ensures quick approval.
- (8) Eliminate local content requirement for manufacturing firms and export obligations.
- (9) Remove other trade-related investment measures (TRIM) inconsistent with the World Trade Organization (WTO) standards within five years with some exceptions <sup>28</sup>.
- (10) Abolish within four years the discriminatory pricing regime against foreigners concerning goods and services provided by the government, including water, electricity, telephone, telecommunication, air transport, and tourism.

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<sup>24</sup> Irvine, Reed, "Reason to Cheer", Vietnam Business Journal, New York September 2000.

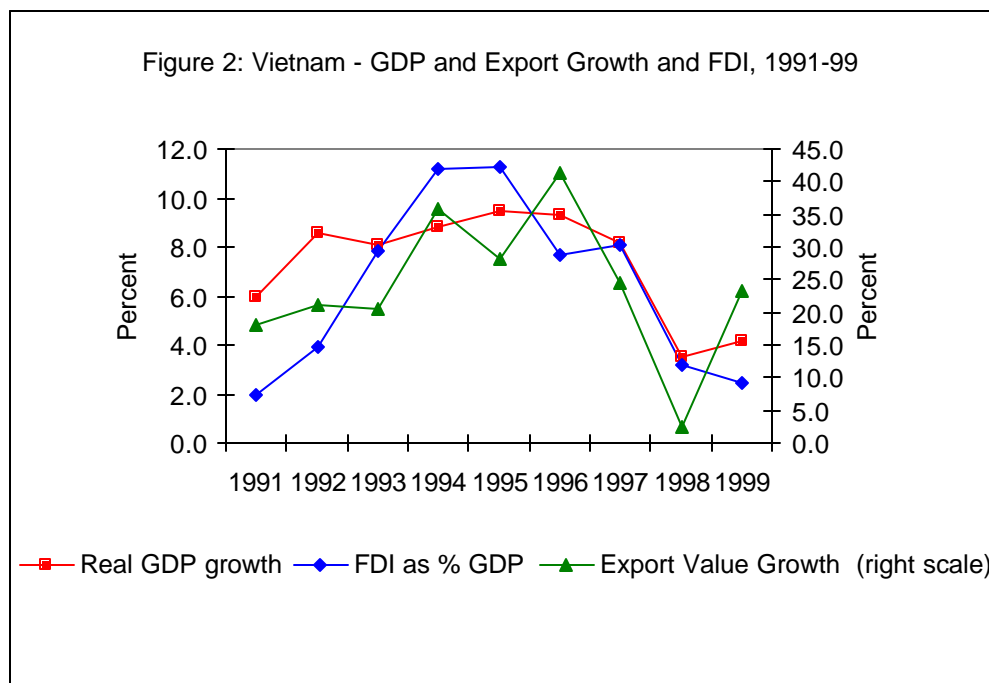
<sup>25</sup> White House, "Vietnam Bilateral trade Agreement: Historic Strengthening of the US – Vietnam Relationship." Washington, DC July 13, 2000.

<sup>26</sup> Two-year limit for projects with a minimum 50% export rate or with a maximum investment capital under \$5 million, and IZ and EPZ projects; six-year limit for manufacturing projects with a maximum investment capital under \$20 millions; nine-year limit for all other projects.

<sup>27</sup> Includes broadcasting, publishing, transportation, banking, insurance, construction, and power projects.

<sup>28</sup> The 80 percent export performance requirement still applies to the following sectors up to seven years: alcohol, cement, ceramics, clothing, footwear, paper, PVC, tobacco, etc.

The key factor is that free competition under the BTA will force Vietnam to restructure non-performing sectors such as banking and public enterprises and to improve business and investment laws. Although this is a bilateral agreement, the European Union and other countries may ask Vietnam for the same "National Treatment" it gives to the United States. It is expected that FDI from the U.S. as well as other countries will increase in the future. In addition to the BTA, another important event that took place in Vietnam last July is the opening of its first stock-trading center after eight years of planning. The establishment of the stock market was delayed for many years since the government of Vietnam was concerned that the stock market might expose the economy to external crisis. However, the domestic market, small as compared to the world, has been sluggish. The slow down of the economy and drastic decline in FDI had persuaded the government to look for an alternative way to attract more foreign and domestic investment. But again, the action was slow as seen by most observers. *"Many of the clauses of the trade agreement do not come into force immediately but are scheduled to be phased in over several years – matching conservatives' desire for gradual reform"*, comments Professor Carlyle A. Thayer of the Asia and Pacific Center for Security Studies <sup>29</sup>.



