Vietnam set to thrive in China's shadow

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Author: Dr. Detlef Rehn, freelance economics journalist

China's economic crisis and its new development model focussing on innovation, consumerism and services are considered by Vietnam as great opportunities For many years, the Middle Kingdom has been known as the "workbench of the world". But prices there have risen sharply, causing foreign companies to look for cheaper locations to take their business. Vietnam is one of the most popular destinations. The involvement of international companies in the country is rapidly increasing, making foreign investment one of the most important drivers of economic development. This trend is expected to continue in the coming years, as participation in various free trade agreements makes Vietnam even more interesting from the perspective of foreign countries. The country offers attractive prospects in the long term, as a new report from the World Bank has suggested. A series of reforms, however, is now essential.

A fast-growing economy

In stark contrast to the global economy, development in Vietnam during 2015 proceeded at a high rate. The country saw an increase in gross domestic product (GDP) of almost 6.7 per cent in comparison to the previous year. This was the biggest increase in eight years and significantly higher than the government's original aim of 6.2 per cent (General Statistics Office of Vietnam, "Socio-economic situation in 2015").

In terms of output, the manufacturing and construction sectors were the main pillars of economic growth. The service industry and, in particular, the retail sector were also performing well. In contrast to this, agriculture and other industries made below-average gains as a result of unfavourable weather conditions.

End consumption was a main driver of growth, counting for almost 70 per cent of GDP (World Bank, World Development Indicators). Very low inflation rates averaging only 0.6 per cent, as well as high consumer confidence, were the main factors for this success. Investments also provided a major boost for GDP. As a result, spending on new plants and equipment in the predominantly foreign investment sector was increased.

Exports have increased by 8.1 per cent in comparison to 2014 – the lowest growth rate in five years. However, Vietnam is one of the few countries in Asia that managed to increase its exports in 2015 in spite of the global economic crisis. This result is owed solely to foreign companies, as domestic companies registered a decline in exports. Imports increased by 12 per cent. Machinery and equipment, electronic products, textiles and other goods for investment projects and further processing in the foreign sector were the main groups of goods (General Statistics Office, loc. cit.). A trade deficit was recorded in 2015 in Vietnam for the first time in three years.

Continued growth expected for 2016

The outlook for 2016 is also favourable. International organisations are once again in agreement that there is strong growth ahead for the country. The World Bank, for example, has forecast an increase in GDP of 6.6 per cent (World Bank, Global Economic Prospects, January 2016). Vietnam itself is aiming for around 6.7 to 6.8 per cent, or even 7 per cent if possible. In fact, it looks as though only country in Asia that may perform better is India ("Gov't looks to higher GDP growth", Saigon Times, 1 March 2016).

Private consumption is probably the strongest driving force for the economy, according to the Standard Chartered Bank ("Standard Chartered revises growth forecast", Vietnam Today, 28 January 2016). These forecasts are also in line with analyses from the Australian ANZ Bank. The bank reacted to the rise in the consumer confidence index to a record high of 144.8 points in December 2015 by stating that Vietnam will "no doubt" be "one of Asia's outperforming economies" come 2016/2017 (ANZ-Roy Morgan Vietnam consumer confidence, Media Release, 23 December 2015). Inflation, however, is set to rise again, with a forecast of around four to five per cent for 2016. Whether or not this, along with high demand for credit, will affect interest rates is unclear ("Vietnam Central Bank Sees Heavy Upward Pressure on Interest Rates", BizNews, 3 March 2016, http://bizlive.vn/biznews/).

Investment is set to create even more momentum for growth than in 2015, according to Standard Chartered, who add that the number of foreign projects in particular is on the rise. That said, domestic companies also seem to be more ready for investment, says S. Mahajan, leading economist at the World Bank ("Rosy Picture", Vietnam Today, 11 February 2016), claiming that both factors will have a very positive effect on industrial production. The construction industry is expected to benefit from aspects such as more investment in infrastructure and the facilitation of foreign investment on the real estate market.

Lastly, exports will once again play a key role in growth, despite buyer countries having weaker economies. This is due to Vietnam's great success in diversifying its exports since 2005, which include high-quality industrial products, especially electronic goods and less raw materials (World Bank, "Taking Stock – An Update on Vietnam's Recent Economic Development", Hanoi, December 2015, p. 16, www.worldbank.org).

Despite a positive overall outlook, however, there are also a number of problems ("Rosy Picture", loc. cit., World Bank, "Taking Stock", loc. cit.). Among these problems are uncertainty regarding the development of the global economy, slow structural reforms and growing financial risks, as well as a high level of public debt to take into consideration (2015: 61 per cent of GDP). Corruption is also a big problem: In the "Corruption Index 2015" published by Transparency International, the country ranks as low as 112 of 168 nation states (D. Luong, "Vietnam's Corruption Problem", The Diplomat, 29 February 2016, www.transparency.org). Geopolitical conflicts – in particular the dispute over the South China Sea Islands – could also potentially damage economic development.

