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Foreign direct investment and trade: The case of Vietnam

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ABSTRACT

By making use of a gravity model, this paper examines the impact of FDI on exports, imports and net export of Vietnam. The empirical analysis presented in this paper is based on a recently released panel dataset involving Vietnam's 19 major trading partners for the period 1990–2007. The paper also considers the impact of FDI on trade during three sub-periods: the pre-Asian financial crisis, the post-Asian financial crisis and during the Asian financial crisis period. The empirical analysis reveals that a complementary relationship exists between FDI and exports and FDI and imports. While the impact of FDI on net-exports is insignificant during the full sample period, a significant positive relationship exists between net-exports and FDI in the post-Asian financial crisis period.

1. Introduction

Since the introduction of the reform policy known as *Doi Moi* in 1986, Vietnam's trade volume has steadily increased. The increase in trade volume has coincided with rapid inflow of foreign direct investment (FDI) in Vietnam. The main trading partners of Vietnam include the European Union (EU), Japan, Korea, China, Hong Kong, Singapore, Taiwan and the United States. The expansion of trade has been accompanied by a rapid growth of foreign direct investment (FDI) with its annual level increasing from US$ 0.34 billion in 1988 to nearly US$ 21.48 billion in 2009 (GSO, 2009). It is interesting to note that the main investors are also the major trading partners of Vietnam.

While the increase in exports has been welcomed, concerns have been raised regarding the effect of FDI on imports. This follows from the fact that manufacturing industries (especially the automobile

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and electronics industries) that are attracting significant FDI rely heavily on imported inputs. It is therefore likely that the direct effect of FDI on net-exports in Vietnam is not significant or may even be negative. However, the existing studies appear to support the view that the indirect effect of FDI on manufacturing sector in the form of technological spillovers and increased efficiency is significant.

A number of theoretical and empirical studies have considered the impact of FDI on trade flows. Early theoretical studies have argued that, in the presence of trade barriers, FDI and trade can be substitutes. In other words, the effect of FDI on trade can be negative. However, empirical studies such as Lipsey and Weiss (1981, 1984), Blomström et al. (1988), Yamawaki (1991) and Fukasaku et al. (2000) have found FDI and trade to be complements. Recent theoretical studies have argued that whether FDI promotes or substitutes for trade depends on the type of FDI (Markusen, 1997, 2002). Markusen and Maskus (2002) have argued that vertical FDI where MNCs geographically split stages of production is likely to stimulate trade. On the other hand, horizontal FDI where MNCs produce identical goods at multiple locations is likely to substitute for trade. The recent empirical work of Beugelsdijk et al. (2008) suggests that FDI and trade are substitutes.

This paper attempts to extend the existing literature by examining the link between FDI and trade in Vietnam; specifically, the link between (i) FDI and exports, (ii) FDI and imports and (iii) FDI and net-exports. Vietnam offers a particularly interesting case study for several reasons. Firstly, among the developing economies, Vietnam has experienced a high level of economic growth and also attracted significant FDI since the late 1980s. Prior to introduction of the reform process that started in the late 1980s, the Vietnamese economy was operating under a centrally planned system and studies on Vietnam are scare due to the unavailability of data. Secondly, in order to increase the inflow of FDI as well as to promote technology transfer from foreign to domestic firms, the Vietnamese government promulgated the Law of Foreign Investment in 1987. An important aim of this law along with other steps taken by the government is to encourage innovation and boost productivity of domestic firms thereby increasing the net-exports. Accordingly, a case study of Vietnam is likely to enhance our understanding of the effectiveness of government policies. In addition, an understanding of the link between trade and FDI in Vietnam is likely to help the Vietnamese policy makers to attempt to harmonize the national FDI and trade policies which is likely to promote sustainable economic growth. Because of the lack of data, FDI-trade nexus in Vietnam has not received adequate attention in the existing literature. This paper which is essentially a replication of the existing literature makes use of a recently released dataset.

The rest of this paper is organised as follows. Section 2 contains a review of the FDI literature. Section 3 deals with FDI and trade in Vietnam. Section 3 focuses on methodology. Empirical results are presented in Section 4 and Section 5 contains concluding remarks.

2. Literature review

A number of studies have considered the impact of FDI on host economies. Generally speaking, FDI not only increases the supply of capital in host economies but it can also result in spillover effects through a number of channels such as imitation, skill acquisition, competition and exports (Görg and Greenaway, 2004). Blomström (1986), among others, has argued that spillovers from FDI are the most important channel for the diffusion of modern technology.

2.1. FDI, productivity and export behavior

Hejazi and Safarian (1999) have argued that both trade and FDI can improve productivity of firms in host countries. Their empirical analysis shows that FDI's contribution to productivity is relatively stronger. By making use of data collected in 1995, Buckley et al. (2002) have considered the spillover effects from foreign to domestic manufacturing firms in China. They have suggested that while the state owned firms have not benefited from the presence of foreign firms, collectively owned domestic firms have benefited from technological and market access spillovers. Unlike Buckley et al. (2002), Liu (2002) and Liu and Wang (2003) have considered FDI generated technological spillovers in China by making use of panel data. Chung et al. (2003) have argued that while the role of FDI in improving productivity in host countries is well known, relatively few studies have considered the technology