### FDI Contribution to Economic Development

<sup>29</sup> Thayer, Carlyle A., "Vietnam's Reforms: New Momentum", Vietnam Business Journal, New York September 2000.

An IMF study <sup>30</sup> has pointed out that during the period of 1992-97, robust GDP growth, large FDI inflows and strong exports were highly associated (figure 2). The main driving forces for economic growth during this period were private consumption and FDI. Foreign-invested enterprises raised the GDP growth by 3.4 and 5.3 percentage points in 1992 and 1993, respectively, followed by 7.9 points in 1994. The FDI performance declined afterward and turned negative in 1996 (table 6). Concurrently, FDI disbursements decreased for the first time. The FDI commitments would have also come down, if the government had not approved two projects worth \$3.1 billion on the last day of the Vietnamese fiscal year. During the entire high growth period of 1992-97, FDI increased the GDP growth by 3.4 percentage points per annum on the average. FDI suffered a serious set back in 1998 with drastic declines in both new commitments and disbursements, due to the Asian crisis. The economic growth slowed down to 3.5 percent, losing more than 8 percentage points to a negative performance of FDI alone.

Total turnover by FDI enterprises increased from 2 percent of GDP in 1991 to 14.2 percent in 1997 and declined to 13.3 percent in 1998 or 8 percent on the average during 1991-98. The transportation and communication sector, heavy industry, light industry, and food industry were the largest sectors, which together accounted for an average of 74 percent of the total turnover during the same period. Agriculture, fisheries, hotels, and construction accounted for another 21 percent. These statistics suggest that FDI was concentrated in import-substitution, high cost industries (heavy industry, light industries producing consumer goods) and non-tradables (hotels, offices, apartments, construction, transportation and communication).

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<sup>30</sup> See footnote 5.

Table 6: Vietnam - Contribution to GDP Growth  
(In percentage points)

	1993	1994	1995	1996	1997	1998
Consumption	17.6	9.5	8.5	11.0	6.5	5.7
Private	14.8	7.5	7.6	9.9	5.8	5.1
Public	2.8	2.0	0.9	1.2	0.7	0.6
Investment	10.2	6.2	6.1	3.2	6.1	-7.9
Public	1.8	-1.1	0.7	1.6	1.0	0.6
FDI	5.3	7.9	2.9	-2.9	3.9	-8.3
Other Private	3.0	-0.5	2.4	4.5	1.2	-0.1
Domestic Demand	20.6	15.7	17.5	11.3	1.7	2.3
Net Exports	-12.5	-7.4	-7.5	-2.0	6.5	1.2
Exports	4.4	14.0	11.5	17.0	19.8	16.4
Imports	16.9	21.4	19.0	19.0	13.3	15.3
<b>Real GDP Growth</b>	<b>8.1</b>	<b>8.3</b>	<b>10.1</b>	<b>9.3</b>	<b>8.2</b>	<b>3.5</b>

Source: Based on data obtained from the International Monetary Fund and the Ministry of Planning and Investment and the State Bank of Vietnam.

The total exports by foreign invested enterprises amounted to \$1.5 billion in 1998 and accounted for only 8.5 percent of total exports. The good sign is that this share rose from 0.1 percent in 1991 to 16.3 percent in 1998. Most of these exports came from two sectors: oil and gas and food industry, which accounted for 78 percent of FDI exports, followed by the hotels and tourism industry with a small share of 9 percent. The imports by FDI enterprises in 1998 amounted to \$2.7 billion and accounted for 26 percent of total imports. This represents a substantial trade deficit of \$1.2 billion, which aggravated Vietnam's current account deficits and raised the import content of FDI products. The heavy industry, light industry, and transportation and communication sector combined caused a trade deficit of \$1.4 billion in 1998 while the food industry brought about a trade surplus of about a half billion dollars. These data indicate that not enough FDI funds have been invested in export-oriented industries. Vietnam has overlooked such low-cost and labor-intensive manufacturing as textiles, garment, shoe, electronics and computer industries, in which Vietnam has great comparative advantage. For the same reason, the impact of FDI on employment is quite small. As of October 1998, there were 2,606 FDI projects operating in Vietnam, employing 290,995 workers, which accounted for 4 percent of total urban work force of 7.1 million <sup>31</sup>. The

<sup>31</sup> See footnote 5.

average number of workers per FDI project was 112 on the average. By the same token, FDI in Vietnam has contributed limited technology transfer to the local economy.