Growing momentum thanks to foreign direct investment

In recent years, numerous foreign companies have set up production facilities in Vietnam. According to the Foreign Investment Agency in Hanoi, more than 2100 new projects were approved in 2015, with a total value of over 16.3 billion US dollars.

An additional 7.8 billion dollars went into existing projects. All in all, direct investment reached 24.1 billion dollars, which is 10 per cent more than the figure for 2014 ("Update puts FDI approvals in 2015 at US$24 billion", Saigon Times, 7 March 2016). According to figures from UNCTAD, Vietnam's foreign investment stock in 2014 was around 91 billion dollars; in 2000, this figure was just 14.7 billion (UNCTAD, World Investment Report 2015, Annex, Table 2).

Roughly 68 per cent of these funds went into the manufacturing sector, particularly in textiles, shoes and the electronics industry. Almost 29 per cent of investment came from South Korea, followed by Malaysia with 10 per cent and Japan with 7.4 per cent ("FDI approvals", Saigon Times, loc. cit.). The reason for South Korea's high investment is intense involvement from the Samsung group, who manufacture television sets, smartphones and other such products in Vietnam. Even investors from the Greater China Economic Area are represented in all important areas. Priorities for investors from the People's Republic of China include the energy sector, real estate, and the clothing and textile industry ("Chinese investment projects in all important sectors of VN economy", VietNamNet, 21 April 2015, http.//english.vietnamnet.vn)

The foreign investment sector is the dominant force behind Vietnam's economy. In 2015, it was responsible for over 70 per cent of all the country's exports, in comparison to around 54 per cent five years ago ("FDI approvals", Saigon Times, loc. cit.). Samsung alone exported electronic goods worth 30 billion dollars in 2015. The share of imports from foreign companies reached almost 59 per cent, 13 percentage points more than in 2011.

As part of the new five-year plan (2016 to 2020), the government in Hanoi wants to increase involvement from foreign investors even more. The aim is for between 65.5 and 72.8 billion dollars (not counting domestic capital), according to Deputy Minister for Planning and Investment, Nguyen The Phuong ("Vietnam to see surging FDI", Vietnam Investment Review, 10 March 2016). To this end, further reforms are set to be implemented in the business environment, especially in terms of new foreign direct investment. Steps have already been taken towards this goal: On 1 July 2015, for example, a new law on investment and business was enforced with a view to facilitating and simplifying procedures for foreign investors (European Chamber of Commerce in Vietnam, Whitebook 2016, p. 22). In addition, in late December 2015, a further 17 sectors were opened to foreign investment, including services in tourism, computers, research and development, and healthcare ("Vietnam lists 17 sectors open for foreign investment", VieNamNet, 31 December 2015, http://english.vietnamnet.vn).

The policy of the Vietnamese government is to encourage foreign involvement on a large scale, although this is not always met with full approval. Due to the country's high dependence on foreign direct investment, it will not be possible to achieve sustainable growth, explains former governor of the Central Bank Le Duc Thuy ("Experts pinpoint economic woes", Saigon Times 15 March 2016). Another problem is that despite strong foreign involvement, the quality of growth on average is still clearly very low ("Vietnam's economy has not overcome period of decline", VietNamNet, 7 February 2016, http://english.vietnamnet.com). The labour productivity rate is just one fifteenth of that in Singapore, one fifth of that in Malaysia and two fifths of that in Thailand ("AEC poses tough challenges for Vietnam labour market", Vietnam Law Magazine, 2 February 2016, http://vietnamlawmagazine.vn). Economist To Trung Thanh from the National Economic University adds that production is limited to the lower end of the value chain, i.e. the assembly of imported components. He also adds that domestic companies are not enjoying the same success ("Vietnam's economy has not overcome period of decline", ibid.). To strengthen domestic companies, the government should do more to attract investment from small and medium-sized businesses in Japan, Taiwan and South Korea in the domestic supply sectors rather than primarily encouraging participation from multinational companies in Vietnam, Trung Thanh argues (ibid).

Government officials appear to be taking heed. The HCM City Export Processing and Industrial Zones Authority and the Japan External Trade Organization (JETRO) organised a seminar mid-March 2016 to bring Japanese and Vietnamese companies together with a view to gauging the possibility of more domestic supply. In 2014, the proportion of Japanese goods manufactured in Vietnam was just less than a third ("Japanese firms seek Vietnamese suppliers", VietNamNews, 19 March 2016, http://english.vietnamnews.vn).

Nevertheless, is it very difficult for Vietnam's small and medium-sized businesses to become part of global supply chains. Some of the reasons for this include insufficient capital, little information on the global market, lack of knowledge regarding the latest management procedures and the requirements of multinational companies in terms of quality, prices and delivery times ("Part of the puzzle", Vietnam Economic Times, 11 February 2016, http://vneconomictimes.com; "Long way to go before VN firms can succeed in int'l market", VietNamNews, 16 March 2016, http://vietnamnews.vn).