The loan component of FDI increased steadily from \$10 million in 1991 to more than \$1 billion in 1997, then dropped by 48 percent to \$0.6 billion in 1998 as the foreign-invested sector began to be hit by the Asian financial crisis. Its share in total disbursement has grown from 6 percent to 70 percent during the same period (table 7). Loan components of FDI flows to the banking sector, and the food industry account for 100 percent and 80 percent respectively<sup>32</sup>. Joint-ventures with SOEs borrowing from FDI sources also increased. Their share of loans in FDI rose from 8 percent in 1991 to 62 percent in 1998. Loan portions from FDI to BCC projects also climbed from 3 percent to 82 percent in seven years, while the figure for fully foreign-owned projects has been relatively stable in recent years and stood at about 41 percent in 1998. Since FDI loans are costly and mature quickly, Vietnam is expected to service large debt repayments soon. By the end of 1998, the stock of debt accumulated from FDI loans amounted to \$4.5 billion. According to a forecast by the Ministry of Planning and Investment, Vietnam has to repay in hard currencies interest and principal obligations on FDI loans, which amount to \$1.1 billion a year on the average during 2000-2005. This could be a bad timing for Vietnam since the economy is not yet out of trouble. In addition, annual dividends on equity amount to about one half a billion U.S. dollars according to a government estimate. These capital outflows will be added to Vietnam's current account deficit and deplete foreign exchange reserves further. The trade balance and net factor income arising from FDI in this early stage are both negative and definitely contribute to current account deficit.

Table 7: Vietnam - Equity and Loan Composition of FDI Disbursement, 1991-99 1/  
(In millions of US dollars)

	1991	1992	1993	1994	1995	1996	1997	1998	1999 2/
Commitment	2,381	2,293	3,585	3,664	6,722	7,702	4,456	1,738	1,563
Disbursement	168	316	922	1,636	2,260	1,963	2,074	800	700
Disb / Com Ratio (%)	7.1	13.8	25.7	44.7	33.6	25.5	46.5	46.0	44.8
Foreign Equity	158	294	697	1,033	1,287	891	1,002	240	274
Foreign Loan	10	38	238	594	989	921	1,072	560	426
as % of Disb.	6.0	12.0	25.8	36.3	43.8	46.9	51.7	70.0	60.8

Sources : International Monetary Fund, Ministry of Planning and Investment, and State Bank of Vietnam

1/ Includes investment from domestic joint-venture partners.

2/ Preliminary.

## Conclusion

<sup>32</sup> See footnote 5.

Vietnam has come a long way since it made a dramatic policy change in 1986 to begin converting a centrally controlled economic system to a free market economy. Within merely a few years, a famine-threatened Vietnam had transformed itself into a food exporter without government intervention. Vietnam enjoyed steady economic growth during 1990-97. FDI played an important role in this process. The national gross national product per capita has increased from \$200 to \$350 per capita in eight years. The progress is quite obvious. However, the pace of progress is too slow and the magnitude of progress is quite small, due to the government's failure to take further reform measures in later years and lack of appropriate FDI and trade policies.

There has not been any profound reform in Vietnam during the last few years. The economic growth has slowed down. External debt has accumulated. Foreign exchange reserves are limited. During a period of economic downturn, financial aid from the Official Development Assistance (ODA) source is likely to shrink. The non-performing state-owned enterprise sector continues to put a heavy burden on the economy. The Labor Ministry forecasts that 8 million people – 20 percent of the workforce – could be unemployed in 2000<sup>33</sup>. Each year 1.2 million of new job seekers enter the labor market. Vietnam has been facing a real threat of a reoccurrence of the economic disaster in the late 1980's. These problems were not quite visible during the high growth period of 1992-97.

FDI inflows have substantially declined in recent years, ignited by the Asian financial crisis. A number of foreign-invested firms withdrew from Vietnam. Long before the FDI retreat happened, the number of jobs in the foreign-invested firms had been small. The FDI sector has experienced a substantial trade deficit. The disbursement rate is low. The prices of utilities and land-use right are high. The personal income tax rate applied to foreigners is ranked top in the Asian region. The auto industry is near bankruptcy. These are strong indications that the FDI policy is not right. Academia, business community, international agencies, and foreign governments have carried out numerous studies on FDI in Vietnam and a number of host countries in Asia and South America. Long lists of recommendations have been sent to the Vietnamese government for consideration. They point out numerous problems that Vietnam encounters: FDI has been concentrated in import-substitution, capital-intensive industries rather than export-oriented and labor-intensive industries; the FDI legislation is vague, restricting and outdated; and market access is rather limited. After a decade, Vietnam is still struggling to determine what FDI policy is right for the country.

What Vietnam needs is a liberal FDI policy with no limits on foreign ownership, and no forced partnerships, particularly with SOEs. (See Box 1 for detailed recommendations to improve FDI environment.) FDI is a long-term and continuing process. FDI projects in the long run will make positive contributions to the balance of payments as in the cases of other Southeast Asian countries and Latin American countries. In addition, FDI will bring about

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<sup>33</sup> Prasso, Sheri, Paul Magnusson, "Vietnam: Welcome Back ?", Business Week, Hanoi August 16, 1999.

positive, indirect and long-term effects on the economy: technology transfer, employment opportunity, rising domestic investment. According to an earlier study, for each job created by foreign-invested firms, another 1.6 jobs are created by other sectors of the economy<sup>34</sup>. A research on FDI into South East Asia found that foreign-invested capital raises domestic investment by the same amount for the economy of a host country<sup>35</sup>.

In July of this year after a long delay due to political reasons, Vietnam finally decided to make two major changes in its economic policy, which the international business community welcomed, although some have argued that Vietnam already passed the "*point of no return*"<sup>36</sup>: signing of the BTA with the U.S. and establishing the stock market. These decisions will be accompanied by fundamental economic reforms such as SOE equitization, banking sector restructuring, and FDI law overhaul. All production sectors of the Vietnamese economy and all kinds of services will be open for foreign investment in the next several months to a few years. These measures will likely spur exports and attract foreign capital and technology, two important elements that Vietnam needs to grow.

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<sup>34</sup> Dupuy, C. and J. Savary, "Les Effets Indirects des Entreprises Multinationales Sur l'Emploi des Pays d'Accueil", ILO, Multinational Enterprises Programme, Working Paper No. 72, Geneva 1993.

<sup>35</sup> Fry, Maxwell, "Foreign Direct Investment in South East Asia: Differential Impacts", Institute of Southeast Asian Studies, Singapore 1993.

<sup>36</sup> Dapice, David, "Point of No Return", Harvard Institute for International Development, Boston February 15, 2000.

Box 1: Recommended Measures for Improving the Foreign Investment Environment in Vietnam  
Under a Progressive and Competitive FDI Policy

Macro measures:

1. Concentrate on manufactured export-oriented and labor-intensive projects (garment, shoe, etc.), high-tech industries (electronics, computers, communication, etc.) where Vietnam clearly has comparative advantage.
2. Develop the private sector, allowing local and foreign private firms to play a larger role in the economy.
3. Reform the debt-ridden banking sector and the legal system.
4. Abolish monopolies of SOEs on import and export trading.
5. Privatize all the state-owned enterprises, especially loss-making firms.

Micro measures:

1. Streamline the lengthy approval procedure for FDI ventures, thus reducing the maximum number of days to issue a foreign investment license from 60 days to 30 days.
2. Make a real effort to stop smuggling.
3. Ensure transparency and fairness with customs procedures and tax laws.
4. Make a real effort to stop the pervasive corruption.
5. Lower personal income taxes for both Vietnamese and foreigners and stop the dual pricing practice.
6. Lower taxes on profits remitted overseas.
7. Lower value-added-tax on imported materials not locally available.
8. Lower utility cost.
9. Seriously implement decrees and circulars, which have been designed and already issued to ease the investment environment.
10. Remove restrictions on who could be employed by foreign-invested firms.
11. Eliminate (a) a minimum level of investment, (b) a minimum level of legal capital as a percentage of invested capital, (c) inflated land-use fees.
12. Provide for longer-term leases of real estate and the ability to obtain local mortgages.
13. Provide for tax deductibility of interest paid on business loans.
14. Allow a realistic valuation of the contribution of skills, technology, machinery, plants and land.
15. Allow a realistic valuation of the contribution of brand names, good will, distribution systems, and tangibles.
16. Provide equal opportunity for all sectors – state, private, and foreign.

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