In order to increase the benefits of foreign direct investment for its own economic development, in its new five-year plan the government in Hanoi is looking to engage in primarily labour intensive projects using high-quality technologies and with an environmentally friendly element. Some of the priority sectors are supply industries, electronics and IT, education and training of workers and the health industry. Special incentives are to be provided for research and development projects. Accordingly, the government will reject projects that have high energy requirements, are potentially harmful to the environment or use outdated technologies (Vietnam to see surging FDI", loc. cit.). Reproaches of this nature have primarily been directed at potential Chinese investment projects ("Chinese FDI in Vietnam: It is time to tighten, experts say" (VietNamNet, 8 March 2016, http://english.vietnamnet.vn).

Pros and cons of free trade agreements

Free trade agreements are seen as a great opportunity to promote business and investment in Vietnam and to increase its competitiveness on an international level, but also to resolve structural issues in the domestic economy. Accordingly, the country is practising a very active free trade policy, most recently closing an FTA with the EU on 2 December 2015. This could apply until 2017. On 20 December 2015, an FTA with South Korea also came into force. Aside from these agreements, Vietnam is already part of three multilateral free trade agreements. On 1 January 2010, an FTA between the ASEAN countries and China came into force. In addition, the ASEAN Economic Community (AEC) was launched on 1 January 2016, which aims to transform the ASEAN region into a large free trade zone. Furthermore, Vietnam is one of the signatories of the Trans-Pacific Partnership (TPP), which is set to come into effect around 2018.

The direct economic benefits of these FTAs appear to be significant. As a result of the TPP alone, first estimates suggest that over the next 20 years Vietnam's GDP will increase by 8 per cent, exports by 17 per cent and investments by 12 per cent. The export structure will also be further diversified in favour of processed products with a higher degree of added value (World Bank, Taking Stock , ibid., p. 29). In the case of South Korea, Vietnam's third largest trading partner after the USA and China, the first positive effects of the FTA are already becoming apparent. In the first two months of 2016, Vietnamese exports increased by around 15 per cent. Generally speaking, Vietnam will enjoy greater access to the world's major markets thanks to these FTAs, and it will also be able to strengthen its business relationships with other countries. In a presentation of the pros and cons of the TPP and other FTAs involving his country, the Prime Minister of Vietnam, Nguyen Tan Dung, stated that the FTAs would strengthen Vietnam's international status ("PM highlights pros and cons of TPP", Vietnam Today, 17 February 2016).

But there are disadvantages as well as advantages, and it is not clear whether these have been considered by everyone in the country. According to the Prime Minister, jobs in agriculture are particularly at risk and the income gap could potentially become greater. He added that it should also be taken into account that companies which do not undergo sufficient restructuring could fall by the wayside. He also remarked that these businesses would need to take "drastic" measures to increase the competitiveness of their products and services. In effect, this will require a lot of effort; after all, Vietnam is one of the weakest countries both in the AEC and the TPP. An additional problem is that Vietnam will have to make adjustments as a result of the FTAs in order to conform with regulations on employment and the role of unions. Indeed, these adjustments will be complicated for reasons related not least to organisation and staffing, a fact that Dung acknowledges.

"Vietnam 2035" – a new World Bank report

Although there is a lot to be done, the outlook for Vietnam is positive. As a new report from the World Bank has revealed, Vietnam could become a upper-middle income country by 2035 – provided it embraces the opportunity to make the right reforms (World Bank, "Vietnam 2035: Toward Prosperity, Creativity, Equity and Democracy", 23 February 2016, www.worldbank.org). Many of the recommendations from the World Bank, which have been made in close collaboration with the government in Hanoi, are directly beneficial for the FTA preparations. These include increasing productivity and competition in the private sector, which involve (for example) better regulations, protection of intellectual property and better policies on competition. Some other goals include equality and social inclusion through more opportunities for minority groups, those with disabilities and women, as well as the provision of services for the middle class in terms of the ageing population and urbanisation of society. Lastly, the World Bank recommends government reforms that define the economic function of the state more clearly than in the past and that reduce its role as an actor with its own economic interests, alongside other aims. Furthermore, citizens should have more opportunities to influence government decisions.

While these recommendations seem likely to give the economic and social development of Vietnam a further boost in the coming 20 years, resistance from interest groups is inevitable, especially regarding the changes that will have to be made to the state apparatus. Nevertheless, the ever-increasing integration of Vietnam into international structures should help the country to overcome this and other obstacles step by step.

About the author: Dr. Detlef Rehn lives and works in Japan as a freelance economics journalist. After studying in both Bonn and Beijing and subsequently holding the position of research associate at the Bonn East Asia Institute, from 1990 until his retirement in May 2014 the graduate economist worked as a correspondent in Taipei, Seoul and Tokyo for the German Office for Foreign Trade (Bundesagentur für Außenwirtschaft, BFAI), which subsequently became Germany Trade and Invest (GTaI).

Konrad Adenauer Stiftung

Social and Economic Governance Programme Asia / Japan Office

OAG-Haus 4F
7-5-56 Akasaka, Minato-ku
Tokyo, 107 0052 Japan
Tel. +81 3 6426 5041
Fax. +81 3 6426 5047
KAS-Tokyo@kas.de
www.kas.de/japan/en
www.facebook.com/KAS.Japan